The Stan Clark Financial Team's

PERSPECTIVES

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Economics and asset allocation

Records are meant to be broken

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On March 5, 2013, the Dow hit a new, all-time record high. The same day, the S&P 500 was just two percent shy of its own all-time high. Both the Dow and the S&P 500 had reached their previous highs on October 9, 2007.

What does this mean for you? Does hitting a record high mean we are in dangerous territory? After all, the two previous market peaks in 2000 and 2007 preceded the nightmarish scenarios of the dot-com bust – and, more recently, the credit crisis.

We're approaching uncharted territory. It's natural to feel some uneasiness. However, Gary Alexander from Navellier & Associates offers a different view of record highs. Alexander cites the records we just mentioned as meaningful benchmarks. But he also points out those records are not inflation-adjusted. We've talked a lot about the effects of inflation: how, over long periods of time, it can distort comparisons to historical numbers. In a previous issue of *Perspectives*, we gave the example of an ice-cream bar costing $1 a long time ago. After factoring in inflation, today that same ice-cream bar would cost $5. Taking inflation into consideration ensures we are comparing apples to apples (or ice cream to ice cream).

With the S&P 500, if we go back and factor in inflation, we learn that the previous peak was in fact *not* in 2007. Instead, it was in late 2000. At that time, the record index value was around 1,500. After factoring in inflation, to make a fair comparison, that same peak would need to be at around 2,030 in today's dollars. As of today, the index is around 1,500. This means the market can still go up about 35 percent before hitting the inflation-adjusted peak of 2,030. So, in real dollars, we're actually nowhere near record territory.

Furthermore, based on the above, we could say that we've been in a long-term bear market since 2000. What's good about that? Well, historically, when the market reaches a new high after a decade or more of struggling, that new high acts as a springboard rather than a ceiling.

Looking back, we find two examples of long gaps between new highs: the 25-year gap between 1929 and 1954, and the nearly 10-year gap between 1973 and 1982. In both cases, the long-awaited new highs signaled the beginning of a massive new bull market. In the first example, after reaching a new high, the market kept rising for another 18 years. In the second example, the U.S. was mired in its deepest recession since the 1930s (sound familiar?), with unemployment at 10.8 percent. Yet late 1982 was the start of the strongest bull market of all time, rising eleven fold in 17 years.

As you can see, history indicates that new highs after a long bear market are more likely to lead to even more gains rather than to the end of a bull market. Still, while compelling, those are only two examples. You could argue that the future depends on today's realities rather than on historic parallels. The good thing is that markets did well in the 1950s and 60s, and then in the 1980s and 90s, because of strong fundamentals.

Do we have strong fundamentals today? In our year-end review a couple of months ago, we talked about what was positive in the market to justify higher stock prices.

1) Despite the strong start to the year, stocks are still reasonably priced. This is because companies have been able to keep growing earnings. The rise in earnings has kept the price-to-earnings ratio reasonable, at around 14x. Keep in mind that, at the market peak in 2000, the P/E ratio was 24x. Since then, earnings have nearly doubled, while stock prices have remained the same.

2) Interest rates remain low and inflation is seemingly under control. This makes it easier for the U.S. Federal Reserve to continue to be highly accommodative in supporting a stronger recovery and employment growth.

3) Economic indicators in the U.S. have been improving, particularly in housing.

Stocks have been doing well lately. It's easy to get caught up in the euphoria. Keep in mind, though, that not everything is positive. We still have some concerns. Anything can happen in the short term – returns can be anything but smooth. So, it's important to stay prudent and on track. That means trimming back your equity exposure if you're above your target. On the other hand, just because we're in record territory doesn't mean records can't be broken.

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