The Market Is Finally Coming To Its Senses

After more than a year of unprecedented stability and gains after which valuations ended up at levels that could only be described as priced for perfection, investors have finally awakened to the reality that there is no such thing as a nonstop advance unburdened by the traditional range of valuation. It has been nearly two years since the opening round market plunge of early 2016 and since then the advance, which accelerated after the election of that year, has been steadily higher, with nary a pullback. Against the context of nearly all of the last century, that kind of happenstance is an extreme variation from what has been and will continue to be thought of as normal.

Stocks move up and down. Markets move up and down. Companies whose results are consistently higher will generally see their shares climb in reflection of that progress. It's not a perfect reflection, but over extended periods there's a definite correlation between profitability and share price. The more consistent the growth, the greater the confidence investors will have in the likelihood that the future will hold more of the same. Greater confidence means a perception of reduced risk, which usually translates into higher valuation, i.e., a richer price-earnings multiple.

When results are inconsistent or cyclical, valuations are lower since investors' expectations are tempered.

With that said, it has been a wonder to observe the continued advance of the market averages over the latest five quarters. To be sure, one of the underlying factors supporting the advance is the global economic resurgence. What's more, interest rates, though on the rise, are still toward the lower end of their historical range. I suppose one could also point to changes in the tax code, but that's an iffier premise for higher stock prices. It's iffier because there is no change in pretax profits or corporate efficiency, so it seems imprudent to place a higher valuation when things are still pretty much the same.

Having already seen a market drop of 4% or so from the recent high, it seems quite likely that this is either the beginning of a normal correction or it's a short-term dip that will be followed by a more substantial reduction later in the year. Coming as it does during the first calendar quarter seems anomalous since this is usually of the two strongest quarters of the year. But that could also have been said in 2016, which began with a plunge . . . and then headed higher.

What's quite well known is the fact that when the market gets too far ahead of itself, returns in the years that follow will generally be moderate. So a correction now really does make sense. And as valuations adjust lower, the potential for gains ahead will improve.