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Dear Clients and Friends,

The Trump presidency has ushered in an extraordinary period of optimism among investors that has taken the stock market to new all-time highs over the past four months.

To put this into perspective, the last time stocks were this strong was in 2009 and then again in 2011 just as the post-Great Recession bull market was getting underway. The result was a multi-year rise in equities which, to-date, has taken the stock market higher by over 200% from the market's lows in 2009.

The natural question then is, could this scenario continue to play out? Could the stock market in fact continue to reach new highs into the foreseeable future? Or could we see another bear market like those of 2000 and 2007?

The answer to both questions is, yes. Stocks could in fact continue to stretch toward new highs from their current overvalued levels over the next few years if the Republican economic agenda of lower taxes, higher fiscal spending, and reduced regulation materializes. For such a bullish outlook to become reality, the markets will also require political stability and more reasonable valuation levels, either from a decline in stock prices, or an increase in corporate earnings.

Practically speaking, with ever-new highs in the stock market averages, the inverse actually becomes more probable. Introduction of expansionary fiscal policies combined with historically low interest rates could overheat the economy and raise stock market valuations to precariously high levels from which stocks could more easily fall. By definition, an overheated economy is one where irrational exuberance, to use Alan Greenspan's phrase, is present in spades, and where investors often make unwise decisions. It was just such irrational exuberance in the face of high valuations that preceded the bear markets of both 2000 and 2007 and resulted in declines of more than 50% in stock prices from top to bottom.

Valuation Matters

Equity valuations have been climbing for the past few years and are now clearly extended beyond their long-term averages by a substantial margin. By valuation I mean metrics such as price-to-earnings (P/E) ratios, or price-to-sales (P/S) ratios, among others.

Currently, the S&P 500's P/E ratio stands at about 26 times the S&P 500's trailing 12 month earnings per share. To put that into context, for the time frame from the early 1900s to now, a period encompassing many bull and bear market cycles, the historical median for the P/E ratio has been about 14. In other words, the S&Ps current price-to-earnings ratio is roughly 86% above its historical median. To offer further perspective, at the market's height in 1999 just prior to a major bear market, the same ratio was 135%, whereas in 2007 at the onset of the Great Recession and the bear market which followed, it was 29%. The same statistical red flag holds true for the S&P's price-to-sales ratio. At 2.5 times trailing 12 month sales versus its historical median of 1.4 times, the P/S ratio now stands 78% above its long-term average. (Source: multipl.com).

Valuation ratios such as P/E and P/S measure what the investor gets for every dollar he or she spends to buy a stock. A stock with a high valuation is one where the shareholder, as part owner of a company, has to spend more to get a quantity of something valuable such as earnings or sales. Conversely, a stock with a lower valuation is one where the investor has to spend less in order to get the same quantity of earnings or sales. To use P/E as an example, Company A has earnings per share (EPS) of $1.00. If the market price of its stock is $10.00 per share, then its P/E is 10. If, however, the price of the stock jumps to $30.00 per share, then the stock's P/E is 30. In the first case, the investor in Company A, would have to spend $10.00 to be entitled to $1.00 of the company's earnings, whereas in the second case the investor would have to spend $30.00 to be entitled to that same $1.00 in earnings - clearly less of a bargain for the investor.

To be clear, valuation levels are tied to human psychology, not just to share prices and corporate earnings. The most basic human sentiments ruling the markets are fear and greed. As stocks rise, greed increases and eventually dominates investors' mindsets, even to the point of irrationality. Investors buy overvalued stocks today on the assumption they will be able to sell them to others at higher valuations tomorrow. Eventually, valuations reach unreasonably high levels where prices are multiples above any intrinsic value investors hope to gain from corporate profits or sales. Often the realization that valuations are too high comes from disappointing corporate earnings reports, which themselves may come from a weakening economy or poor corporate prospects. When investors understand the extent of the disparity between their expectations and factual reality, fear sets in and selling ensues.

That said, the market does not seem to be at that point just yet despite its extended valuations. As is the case with many things in the often oblique world of investing, rich valuations can persist for long periods of time, even as stocks climb to new highs. Much depends on the combination of investor expectations mixed with real-life data flow. That makes buy/sell decisions trickier because today's high valuations may lead to even higher valuations tomorrow until investors understand the perils. Part of the art of investing is sensing whether or not valuations are too low, too high, or somewhere in between. Events and probabilities have to be weighed, investor psychology has to be considered, and careful attention has to be paid to possible outcomes.

The Republican Agenda and the Markets

To-date, the stock market's post-2016 election euphoria has been based only on the *possibility* that the Republican economic agenda will be implemented flawlessly, and could potentially lead to higher profit margins for companies and more cash in consumers' pockets. There is an expec-

tation that Washington will be more business-friendly, which would benefit both corporations and consumers alike. In fact, consumers already appear to feel more confident. The March 2017 Consumer Confidence Index registered the highest level it has seen in 16 years, at 125. That is broadly viewed as a good sign for corporate profits in the months ahead.

Yet, while all the anticipation and excitement about broad economic expansion in the near future has been positive for investor sentiment, the old Wall Street maxim, "buy the rumor, sell the news", may be a more useful way of viewing the stock market's recent strength. The "rumor" which is a broad brush, idealized set of government proposals that are theoretically favorable to corporate earnings, will eventually give way to the "news" which may be less favorable, depending on a thousand bargains Congress will have to make with itself and with the President.

As I wrote last time "*The new administration's potential economic policies are as yet unclear to investors and may not be fully known for months after the new administration takes office. Greater clarity in the direction and scope of policies that affect corporate earnings, interest rates, the dollar, stocks and bonds could lead to greater confidence among investors and result in less of a need to protectively maintain cash at higher-than-normal levels.*" My view on this still holds. The reality of finalized legislation may be different from the hopes and anticipation of investors.

A Long-Term Perspective is Key

High valuations and as-yet lack of clarity on the proposed new Federal initiatives make it imperative to proceed with eyes wide open. If there is a silver lining to all of these uncertainties related to valuations, earnings, and the Republicans' plans, it is that even in the current market environment where stocks generally are expensive, some investment opportunities may be found, albeit in small numbers. My fundamental selection criteria emphasize conservative investment principles focusing on sustainable earnings power, strong balance sheets, enduring business models, and strong management teams, in addition to reasonable valuations. In due course, valuations will normalize and buying opportunities will be more plentiful.

Through the ups and downs of the markets, a long-term perspective is key to staying the course and reaching investment goals. The great Warren Buffett summed it up well: *"Over the long term, the stock market news will be good. In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a fly epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497."*

A great long-term perspective indeed!

Best to all,
V. Henry Astarjian

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