Is the Stock Market Doomed?

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This title is derived from a recent article in the Wall Street Journal highlighting the fact that the S&P 500 index is overvalued as it nears an all-time high P/E ratio. This ratio is simply a valuation calculation that takes the price of a stock and divides it by the earnings per share. A similar characterization was proffered by Alan Greenspan, past chairman of the Federal Reserve, suggesting that investors were suffering from “irrational exuberance” in early December of 1996 when the stock market was making new highs. The other half of the title in the article that we omitted was “Yes, But Maybe Not in 2025.” Similarly, Mr. Greenspan’s quote was made some three years before the stock market peaked at a substantially higher level. Could this forecast end up like the recent forecasts of an imminent recession?

Some investment managers question the value of a P/E ratio as a measure of the overall riskiness of stock investments. A very successful ETF fund manager recently eschewed earnings as the basis for a stock’s current and future value. To support that contention, a scatter diagram of stock prices and P/E ratios does not reflect a systematic relationship. One fallacy of this measure is the companies without earnings are excluded even though many of them subsequently experience strong earnings growth. Our experience has been that purchases of cheap stocks (low P/E ratios) have not ended well while avoiding stocks just because they have a high P/E ratio has been a mistake, sometimes a big mistake.

On another level, the market P/E ratio (S&P 500) is calculated by taking the average stock price as the basis for the calculation rather than the median stock price. When there is a surge in some stocks, i.e., an abnormal distribution, this calculation will be distorted toward a higher P/E ratio even though the rest of the market’s P/E ratio could be much lower.

Another distortion can occur due to the actual or expected rate of inflation. Since most companies’ stock prices have certain expectations built in based on future earnings, increasing inflation will lower the value of those future earnings. As a result, the P/E ratio will fall. For example, the S&P 500 P/E ratio in 1974 was 9.5. In 2023, the P/E ratio was 23.5. In December of 1974, inflation was 12.3%, while in 2023 the inflation rate was only 4.1%.

The P/E ratio analysis seems to have a sophisticated following. According to the article mentioned above, one major brokerage firm expects stock prices to grow at an annual rate of 3% for the next ten years. A major bank’s forecast is only a 0-1% growth rate. And a major mutual fund company’s estimate for the same period is only 2%. We would question those bearish forecasts based on the current economy, inflation, and American wealth. When the stock market is doing well, there are always naysayers who prefer to be negative.