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OBSERVATIONS ON THE MARKET No. 313

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The movie *Dunkirk* opened a few days ago. It is about the allied forces being evacuated from France in 1940 as German forces were moving in to occupy France. The movie is not supposed to be historically correct, but rather to show the drama and the herculean task of the event. We forget that in 1940 the outcome of World War II was far from certain. We automatically assume that 'good' eventually prevails, but we have no idea of the daily struggle, so we can't relate to how difficult it truly was. Most of us were not even alive during the 1940's. When you look back on history, the outcomes appear to be somewhat obvious, and being a hero is easier when we know the outcome. Financial history seems to work the same way.

The market declines of 1975, 2002, and 2008, were all obvious times of fantastic opportunity. At least they look that way from a casual glance at a long-term chart which doesn't show any of the daily challenges. Long-term charts are great at giving the 'big' picture, they just completely leave out the emotional stuff. In 1975 things were a mess. We had high inflation and slow growth, not an easy set of variables to work with. To kill inflation, you need to slow the economy even more. To create growth, the common prescription is usually to stimulate inflation. In 2000, it was the internet bubble. Making money was a distraction, it was all about capturing hits on a web page. We are still in the recovery portion of 2008, however, nine years heals many old wounds. Buying low wasn't so apparent when GE was within a few days of bankruptcy. The banking system was basically shut down for several days, and it was not obvious how the economy was going to regain its footing. History has a way of making us forget all the pain and tribulation. Market highs make us forget that pain even exists.

The internet bubble seems so obvious now. Maybe companies do have to have revenue before they are worth billions of dollars. Looking at a price chart of the NASDAQ which was almost rising vertically in the years leading up to 2000, was obviously not sustainable. However, when the

daily comments are nothing but praise about how the internet is making business more efficient and profitable. Maybe it is a new era. Leading up to 2007, it was all about diversification. If you put a bunch of higher risk assets in a package, it makes the individual assets less risky. Every college finance class teaches the benefits of diversification. It turns out that junk mixed with junk is still junk. When you are making money, and it seems easy, you should probably start to pay attention to what you're buying, and how much you are paying.

In June of 2007, the earnings of the S&P 500 reached a high of \$85. The index was trading at 1500, so the market was valued at 17.6 times its earnings. That also means the index had a 5.6% return on what it earned. Currently, earnings have recovered from the 2008 recession and are now at a high of \$105. That is a healthy advance of 23% from the worst recession in 50 years. However, the market has recovered from its 2007 high to move up another 64%. That is three times the advance of earnings, and it leaves the market priced at 23 times current earnings. The market's valuation, based on earnings, is 35% higher than it was in 2007. Earnings are expected to climb to \$132 by next year, so that would bring down valuations, to a more respectable 18. However, estimates have a habit of being revised downwards when they are dealing with the future. The main reason for a higher market currently is the continued outlook for low interest rates, low inflation, and slow but steady growth. The market has priced in more of the same.

Are we going to continue to get more of the same? It is the pesky details of history that we soon forget, but it is the details that ultimately matter. If this market finally relents to a correction, it will probably be something that will seem obvious after the fact, things never stay the same for very long. But in ten years we probably won't care or remember. (Very few B17 crews survived to their 20th mission the first year they flew over Europe at the beginning of WWII. We hardly remember how hard the fight was. I had to look up what the battle of Dunkirk was.)