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Money

A CLOSER LOOK AT GRAVITY

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Gravity can often be used for our benefit. Sometimes, it can be defended against, or even overcome temporarily. But, it can never be ignored.

For centuries, man longed to fly like the birds. Thousands of contraptions were invented over time, but with the exception of ballooning, nothing broke through until December 17, 1903 in Kitty Hawk, NC. Since then, flight has literally and figuratively soared beyond the wildest dreams of man. However, one thing has never changed. No matter how far and fast we go, unless we break the bounds of Earth, gravity will always win. Even then, it cannot be ignored.

If we look closely, we can determine the gravitational pull in other areas, too. In the market, economic fundamentals create a gravity as powerful and certain as the attraction between the planets. By understanding these gravitational forces at play, one can make determinations about what the market is apt to do over time. If you consider the current market within this historical context, it's easy to determine that the gravitational pull is down. Take a look at two separate, though similar, measurements: the price to earnings ratio (PE) and the market cap to gross domestic product (GDP) ratio. Both of these forces can act on the market with a certainty of gravitational pull between the planets and stars.

The PE ratio is a measurement of the earnings of a company with respect to its market value. The PE can also be applied to groups of stock, indexes, and the market as a whole. The market cap to GDP ratio is the measurement of the total output of a sector or nation with respect to its total market value. Both of these metrics are understandable at a fundamental level. By all rights, as a company makes more in profits, its market value should rise — and vice versa. The same applies to an economy's total output. The more an economy produces, the more it should be worth.

Sometimes, markets will behave in an anticipatory way and make it harder to try and predict an outcome. Traders will identify a sector or economy they believe will take off and invest heavily in anticipation of huge profits. Due to the emotional, and often irrational, nature of investor behavior, primarily driven by two primal forces — fear and greed — these instances can take on lives of their own. However, as in the tech bubble of the 1990s, these are rarely real, and gravity always wins out. Nobel Laureate Robert Shiller has made this point repeatedly in his multiple editions of the classic on behavioral economics, "Irrational Exuberance," predicting with chilling accuracy the crashes of 2001 and 2008.

The recent corrections, and any that follow, should be no surprise to anyone. If you look at the center of gravity leading up to today's market, you will observe — by all metrics — the market has been significantly overvalued. In fact, in a historical context, it has been positioned for a fall just as surely as a plane that is running out of fuel. According to both metrics cited above, today's market is significantly overvalued. If you look back, you will see that the last three times the market cap to GDP ratio was this overvalued were in 1972, 2000, and 2007 — immediately before three of the worst market crashes in history.

Looking at the PE ratio, we notice even more disturbing indicators. Going back to the turn of the 20th Century, we can track secular bull and bear markets to levels of the PE ratio. Never, in the history of the modern stock market, has a true bull market recovery occurred while PE ratios were over 15. And every time the overall market cap reached 25 or more, there was a significant crash. What's the current PE ratio, and what should it tell you?

The "Irrational Exuberance" of the investing public kicked in, and the market soared — in spite of the fact that stocks have been significantly overvalued, in spite of the fact that interest rates are still at record lows and will come back up at some time in the not-too-distant future, in spite of the fact that we are sitting on the third significant economic bubble in the past 15 years, and in spite of the fact that we've all been through this before and know what is coming.

In spite of gravity.

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