AN ALI-BUBBLE? September 2014

The recent, eagerly anticipated initial public offering of $25 billion of Chinese e-commerce giant, Alibaba, brought to mind the excesses and hyper enthusiasm of the late 1990's for many veteran investors. The stock was initially issued at a price of $68 per share and immediately rose as high as $99.70 before settling in the low $90 range. As the largest IPO of all time, does the Alibaba offering mark a peak in the market as investors abandon all reason to chase the latest untested but very promising new venture?

As investors, being all too human, we have a tendency to be governed by our recent experiences. The pain inflicted by the market decline in 2008-2009 is still fresh as are the memories of the bubble in technology stocks of 1999-2000. We tend to keep looking over our shoulders for signs that these unpleasant experiences may be upon us once again. Often, however, we are, like generals of old, caught up in fighting the last war, and are usually surprised by something totally unexpected.

As we have stated in prior communications we are mindful of the excesses in today's markets but we are not expecting a major, sustained decline in the stock market. It is important to look at valuations when comparing the current stock market to those preceding the declines after 2000 and 2007. In a recent Barron's article of September 9, 2014, a table provided by Bank America Merrill Lynch compared the valuations of the S&P 500 on August 31, 2014 with those of the market peaks in 2000 and 2007. Some of the more interesting numbers are as follows:

	2000	2007	2014
S&P 500	1527	1565	2000
Trailing 12 mo. Earnings	$51.02	$90.06	$111.83
Trailing 12 mo. P/E	29.9	17.4	17.9
Forward 12 mo. P/E	25.1	15.0	15.6
Price/Book Value	5.4	3.0	2.8
Dividend Yield	1.1%	1.8%	1.9%
10 Year Treasury Yield	6.2%	4.7%	2.4%

It seems unlikely, based on these statistics, that we are facing a market collapse along the lines of the bursting of the tech bubble in 2000 as the S&P 500 is much less expensive now at 17.9X earnings versus 29.9X in 2000. Investors are paying 17.9X for $111.83 of S&P 500 earnings now versus 29.9X for $51.02 in earnings in 2000. Also, it was not only technology companies that were overvalued in 2000 as many industrial, health care and consumer products companies sold at extreme valuations. The fact that the 10 year Treasury Notes offered a very competitive yield in 2000 of over 6.2% versus today's rather paltry 2.4% is another incongruity.

The valuation levels for 2007 and 2014 are much closer however, with the exception being the 2007 10 year Treasury yield of 4.7% versus 2.4% today. One could argue that as yields rise in the next few years the 10 year treasury could reach the 4.7% level. Would this provide an insurmountable hurdle for the stock market in the years to come?

To answer this question it is important to realize that the most likely cause of rising interest rates over the next few years will be the increasing demand for credit in a recovering economy. In a recent presentation to the Maine CFA Society, Professor Joel Litman, Chief Investment Strategist of Valens Securities, discussed the positive effects of the credit tightening cycle on the stock market. During the monetary easing environment companies have conserved cash, strengthened their balance sheets and repurchased stock. As the economy continues to improve companies are ready to commit capital to new projects and new employees. This increased demand for capital as the Federal Reserve backs away allows for the normal increase in interest rates as the recovery gains strength.

Professor Litman pointed out that during this credit tightening phase employment improves and that employment numbers are a lagging indicator for the economy. Generally, business improves before additional employees are added. Peak employment numbers, which we don't know until after the fact, generally precede a market decline. In addition, Professor Litman believes that higher interest rates will not discourage home buyers as the better employment picture and the desire to buy before rates go even higher will spur demand.

There is also room for expansion in P/E levels according to Professor Litman. He offered a study that for years when inflation was less than 4% and capital gains and income taxes were favorable the average P/E was 20.1X. P/E multiple expansion was also the subject of a report by Ned Davis Research Group in July. The report noted that while the earnings of the S&P 500 have grown significantly since 2009, P/E ratios have actually contracted during the same period. We are not making any predictions about P/E multiples but it certainly makes a difference. For example, with earnings estimates on the S&P 500 at $125 or so for 2015 a 17 multiple brings the S&P 500 to 2125 while a 20 P/E brings us to 2500.

So while there are similarities in valuations between 2007 and 2014, we seem to be at a much different point in the economic cycle. Perhaps we will be blindsided again, but it is hard to imagine we are on the precipice of another financial debacle like that of 2008-2009. The challenge ahead seems to be the pace of the increase in interest rates and the reaction of investors to the Federal Reserve raising rates sometime next year. Many investors fear the negative market reaction to the initial tightening (raising interest rates) of the Fed. A recent article on MSN Money acknowledged a report by Sam Stovall, U.S. Equity Strategist for S&P Capital IQ, who noted that since 1946 the S&P 500 has declined 6 months prior to the initial rate increase in 13 of the 16 instances. The market declines have ranged from 5-10% in 6 of the 13 instances, 10-20% in 4 and over 20% in 3. While these statistics certainly raise concerns it is important to add that 6 months after the initial tightening by the Fed the S&P was actually higher. According to Mr. Stovall, the S&P 500 usually regained any lost ground and averaged a gain of 1.3% 6 months after the initial rate hikes.

The pace of the recovery impacts both the rate of increase in interest rates and the reaction of the stock market. In a moderate recovery the gradual rise in interest rates is not necessarily detrimental to stock prices. Professor Litwin presented a report by Liz Ann Sonders of Charles Schwab showing that in years where real GDP growth was between 0.5 and 6.0% the S&P 500 has averaged gains of 7.2% It seems likely that our ongoing economic recovery should fall within this GDP growth range.

So while the stock market seems somewhat expensive and subject to over exuberance regarding certain IPOs, we do not believe it is extremely overvalued. There will be volatility and likely a correction of some magnitude associated with the impending Fed increase in interest rates but we believe the positive effects of the ongoing recovery will allow the market to advance over the long term.

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