July 1, 2014

The U.S. Stock Market: Are Current Valuations High? (July 2014: Dow Jones 17,000)

The Dow declined from the October 2007 peak of 14,166 to the March 2009 low of 6,547—a staggering $13 trillion market value loss. As equity investors realize, the U.S. stock market has been on a bull run for over 5 years. The current upward trend is the fourth strongest recovery in stock market history (Chart 1). By a number of measures, valuations are becoming extended. The trailing price-over-earnings (P/E) ratio on the Dow Jones Industrial Average is 16.4 and the S&P 500 Index is 19.3, according to data by the *Wall Street Journal*.[1] It is impossible to predict how much higher the market might go, and what events could trigger a sell-off.

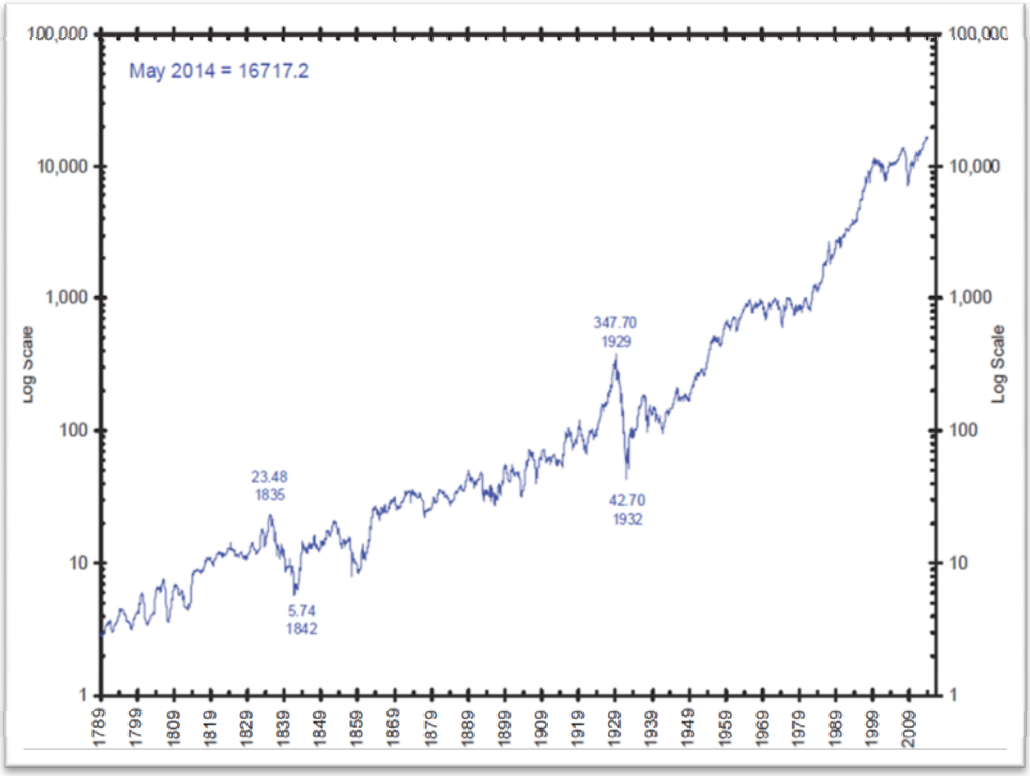

Chart 1. DJIA from 1789 to July 2, 2014.

A number of industry observers and participants are expressing anxiety about the current high valuations, but others remain less concerned.

Warren Buffett, in a Fortune 2001 interview, addressed his method of understanding broad market valuations. He stated that **the ratio of market capitalization to GDP is "probably the single best measure of where valuations stand at any given moment."**[2] Where does the ratio stand today? John Hussman of the Hussman Fund in his recent weekly newsletter writes that "The ratio of market

[1] *The Wall Street Journal*, July 16, 2014, pp C6
[2] *Business Insider/Advisor Perspective*. Jan 9, 2014. http://read.bi/1nbhoQ3

capitalization to GDP (Chart 2)…is beyond every point in history except for the final quarter of 1999 and the first two quarters of 2000."[3] According to this measurement and because profit margins are peaking, Hussman believes the market is unsustainably high.

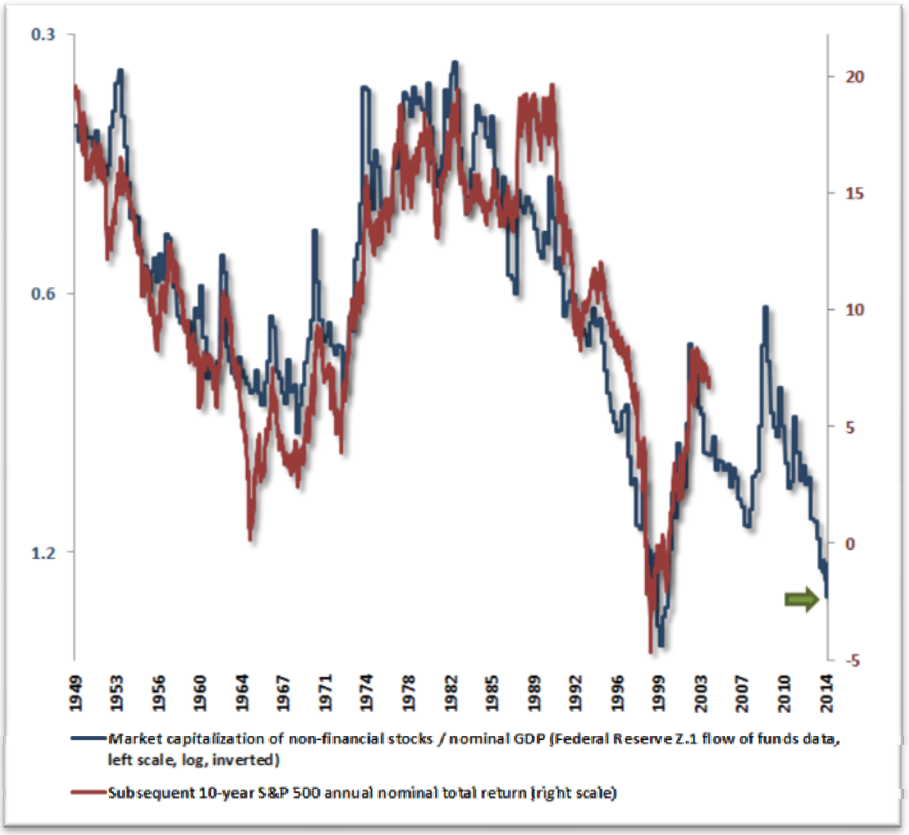

Chart 2. Market capitalization-over-GDP ratio.

Additionally, there are other headwinds facing our economy. Robert Rodriguez, CFA, Managing Partner and CEO, FPA Funds, in a speech "Reality Check" delivered to shareholders on July 1, 2014, articulated his viewpoints regarding the strength of the economy and possible consequences. To summarize, Rodriguez detailed the following concerns:[4]

- Financial system excesses being caused by Quantitative Easing (QE)
- Government creating complexities in the financial system (Dodd-Frank Law)
- Uncontrolled government debt and entitlement liability growth (Affordable Care Act)

On the other hand, if one does "a fundamental analysis of each of the 30 Dow components, it has become clear that the Dow is not as high as it looks based on the fair value of its constituents. No less than half of the 30 Dow stocks are currently trading at reasonable valuations based on each company's earnings power. There are a few Dow components that appear pricey today. Yet even though the index is at an

[3] http://hussmanfunds.com/wmc/wmc140707.htm
[4] http://www.advisorperspectives.com/commentaries/fpa_070114.php

all-time high, there is still an amazing amount of value to be found within the group." Says Chuck Carnevale, a long-time investment manager, in his July 9, 2014 article.[5]

After a five-year bull market rally, valuations have increased substantially in certain sectors and in some individual companies. However, there is no broad consensus about the market direction and valuations.

We also face a number of other economic as well as geopolitical issues which could cause a market pullback: increasing government debts, political intrusion into the private sector, and various international tensions. Investors are confronted with unprecedented challenges when investing funds in the current economic period of historically low interest rates and high asset valuations.

For professional investors, the importance of diversification and prudent asset allocation continues to be the best tool available. Communications with clients to have a mutual understanding of investing strategy and expectations will be more rewarding than ever. For now, a degree of vigilance is warranted.

- Roger L. Johnson

[5] "Is Dow 17,000 Dangerously High?" *Seeking Alpha*. http://bit.ly/1oYAg3d