Are the Markets Overvalued and Overbought?

This market is acting peculiar this late in an economic and market cycle; some of it has to do with the new President. Many of us did not anticipate the results of the election. Also, when there is this much change and uncertainty the markets normally become more volatile.

The bullish nature of the current market has a lot to do with the potential of new stimulus for the economy.

This report focuses on valuations and price action.

Below is a current chart of this bull market that started in 2009:

Let’s review the chart:

- The market bottomed in early 2009 and more than doubled by 2013. Most gains in a bull market are made in the first 3 to 4 years.

  The markets were oversold in 2009

- Notice that the move went up in about a 45 degree angle, and would pull back to the long-term trendline (black upward trending line).

This is normal price action. Once a bull market is underway, it is best to wait for pullbacks to the trendline to add to or make new investments.

Prices did not significantly breach the trendline, meaning the bull market remained intact. 2011 was a tough time for investors and the markets due to the Arab Spring, Grexit, and the triple tragedy in Japan.

- From 2014 to most of 2016 the market moved sideways, normal price behavior this late in the cycle, and was a red flag that the bull market is in its mature phase, before a decline phase. From a price, technical analysis, the sideways pattern is called a topping, major reversal pattern.

I thought the market would have a difficult time after this topping pattern. See the next section about earnings and valuations.

- After the elections, the markets had a parabolic move. The markets and most stocks are now overbought. I write about this move in the section after the earnings and valuation analysis.

Earnings Growth and This Bull Market

Earnings is one of the main drivers of stocks and markets including the current bull market. To understand why earnings are so important to stock and market valuations, click here to read my article about the impact of earnings and stock/market valuations.

Below is a table of the earnings and valuations of this bull market:

Dow Jones Industrial Average				
	Qtr	Closing	12-Mth	P/E
Year	Ended	Avg.	Earns	Ratio
2016	**Dec.30**	19762.6	NA	NA
	Sep.30	18308.15	938.01	19.5
	30-Jun	17929.99	918.38	19.5
	Mar.31	17685.09	930.65	19
2015	Dec.31	17425.03	976.52	17.8
	Sep.30	16284.7	1043.79	15.6
	30-Jun	**17619.51**	1040.66	16.9
	Mar.31	17776.12	1093.78	16.3
2014	Dec.31	17823.07	1079.08	16.5
	Sep.30	17042.9	1143.49	14.9
	30-Jun	16826.6	**1309.69**	12.8
	Mar.31	16457.66	1286.32	12.8
2013	Dec.31	16576.66	1299.71	12.8
	Sept.30	15129.67	1172.72	12.9
	28-Jun	14909.6	976.45	15.3
	Mar.29	14578.54	933.61	15.6
2012	Dec.31	13104.14	901.18	14.5
	Sept.28	13437.13	885.43	15.2
	29-Jun	12880.09	903.73	14.3
	Mar.30	13212.04	903.5	14.6
2011	Dec.30	12217.56	893.44	13.7
	Sept.29	10913.38	924.17	11.8
	29-Jun	12414.34	896.69	13.8
	Mar.30	12319.73	878.69	14
2010	Dec.30	11577.51	826.75	14
	Sept.29	10788.05	783.63	13.8
	29-Jun	9774.02	739.88	13.2
	Mar.30	10856.63	687.81	15.8
2009	Dec.30	10428.05	558.83	18.7
	Sept.29	9712.28	350.97	27.7
	29-Jun	**8447**	357.13	23.7
2007	Dec.31	13264.82	199.87	66.4
	Sept.28	13895.63	277.24	50.1
	29-Jun	13408.62	**824.65**	16.3
	Mar.30	12354.35	644.21	19.2

Let's review the table:

- In the previous cycle, earnings peaked in 2007 at about 824 (4th column 12th-Mth Earns). The market peaked at around 14,000 in late 2007.

  The financial crisis started September 15, 2008 when Lehman Brothers declared bankruptcy.

  The market lost half its value by March 2009.

- Earnings collapsed after peaking in 2007.

- Earnings started to recover in 2009. I began recommending stocks to subscribers and personally started investing in late 2008 and was close to being fully invested by late 2009.

Investors should start investing when the markets are basing (moving sideways after prices have found a bottom during a bear market), but more importantly when earnings visibility starts to improve.

- The P/E will look very expensive early in a bull market because of the contraction in earnings. Once earnings start to recover, the P/E starts to contract because earnings start to grow. For example, the P/E looked expensive in late 2007 and for much of 2009, but the P/E starts to contract in 2010 because of earnings growth.

- Investors should start investing in stocks when the P/E is low and the dividend yield is high. The market was undervalued from mid-2009 to early 2015. This period is the light green shaded area.

- The market got expensive in late 2015 and is even more expensive today. This period is the red shaded area.

- Also, notice that earnings peaked in mid-2014 at 1309.69 and started contracting and went below 1000, another red flag.

- Historically, the P/E has averaged about 16.50. The current market P/E and many stocks are higher than 16.50. This market is overvalued.

- I started recommending that investors start taking profits in late 2015 and all through 2016. We more than doubled our money during this market cycle, and we want to have money to buy during the next bear and undervalued market, and double our money again in the next economic and market cycle.

Personally, in 2015 I had about 44 stock investments. Today I have about a dozen.

I've been an investment professional for over 30 years, and the important lesson that I've learned, confirmed by years of personal research and experience - you make the most amount of money, with the least amount of risk when you invest in stocks when they are undervalued and oversold, at the beginning of an economic, market cycle. This requires research, patience and discipline.

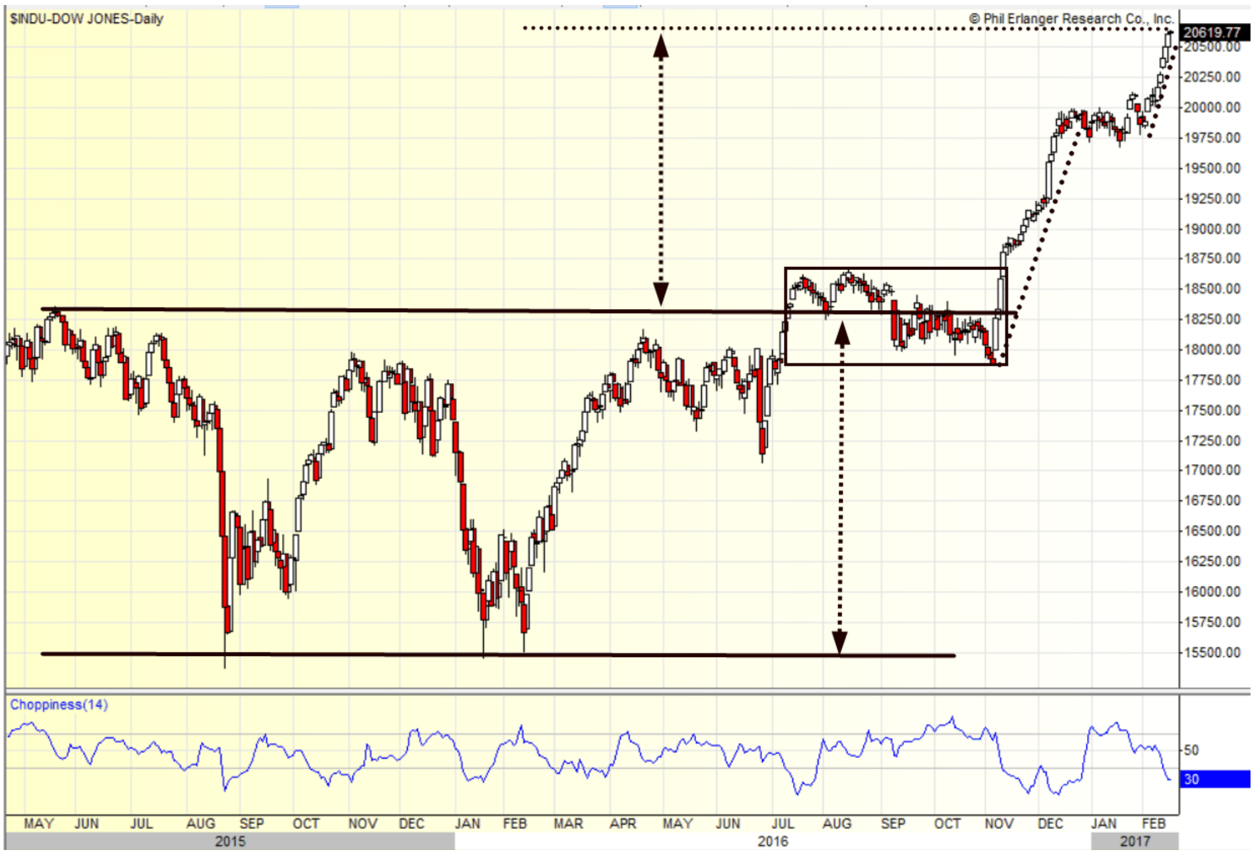
Interest rates and inflation are also very important to stock valuations. Click here to read my article on the importance of inflation and interest rates on the market and stock valuations. Inflation and interest rates stayed low for much of this bull market, helping valuations and P/E expansion.

Interest rates, inflation and oil prices have all started rising. A headwind for valuations.

I was quite surprised to see P/Es expand this late in the cycle. The current parabolic move also makes me nervous.

Current Parabolic Move

Below is a chart of the current parabolic move of the market:



First, let’s list some of the reasons for the parabolic move:

- There is less uncertainty with the direction of the economy and country after the elections.
- Some investors and traders are very enthusiastic about the new pro-business, pro-growth administration. The economic team including the Secretary of State are all accomplished successful, impressive business and Wall Street professionals.
- With a Republican President, Congress and Senate we will probably see some tax reform and cuts, repatriation of corporate profits overseas, and infrastructure and military spending. We don’t know when or what will be passed, so there remains uncertainty and risk, especially if these laws are delayed or not enacted.

- The economy continues to be positive, and earnings are finally starting to improve.

- Short-covering (traders who sold short the market need to buy back to cover the losing short positions).

- Once prices move above resistance and new highs are made, it is easy to continue to make new highs. This is explained in more detail in the next section of the chart explanation.

- Traders and some investors have learned to buy on dips, so any selling is met with buyers waiting to buy at lower prices.

Let’s review this chart:

- The market was establishing a topping, major reversal pattern from 2014 to most of 2016.

- The market did breach resistance around the middle of last year due to a handful of global government bond yields moved negative, causing money to move to the U.S. because of our higher rates, and a healthier economy.

  Currently, those negative rates have turned slightly positive.

- The uncertainty of the elections caused prices to move back to the topping pattern of the market.

- Once prices move above resistance and new highs are made, it is easy to continue to make new highs. Resistance is basically where previous investors and traders bought and are a potential supply of stock, resistance. Once prices move above resistance that supply, sellers are gone and there is little resistance, selling left.

  Once prices break above a new resistance and makes new highs, prices will normally move about 3% to 10% above resistance. So far, the market is about 3% above the resistance of 20,000.

  Round numbers can also be the new resistance. In this case that could be 21,000.

- Breaking resistance and making new highs creates a buy signal. Also, trend followers and momentum players jump on the trend and the upward trend goes parabolic.

- During this parabolic move, any selling is met with buying.

When you see parabolic moves, it is normally a sign of speculation. The almost 90 degree trendline will be easy to break causing a sell signal, so these speculators will take profits or sell to minimize losses. These parabolic moves are difficult to sustain.

If no action is taken soon in terms of tax cuts and infrastructure spending, we could see profit taking, and a reversal of the parabolic move.

- The bottom pane of the chart shows the choppiness indicator. This important indicator tells us the strength of a move (up or down). A move normally starts when the indicator is above 60 and starts to decline. The move is near the end once the choppiness indicator drops below 30. According to this indicator, the current parabolic move is close to the end of the current parabolic move.

At some point, a new resistance will be made and new higher trading range will be established. The new higher trading range could be from 21,000 to 18,250. Caveat, it’s very difficult to predict the future, especially in regards to where the markets might be, so the above potential trading range is a projection based on what normally happens with these type of price patterns and price actions occur.

It is best to buy assets when they’re cheap, and sell them when they’re expensive (unless they pay a dividend that has a long history of increases and a moderate payout ratio.

Summary

- The markets were undervalued and oversold from 2009 and 2010, and remained undervalued until 2014. The best time to invest in stocks is when they’re undervalued and oversold.

- What drove the markets higher as in most cycles: earnings growth, low inflation and interest rates.

- Are the markets currently overvalued and overbought? YES!!!!

- The current parabolic move is caused by several factors: less uncertainty after the elections, improving earnings, healthy economy, the prospect of stimulus through tax cuts, and infrastructure spending.

- The current parabolic move is a sign of speculation and just as fast as it moved up, it can move down.

- Admittedly, we will probably establish a new higher trading range versus last year because of the potential stimulus we will probably see later this year and next.

I will be writing my short-term investment, trading strategy that should be out in March. The long-term strategy is to buy when stocks are undervalued and oversold, have a long-term view and take profits when prices are overvalued and overbought, and as a market and economic cycle are in its mature phase.

I will write more about the President's economic proposals and the potential impact on the economy and markets. My research report should be out toward the end of March. My research will show that many of the President's proposals will not create the economic growth that will create millions of high paying jobs. The promise of more high paying jobs is one of the main reasons President Trump was elected.

It's hard to really tell what's going to happen. I'm surprised that there has not been any significant profit taking as nothing significant has been passed to help the economy.