

Are the Bears Crying Wolf?

By Kerry Pechter Wed, Feb 25, 2015

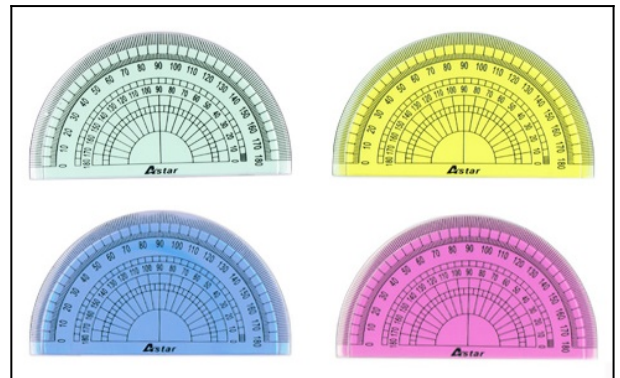
As Bulls celebrate Janet Yellen's latest walk down "easy" street, technical analysts tell RIJ that, according to their charts, Wall Street is headed for hard times.

Remember protractors? Those six-inch plastic half-moons that helped you pass high school geometry? I still have one, and it helps me decide if stocks are overvalued. That's right. When the angle of the rise in the S&P 500 Index exceeds 67.5%, I back away from equities.

Call it "poor man's technical analysis."

When this homespun methodology starts telling me that equities are no longer a bargain, I don't necessarily sell shares; I just stop buying more. To be sure, I've missed more than half of the current rally. But I don't feel terribly alone, because serious technical analysts seem to share my belief that stocks are too dear.

Chart watcher Brad Lamendorf, for instance, is chief information officer at the Lamendorf Market Timing Report and sub-advisor to the Advisor Shares Ranger Equity Bear Exchange Traded Fund. In the February issue of his report, he writes, "At the present time EVERYTHING is overvalued."



"From a historical perspective," Lamendorf concludes, "equity markets are exceedingly expensive. Investors have become far too over-confident, as evidenced by the sentiment gauges highlighted in this issue of LMTR."

Of course, bear fund advisors like Lamendorf, John Hussman and others have been calling for a crash for many months or even years. But when I showed Lamendorf's charts to Doug Short, a technical analyst who writes the Financial Life Cycle blog at AdvisorPerspectives.com, he didn't dismiss Lamendorf as just another bear crying wolf.

"[Lamensdorf's] conclusions match spot-on the conclusions I reach in the indicators I track monthly," Short told *RIJ* this week. "An amplifying concern I have is the magnitude of margin debt. The concern is that we could potentially see a sudden liquidity problem in the event of a major downside shock."

Jim Otar, a Toronto-area advisor, writer and creator of the Retirement Optimizer, takes it for granted that we are headed for a setback, but he doesn't know when it will occur. "I think [equities are] a little bit overvalued but not stratospheric considering where bond yields are and current, excessive political/social risk present throughout the rest of the world," Otar told *RIJ*. "I am sure there will be some correction of 20%-40% some time during the next three years, but that is nothing unusual."

Lamensdorf's lament is based on his observations of three ratios: the equity-price-to-sales ratio, the ratio of enterprise-value-to-EBITDA (earnings before interest, taxes, depreciation and amortization), and "Tobin's q," the ratio of the market value of a company's productive assets to the cost of replacing those assets at current prices.

Those three ratios are at their second-highest levels ever—second only to levels seen just before the millennial tech crash, he writes. The price to sales ratio is 1.7, which is second only to the 2.1 registered in 2000, the enterprise value to EBITDA ratio is also at its second highest level, after 2000, at 11.5. Tobin's q is 1.09—its highest level since peaking at more than 1.6 in 2000.

All of which tells him that the market is overripe. Short's measurements point to the same conclusion. "Based on the latest S&P 500 monthly data, the market is overvalued somewhere in the range of 60% to 94%, depending on the indicator, down slightly from the previous month's 61% to 96%," he wrote on February 4.

"Overvaluation would be in the range of 73% to 105%, little changed from last month's 74% to 106%. At the end of last month, the average of the four [indicators I use] is 77%, off its 80% average last month, which topped two standard deviations above the mean and was the highest average outside 46 months during the Tech Bubble from September 1997 to July 2001."

Margin debt is one of the things that Short looks at, and his charts show that it is at all-time highs, in real terms. It spiked in March 2000 at about 280% of its 1995 value, at about 330% of its 1995 value in July 2008, and it peaked at about 360% of its 1995 value in February 2014. In current dollars, New York Stock Exchange margin debt is now just below its

February 2014 zenith, at about \$450 billion.

“Leverage on the NYSE continues to hit daily highs, reinforcing the complacent nature of the market,” Short told *RIJ* in an email. “In our opinion, when the market turns downward its force will be swift.”

Technical analysis may or may not be valid, but it’s difficult to rely on fundamentals at a time when, as Short writes, “the markets [are] largely driven by the... Federal Reserve,” or when stock buybacks may be distorting the market indices.

Writes Lamendorf, “Earnings are being artificially manufactured rather than growing organically. Instead of funding [rising pension] liabilities, corporations have been manipulating their balance sheets by creating corporate buybacks to bolster earnings-per-share, thereby directly manipulating the PE.”

Another keen market watcher is Charles Biderman, chairman of TrimTabs Investment Research and portfolio manager of the TrimTabs Float Shrink ETF. He has been keeping track of stock buybacks.

“A lot of people think there’s a relationship between the market and the economy. But in the stock market, there’s just shares,” Biderman told *RIJ*. “Since 2011, the share count has been falling. As the total number of shares goes down, there’s more money chasing fewer shares. Share prices go up. There is no sustainable economic growth absent all of these tweaks and twinges.”

Biderman brushed aside suggestions that cheap money might be fueling stock buybacks or contributing to the near-record amount of margin debt, but he believes that low rates have fostered bubbles in, say, commodities. “When you cut interest rates to zero, products that you have to borrow money to buy become cheaper, and demand is pulled forward by the price cut. If Janet Yellen raises rates, the economy will crater,” he said.

We all know that market timing is a loser’s game and that the market is theoretically efficient. But if you’re a Boomer on the cusp of retirement and your vulnerability to sequence-of-returns risk is at or near its peak, statistics and statements like this can’t help but give you pause.

If stocks are in fact highly over-valued, this might be the right time to sell some long-held shares and start funding, say, a flexible-premium deferred income annuity. Annuity yields may be low, but you’ll be paying for your contract with arguably over-valued equities.

This just in: The Treasury Department's Office of Financial Research issued a [bulletin](#) on February 26 entitled, "Volatility Returns Amid Oil Price Declines, European Developments." It said in part:

"In Q3 2014, analysts had forecast 2015 earnings growth of approximately 12%; the current consensus estimate is 4%, while revenues are expected to remain flat. The principal cause of this change is the decline in oil prices, and its sizable impact on energy firm earnings. The other main cause is the stronger U.S. dollar, as roughly one-third of U.S. corporate profits are earned overseas. Meanwhile, earnings results from Q4 2014 have been mixed.

"Despite the markdown in expected earnings, broad U.S. equity prices remain near all-time highs. The forward price-to-earnings ratio is at 17, the highest since 2002 (Figure 6), while the cyclically-adjusted price-to-earnings ratio is highly elevated at 27.

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