

>: Why Dow 6,586 is "Fair Value" (or very overvalued!)

Tuesday, February 3, 2009 / Chris Rowe

The market will most likely break new lows and scare the daylight out of most of us once again. Today I'll give you the short-term and long-term indications of why this is going to happen. You can either buy some put options, or a box of tissues while you can still afford it.

Is it unreasonable to shout from rooftops that, since this is America, the stock market is going to be fine?

Perhaps, perhaps not. It all depends on the one very important variable in that argument: Time frame.

Sure, over time, everything will work itself out. But, gee whiz! - Take a shot, will you? One could argue that making a prediction while hiding behind a 1 - 20 year time frame is a major cop out. Let's talk realistically and let's talk time frames.

Understanding seasonal trends is absolutely essential when it comes to investing in the stock market. I go into this in detail in the *Internal Strength System*, but today I'll explain a few basic concepts and apply them to today's market.

The first thing to understand is that institutions dump a ton of cash into the stock market on an annual, semi-annual, and quarterly basis. All three versions add new money to the market in January (because funds that invest quarterly, funds that invest semi-annually, and funds that invest annually are all scheduled to make contributions in January).

Therefore, if stock market sentiment is positive people tend to buy in December ahead of the institutions that prop up the market with scheduled contributions. However, when stock market sentiment is negative (like now) the investors that have the flexibility to do so will attempt to wait until January arrives so that they can sell into the demand that comes when new money is added to the market in January.

What's the point?

Considering *whowas* in control in the month of January (demand or supply) is very important. If the market moves lower in January, that shows that *so much stock was distributed* (sold to stock buyers) that even though the scheduled institutional stock buying was present, the selling pressure still managed to push stock prices lower.

Well guess "what?"

January, 2009 showed an 8.6% loss in stock market value, and there is little reason (except for "relief rallies") that this market should recover any time soon.

The "January Barometer" (devised by Yale Hirsch in 1972) says that as the S&P goes in January, so goes the year. This has proven to be incredibly accurate. In fact, since 1950 this has proven true all but 5 times, for a 91.5% accuracy rate.

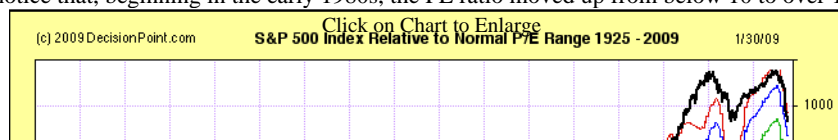
Then there's the "December Low Indicator", originated by Lucien Hooper, which forecasts a further stock market decline when the Dow closes below its December closing low during the first quarter. This has already happened. And since 1952 this has proven to be 92.8% accurate.

We just entered February, which is typically a weak month, and the market is trading right near the recent low as well as the psychologically important 2002-2003 lows. If those lows are violated, again, the panic selling will continue as volatility rises.

Obama ran on "change". Well, this economy certainly has changed and will continue to change into an economy that most of us haven't experienced in our adult lives. There will be a lot of denial along the way, but reality will set in in the coming years (at which point, most will forget all about the articles I've written on the topic recently).

Another indicator (which is really just a quick and dirty indicator but great for perspective) is the historical PE indicator. Many investors believe that on a very long-term basis, you can tell if the market value is fair, overvalued or undervalued by looking at the PE ratio of the S&P 500. A PE of 20 times earnings is overvalued, 15 is fair and 10 is undervalued. By this measure, to be considered at "fair value" (PE of 15) the market has to come down by about 17%, and for the S&P 500 to have a PE of 10 (undervalued) it would have to decline 44%.

The chart below dates back to 1925, which allows you to see what happened in the Great Depression. While that part is interesting, it's not what I want to focus on here. The red line shows where the market would be at a PE of 20, blue line PE of 15, green line PE of 10, and the black line is the actual S&P 500. You might notice that, beginning in the early 1980s, the PE ratio moved up from below 10 to over 15, and remained above 15 from about 1986 until today.



valuation altogether. The more recent market top in 2007 had more reasonable valuations *on the surface*, but those "real" valuations were propped up by cheap financing and high leverage (now, a thing of the past).

Sure, eventually things will get better. But do you think we will soon forget the hangover we are feeling (and are about to feel)?

Sure, it's human nature to forget lessons of the past, especially in the financial markets. But in how long will that be?

The point is that, as I said in a recent *Tycoon Report* article: We are used to the 30-40 year trend where corporate profits were largely a function of cheap financing and high leverage. But valuations should be viewed in the right context: In a global economy that is de-leveraging (not leveraging).

What does that mean?

It means it makes sense to consider a market with lower earnings growth, thus lower PE ratios.

QUESTION 1: In an economy that is de-leveraging, where hedge funds are still puking up stock, where government bonds are being sold by foreigners, where banks are hoarding cash, is it unreasonable to think that the market should be trading at a PE considered to be at least FAIR VALUE (a PE ratio of 15), which puts the market 17% lower? Because 17% lower puts the S&P 500 at 684 and the Dow-30 at 6,586. And that, of course, means the market would end up well below the most recent market low and 2002-2003 bottom.

QUESTION 2: In the type of economy I just described (today's economy), where the process of global protectionism has already begun, would it be that far fetched to consider the market assigning PE ratios closer to 10 (remembering that a PE of 10 puts the market 44% lower)?

QUESTION 3: Is it far fetched to consider the possibility that earnings will significantly decline? Because when the earnings decline, that means the PE ratio goes up. In other words, a PE of 15 (historically fair value) based on the trailing 12 months puts the market 17% lower, but a PE of 15, when earnings are much lower, puts the market much lower.

People laugh when other people say this is the worst crisis since the Great Depression. The people who are afraid to go that far out on a limb compare our economy to the post World War 2 economy. The folks that deny both statements are focused on what's happening today more than they are considering the next 5 or 6 steps over the next couple of years - the economy we will soon experience.

Take another look at the chart above. Notice that while the market assigned higher valuations relative to earnings briefly after second world war (1945), the PE ratios from the late 1940s to the early 1950s remained below 10! Study the valuations the market gave stocks relative to earnings in the early 1930s.

Look at the period from the mid-80s through today. The market was assigned PE ratios above 15 (above fair value) because higher growth rates were *expected*. Do you think that the market will always do that? If you do, you need to study *the entire* chart.

I realize that when people write about markets that happened several decades ago, it's incredibly hard to fathom. It sounds over-exaggerated. It sounds coo-coo. I know.

For some more perspective, feel free to review the *Tycoon Report* articles I've written over the last couple of months by [clicking here](#).

?Profit from the Trend?



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