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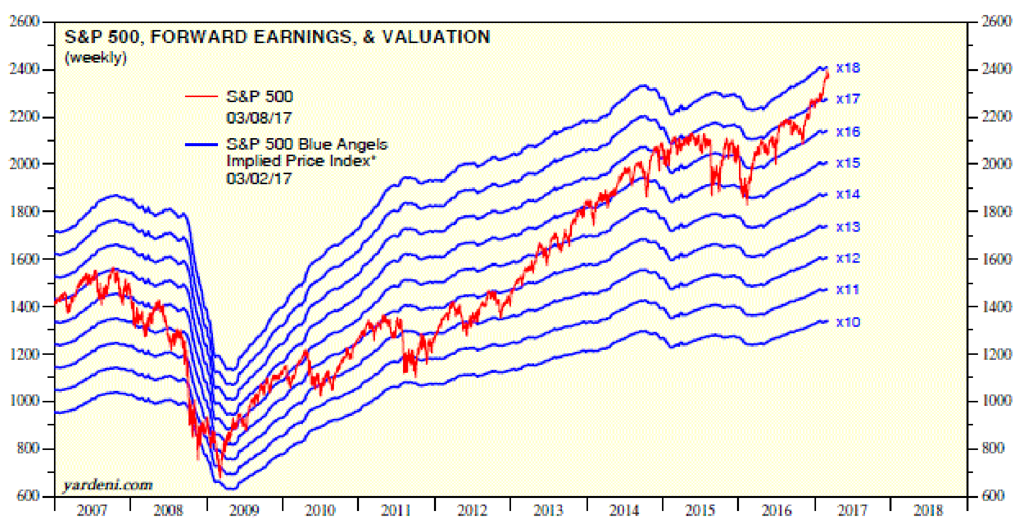
Trump Bump – Now What?

The market has had over a 10% run since the election. From a market that was fairly valued to start with regardless of your political persuasion, this has been a rather impressive run. But a prudent investor should ask, "Is the market overvalued?"

To measure a markets over (or under) valuation, we must have a 'scale' of measurement. Like pounds or inches (i.e.; too heavy or too tall), financial advisors have a favorite form of measurement, the Price-to-Earnings ratio, or P/E ratio. As we have stated before, corporate earnings (profitability) is the single best predictor of stock prices. Simply put, if earnings are going higher (or lower), stock prices 'should' be going higher (or lower). What Wall Street is telling us for the past few months is that Trump's agenda of lower regulation, taxes, etc. will be good for Corporate America. But how good is it, for how long and to what extent?

What I would caution everyone about is that expectations are running ahead of reality. Take a look at Chart #1. This is a chart from the economist Ed Yardeni, one of our favorites.

Chart #1:



* Implied price index calculated using forward earnings times forward P/Es.
Source: Standard & Poor's and Thomson Reuters I/B/E/S.

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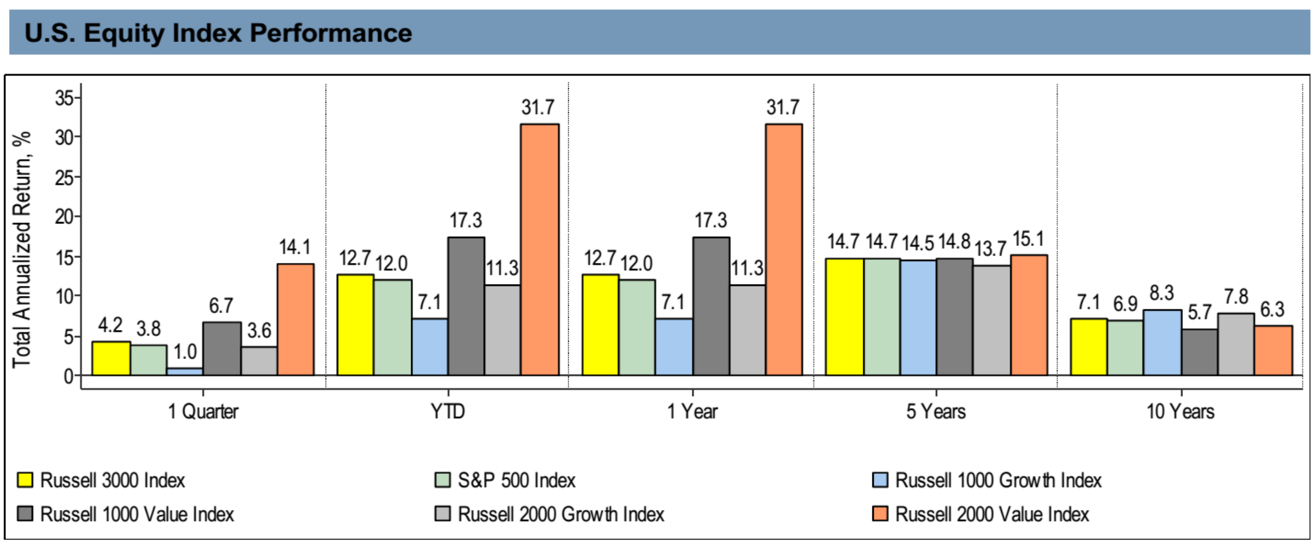
With interest rates low, and corporate earnings growing at an 8-10% rate, I don't have a problem with a 16-17x P/E ratio. When it gets to 18x, I would like to see either lower prices (a correction) or higher earnings. But I don't expect to see "justifiable" earnings until next year. Can markets go higher? Of course they can! Look at the late 1990's, where we were at 26 P/E Ratio. Remember the "New Paradigm" or the "this time it's different" of the internet boom (and the crash of 2000 - 2002)? So, maybe you now understand my caution. But as we get into the third quarter of this year, predictions of 2018 earnings will emerge, and prices may rise again.

But Where to Invest?

Not to get too nerdy on you, but hopefully you will find this interesting (or not - LOL!). Here it goes: In 2016, Value Funds did much better than Growth Funds (see Chart #2).

Chart #2:



Source: Retirement Plan Advisory Group; Market Review 4th Quarter 2016

Under the YTD column, the Russell 2000 Value Index did 31.7%, where the Russell 2000 Growth did 11.3%. Yet, for the past 5 years, they have switched places (Growth topped in 2013 and 2015, with Value topping in 2012, 2014 and 2016). Now here's the punchline: Take a look at the same chart, but for the 5 years. They are all the same!!!! Spooky, huh?

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So, the lesson today boys and girls, is not to chase last year's good idea! I know this is a little corny, but remember, "It's not about market-timing, but time in the market." 'Nuff said.

If you would like to discuss the market and/or your account(s), please call me at 713.428.2050, x2 or via email to josborn@houcap.com.

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