THE TYCOON REPORT

>: Why Dow 3,931 is "Fair Value" Based on GAAP Earnings

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Two weeks ago I wrote an article"Why Dow 6,586 is "Fair Value" (or very overvalued!)" But that's only another 16% decline. That can happen in a single day

Today I'm here to tell you that the market can, and probably will, trade another 30% to 50% lower before the next bull market starts. (NOT "BEAR MARKET RALLY", BUT "BULL MARKET"). As this happens, you can make huge profits by taking bearish positions. But I want to make sure you TOTALLY GET what I was saying two weeks ago, because it might mean the difference between your account's boom or bust!

The valuation that I was discussing was based on what the market considers "fair value" to be - AS OF THE THIRD QUARTER OF 2008. Based on some comments left on my article it seems this needs more explaining.

The market valuations of Dow 6,586 and S&P 684 PE ratio (price to earnings ratio) of the trailing 12 months as of the third quarter of 2008.

But after publishing the article, it occurred to me some of you may not be familiar with what that even means. So if you DO know what that means, then pleasebear with me for 3 or 4 paragraphs. (I promise this isn't an article about what PE is so, again, bear with me.)

If a company earns $1.00 per share and the price of the stock is $12.00 per share, then it's trading at 12 times earnings and it has a PE (price to earnings ratio) of 12.

If a company earns $1.00 per share and the price of the stock is $35 per share, then it's trading at 35 times earnings (with a PE of 35).

When a company earns $1.00 per share, how do we know what stock price is reasonable? Well, there are a large number of things to consider, but at the most basic level, when investors think the company will grow their earnings faster, they are willing to pay a higher price. Check out the example below where both companies earned $1.00/share.

Company (Stock) A

2004 earns 16 cents per share
2005 earns 20 cents per share (25% growth)
2006 earns 30 cents per share (50% growth)
2007 earns 50 cents per share (67% growth)
2008 earns $1.00 per share (100% growth)

Company (Stock)B

2004 earns 70 cents per share
2005 earns 78 cents per share (11.5% growth)
2006 earns 87 cents per share (11.5% growth)
2007 earns 93 cents per share (7% growth)
2008 earns $1.00 per share (7.5% growth)

Both companies earned $1.00 in 2008, but obviously company A is growing their earnings *much* faster. So even though they both earned $1.00 per share, company A will probably have a*much* higher stock price (because investors are willing to assign company A a higher PE ratio).

Okay, so we got that out of the way. Now I'm going to give you the very short version of what I'm saying about future market valuation ...

Corporate earnings are going down, as the global economy is in a recession (and may even slip into a depression). So if earnings for the S&P 500 over the last 12 months are $46.00 per share and the S&P 500 closed Friday at 826, then based on GAAP earnings (calculated using Generally Accepted Accounting Principles) the S&P 500 has a PE ratio of 18 because $46 (GAAP earnings) x 18 (PE ratio) = 826 (S&P 500 current valuation).

Now ask yourself: Why would we allow the S&P 500 a PE ratio of 18??

When the S&P 500 has a PE ratio of 20 or more, it's considered overvalued, a PE ratio of 15 is considered fair value, and a PE ratio of 10 is considered undervalued. But a low PE ratio is assigned to stocks when the earnings growth is expected to be low.

Now ask yourself: Do we expect stellar earnings growth, low earnings growth or NEGATIVE earnings growth?

There are two things that can bring valuation of the stock market down (in this discussion):

months. That means S&P 500 earnings will be $23.00. If the market trades at 18 times earnings (PE of 18), then the S&P 500 will be at 413 (a stock market decline of 50%).

2. Lower expectations to a reasonable level
. Now, if earnings really do decline by 50%, then we aren't looking at stellar earnings growth, are we? We aren't even looking a low earnings growth. We are looking at a market that should probably be assigned a PE of 10 or 15.

PE of 10 on $23 earnings = S&P 500 at 230 (another 72% decline)
PE of 15 on $23 earnings = S&P 500 at 345 (another 58% decline)

Even if earnings didn't decline, and we just saw zero growth for several years, the market should be assigned a very low PE ratio. If earnings stayed at third quarter 2008 levels of $46.00 and the market had a PE ratio of 13, the S&P 500 would be at 598 (a 29% decline).

OUCH ...

... for those who have no bearish positions.

Guess "what?" Q4 earnings season is almost complete. It looks like the S&P 500 will have a PE ratio in the 30s! If one more person comes out and says America is on sale I will be forced to use profanities.

Now maybe we get a nice pop in this stock market before that happens. That is TOTALLY in the cards. Anything can happen. Maybe the market rallies 25% before that happens. But if the market does rally, then start putting on your bearish positions. Members of *The Trend Rider* are hedged and prepared.

Are you?

I'd love to hear what you think. Do you believe that a PE ratio of 18 is realistic for the S&P 500? Are you at least hedged against the possibility of more declines ahead? Please let me know your thoughts by commenting on this article below.

?Profit from the Trend?

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