

## Three Reasons Why .... Stocks are Overvalued.

by Lundy S. Hill ( October 12, 2004 )

What follows is merely my opinion. I will give the three top reasons why I see that this stock market has no room on the upside. It also has big potential on the downside.

**Reason #1.** Current conditions are not typical for the beginning of a bull run. Stock bull markets of the last 100 years have typically started with high interest rates, high inflation and after extended bear runs.

High interest rates because then there is only one way for interest rates to go - down. That is conducive to a stock market rally. Now, interest rates are coming off of generational lows. They have only one way to go - up.

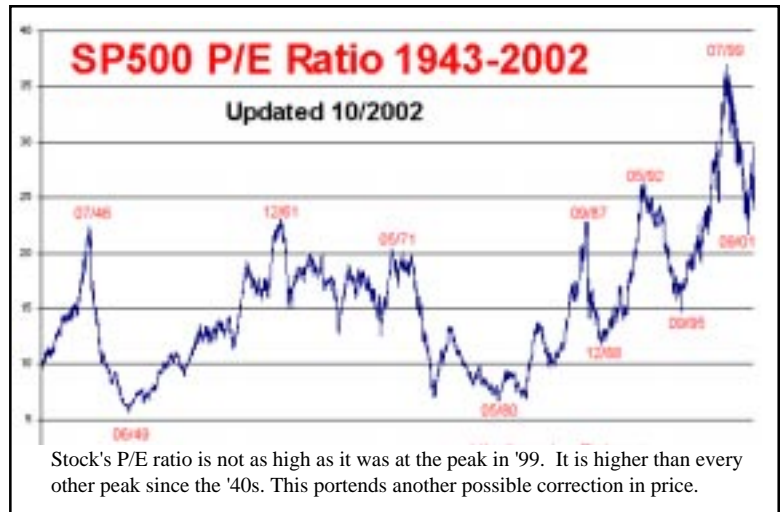
High inflation corresponds with high interest rates. Right now inflation is low. From the looks of crude oil and gold, inflation could be heading higher. This is bad for stocks.

Bear markets usually last from 8 to 17 years. Not two or three. The average bear market of the last 100 years has lasted 14 years. It shows an average return of 0.3%.

**Reason #2.** Loss of Stimulus. In the last few years we have had a government tax cut and huge housing re-financing. Both of these put money into the pockets of investors. To determine if a swimming pool is going to rise, look at the amount of water flowing into it. The same principle works with the stock market - look at the amount of money flowing into it. Tax cuts and re-fi's gave us a good run in 2003. However, these two spigots have been turned off. Another spigot, mutual funds, is also turned off for all practical purposes. Mutual funds are practically 100% invested with little funds left to buy anything else. Where will the new money come from to propel a stock market rally?

**Reason #3.** No Value. Low stock market valuations represent value. Value is a good thing. When valuations are low, they typically go up. This means stock prices go up. When valuations are high, stocks have a good chance of going down. Let's look at some common valuations.

At the beginning of 2004, the stock market had a Price/Earnings ratio of 27. Bull markets usually start with a P/E ratio less than 10. In 1920, the P/E was 8. As it was in 1950 and 1980. All starts of dramatic bull runs. A revealing note is the 30 year cycle in stocks. Does this mean the next bull will start in 2010?



Currently, stocks show an Annual Dividend of about 2.1%. Major stock market bottoms typically show a dividend yield of 10%. The current dividend is even higher than the 1929 value. Right now, stocks show a Price / Book Value of 5.5. This value has come off its peak of 10 on March of 2000. Therefore, it still has a long way to go before it finds fair value at around 1 to 2. Look at what corporate insiders are doing. Right now, insider sales is about 27 : 1. This means corporate officers are buying 1 share for every 27 they are selling. The insiders see no value.

I believe this market offers little value and that the "recovery" is false. A REAL recovery should show Non-Farm Employment increasing about 2 - 3%. Industrial Production should be increasing 8 - 10%. Real Personal Income should be increasing 5 - 7%. None of this is happening.

Is it possible that the economy can pick up and still have a flat to negative stock market? Sure, from 1964 to 1981, the economy grew 373% as measured by nominal GDP. Yet, stocks remained flat.

These valuation methods might suggest that stocks are overvalued by 30 to 50%. This may mean the S&P500 futures index could fall from its current level of 1120 down to the 600 to 800 range. Protect yourself by diversifying. Not only in investment classes but also thru market neutral / bearish positions. An index daytrading program or a commodities trading program might fit your needs.

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