The Market Needs A Breather

In the aftermath of an extended runup in stock prices, such as what we have experienced since the early months of 2009, investors tend to get increasingly concerned about the possibility of a dramatic downturn. To be sure, there are reasons to believe that could happen, but there is a substantial basis for expecting a less troublesome outcome.

The two most traumatic market plunges of the latest two decades came during 2001-2002 and 2008-2009. In both cases, the circumstances were quite different from what we are seeing today.

The dot.com silliness that ended during 2001-2002 was an accident waiting to happen that most certainly did. That was the era of The New Economy, price-earnings multiples in the triple digits, and widespread chatter about why it's different this time.

When typical valuations are double those that prevailed in the past and companies pride themselves on continuing to run in the red, one can only wonder what is wrong with this picture. They didn't have to wait long to find out.

Earnings Have To Catch Up With Valuations

Yet even then, the Dow Jones Average moved sideways for almost two years before giving up the ghost and plunging almost 4000 points from the peak reached toward the end of 1999. From that high point, stocks fluctuated widely for more than a decade, but were unable to move into new high ground until more than 10 years later. It took that long for earnings to catch up and bring valuations down within traditional levels.

The 2008-2009 debacle took place within the same period, but its credentials were quite different. That difficult time was precipitated by an extraordinary level of banking problems, to the point where the global credit markets found themselves frozen, which cast serious doubt on the ability of the business community to continue functioning.

Thanks to swift government action, Armageddon was averted, but not by much. Still, there was no parallel to where we are now.

The current situation is one in which investors have turned much more optimistic based on hopes of a more favorable business climate and an acceleration of corporate profits. Reduced regulation, lower taxes, and an increased emphasis on doing things to spur activity are viewed as good things. The hitch is that it is increasingly unlikely that these hopes will be fulfilled.

Congress Is On A Bumpy Road

With one political party at the reins across the branches of government, it seemed reasonable to expect that a good part of the promised plans would sail through and get under way. But the false starts that have occurred so far suggest that more tempered expectations may be called for.

The biggest nonstarter so far has been efforts to replace the Affordable Health Care Act. That hit a road block from the Freedom Caucus. Next up on the agenda is tax reform, but there's every reason to think that will be an even higher hill to climb. Reduced taxes and a more favorable path for repatriation of earnings from foreign subsidiaries might well help pick up the pace, but the fate of that possibility is anything but assured.

Farther down the path will be whatever can be done to start fixing the country's infrastructure, a task that theoretically might get support from legislators on both sides of the aisle. Even so, given the continuing polarization inside the Beltway, one would be ill-advised to view this as a sure thing. Indeed, the more conservative stance on this and the other agenda items would be to consider them possible, but not probable. Better to be surprised than disappointed.

So here we are at the back end of what began as a vigorous market rally that more recently morphed into a broad sideways channel, a.k.a., marking time. In an ideal world, one could look forward to at least a few quarters of more of the same while underlying earnings catch up and bring valuations down to a more moderate level. Let's hope that will be the way things pan out, but it's most definitely not a certainty.

Expect A Market Dip

What is likely, however, is an interim dip of 10% or so sometime between now and yearend. It may already be under way. Since the beginning of March, the post-election upsurge seems to have been petering out. At the same time, the rate of overall volatility has been steadily lower. One might think this is good sign since low volatility can easily be mistaken for reduced risk, but it would be dangerous to think that's the case now.

There are too many hot spots to think that everything's cool. It's not. Daily events in the Middle East and North Korea are increasingly concerning. And friction between Washington and the rest of the world is building. That's not a prescription for complacency.

An extended period of marking time would a healthy follow-up to the exuberance of recent months. Far better than resumption of strong upward momentum.

Profitable investing comes from efforts to focus on the horizon, not on what lies just ahead. That's even more so now.