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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

First, the good news. There are several factors that suggest the bull market is not over yet, and that more gains can still be achieved. To begin with, earnings for the 2nd quarter are beating expectations. Though only about 20% have reported, the number of companies that have missed their estimated earnings is only 17%. If this trend continues, this will be the best quarterly earnings performance of positive earnings announcements in over two years. In the short-term, markets live and die on expectations.

Geremy Grantham writes a quarterly letter to the clients of GMO, a $118 billion global investment firm, and is known for being a cautious long-term thinker. In his 2nd quarter letter, he lists a few reasons as to why the market will probably reach bubble status (according to Grantham's definition) before turning south in a significant way. His primary focus is that mergers and acquisitions will most likely increase in number over the next year. Deals thrive with low interest rates, and they appear likely to remain low for the foreseeable future. Current high profit margins can be used to pay the interest costs to finance deals, and higher stock prices can also be used to pay for acquisitions. Markets love deals.

The US has begun the exit from monetary stimulus, but the rest of the world has not. Europe and Japan are still very much in stimulus mode. The Fed is proceeding with great caution in their attempt to exit monetary stimulus, Europe and Japan are more than happy to keep serving fiscal cocktails. Global liquidity drives up asset prices. When you also consider that the economy is showing some signs of life, this also gives investors hope of better things to come. Unfortunately, a bell does not ring when the party is over.

Now for the bad news. The market is not cheap. The *Wall Street Journal* ran an article on July 11th titled "How Overvalued Markets Translate Into Lower Returns." The article had a graph showing how six different valuation measures compare the current market to past market peaks since 1900. There have been 35 of them. The six measures of value where: Price-to-earnings ratio, Cyclically adjusted price-to-earnings ratio, Price-to-book ratio, Price-to-sales ratio, Q ratio, and dividend yield. Presently, five of these measures are in the range of 82% to 89%, and one, the price-to-earnings ratio, is at 69%. If a measure stands at 82%, that means that of the 35 previous market highs, current prices are higher than 82% of them. You always have to consider the circumstances of why prices are where they currently are. Historically low interest rates justify, to a point, higher valuations. However, experience teaches you that you don't know when the party is over until it is too late, which implies that you have to leave early if you don't want an investment hangover.

The chart below illustrates one way to avoid a major investing hangover. It simply shows that dividend-paying stocks over the long-term produce the same returns, but have less volatility. This means that they tend to go down less in market corrections. This is the first step you should take as an investor if you are worried about a market being overvalued.