Perspectives

Why the Bull Market Is Toast

By David Gratke | Posted: 02-20-15 | 12:08 PM | Email Article

The market is off to a shaky start this year, and wobbly overseas economies get much of the blame. Will the downturn continue, and the six-year-old bull market expire? Yes. Too-high valuations and falling investor risk appetite signal that.

This bull market certainly has enjoyed a very long run. The Stock Traders Almanac says the longest bull market since 1900 lasted 2,836 days, from October 1990 to July 1998, and almost quadrupled. Today's bull has been around for about six years and has almost tripled in value.

Let's examine the problems this bull market faces:

Stock market valuations.
This is the highest stock market valuation since the 1990s tech bubble. The price/earnings ratio for U.S. stocks is unsustainably lofty. Think of P/E ratios as if we were talking about the price per square foot when valuing real estate. Same principles, same outcomes. High P/E ratios historically portend lower than average future returns, while low P/Es suggest higher ones.

Many metrics show the market's towering altitude. Averaging four of them, including the Standard & Poor's 500 P/E and the Q ratio (where you divide total market value by the total cost of replacing corporate assets) finds that stocks today have the second highest valuation in 85 years. Only the late-1990s tech bubble surpasses this.

Let's go back even further, to the late 1800s, and use Yale Professor Robert Shiller's method to smooth out periodic earnings fluctuations and make inflation adjustments. Known as cyclically adjusted P/E, or CAPE10, this method tracks P/Es over 10-year periods. Other than 2000 and 1929, the market now has the highest P/E ratios recorded.

Today's CAPE 10 P/E ratio is 27 times earnings, which portends low future returns from the unmanaged stock indices. It's just simple math.

Then there's Warren Buffett's favorite yardstick, comparing stock market valuations relative

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to gross domestic product. This goes back to the middle of the 20th century, when quarterly market valuations were first published. Other than in 2000, at the peak of the tech craze, this has never been higher – with the current market valued as 31% above GDP.

Averages, of course, can be skewed when large numbers on one end of the spectrum overweight the mix. You can solve that by using a median number, which treats all of them the same and homes in on the one in the exact middle of the pack. Looking at median valuations for the New York Stock Exchange shows that the current collective P/E is the highest in the postwar era.

Stocks dip.
Since mid-summer 2014, global investor appetite for risk began to wane. Analysts view this as a market topping process. This is also one of the reasons the U.S. dollar is climbing against foreign currencies, as well – a flight to safety as overseas investors put their money in dollar-denominated assets.

U.S. large-capitalization stock market indexes went higher all through 2014. Meanwhile, many foreign indexes and U.S. small-caps declined. With about 40% of S&P 500 profits coming from outside the U,S., how long can the S&P 500 (large cap) stay high, especially with a strong dollar, which harms earnings?

Junk bonds do, too.
When high-yield issues declined in previous cycles, stock markets typically followed. This has historically been a very good early warning indicator for the direction of the stock market. So far in this cycle, high-yield bonds appear to have peaked in mid-2014.

All this leaves traditional stock and bond markets at risk. Other than the influence of central bank actions, current market valuations are not justified. The basic, underlying economic fundamental tenet of investing is that you establish a fair price for a security today, based upon that investment's expected future cash flows. The process has gotten out of whack, so stocks are due for further declines.

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