Weekly Market Commentary

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Is the Party Over?

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Highlights

At any given time, there are always some bubbly valuations among industries and stocks that are hot. But overall, looking at valuations, the party in the stock market may not be just getting started—but it is not yet close to being over.

Consumers are the most confident they have been in over six years, according to last week's widely watched consumer confidence report from the Conference Board. Investors have been feeling confident too. The high valuations of stocks in some industries have been the talk of the markets lately, leading some to fear that a bubble in stock market valuation is again developing as investors become overly optimistic.

The valuation of the stock market has risen sharply over the past year as investors have anticipated a better environment for growth. To gain perspective on whether a bubble has developed, we can compare the price-to-earnings ratios (PEs) of all 62 of the industries of the S&P 500 Index today to the same day 14 years ago in March 2000, at the top of the bull market—the last time a bubble in stock market valuation popped. The stock market was really **"bubbly"** in March 2000, with valuations of many industries floating higher, but now industry valuations are relatively flat.

Source: LPL Financial Research, FactSet Data Systems 03/31/14

Fourteen years ago a bull market came to an end, and 16 of the 62 S&P 500 industries, accounting for about 70% of the S&P 500 companies' total market value, had PEs that could be called "bubbly"—PEs of over 30 on companies' current fiscal year earnings estimates. Now, on March 28, 2014, just four industries out of 62—accounting for less than 4% of the S&P 500 market value—have PEs over 30.

At any given time, there are always some bubbly valuations among industries and stocks that are hot. But overall, the S&P 500 PE is currently a bit over 16 on current fiscal year estimates, slightly above the long-term average, but only half of what it was in late March 2000. Looking at valuations, compared to 14 years ago, the party in the stock market may not be just getting started—but it is not yet close to being over.

Of course, factors other than a valuation bubble could contribute to a bear market. After all, we saw a major bear market in 2008 and early 2009, without the market hitting 2000-like valuations. This was because markets had priced in an outlook for a much better economic environment than the financial crisis and deep recession that actually took place. In last week's *Weekly Market Commentary:*

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

2 "Bubbly" S&P 500 Industries

2000	2014
IT Services	Health Care Technology
Wireless Telecommunication Services	Real Estate Investment Trusts (REITs)
Capital Markets	Internet & Catalog Retail
Food & Staples Retailing	Construction Materials
Health Care Equipment & Supplies	
Specialty Retail	
Industrial Conglomerates	
Energy Equipment & Services	
Semiconductors & Semiconductor Equipment	
Biotechnology	
Software	
Electronic Equipment Instruments & Components	
Technology Hardware Storage & Peripherals	
Communications Equipment	
Media	
Internet Software & Services	

Source: LPL Financial Research, FactSet Data Systems 03/31/14

What's Priced In? we looked at the economic outlook the markets are pricing in. While the markets are optimistic that growth may improve, they do not appear to be pricing in an overly optimistic outlook.

But what about consumer confidence; is the jump in March to a six-year high a sign of too much optimism? Not even close. The index is at 92, the best in six years, but well below the 100 it averaged in 2005–2007, and a far cry from the 140 averaged in 1998–2000, when the party was really heating up and valuations became "bubbly" across most of the stock market.

Although valuation may not be a negative for the overall stock market, it is no longer a positive. Valuation was a key factor behind the attractiveness of stocks a year ago; this is less the case now after strong gains over the past year have pushed up PEs. We expect earnings growth to be the primary driver of stock market performance in 2014. While market pullbacks—or market storms as we have taken to calling them—are likely this year, we do not believe valuations are high enough to result in a long painful hangover in the form of a bear market. Instead, we continue to foresee a potentially solid year for stock market performance. ■

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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