The Dow Jones at 5,000: Sensible or Senseless?

Less than 18 months ago, the skeptics were right as the stock market failed to pierce the Dow Jones 4,000 mark. In January 1994, the stock market actually went through this supposed barrier in intra-day trading but pulled back and never closed above 4,000. Then in the sell-off that followed during the first half of 1994, the market pulled back to 3,593, frightened by the spectres of higher inflation or a damaging recession. The Federal Reserve Bank raised interest rates seven times during 1994, causing the worst bond market in decades and a lackluster stock market.

But the tide turned in December, 1994, and by January, 1995 the bull market resumed its charge. During the first six months of 1995, the S&P 500 Index produced a total return of 20.1%, while the broader Value Line Index advanced 12%. The market was led by a powerful rally in technology stocks, but there was broad participation by traditional growth stocks and financial issues as well. However, many utility, retail, and restaurant stocks barely advanced at all, while some cyclical companies were out of favor as well. Bonds bounced back this year. High quality corporate bonds with a maturity of 3-5 years returned 9.9% during the first half of the year compared with a dismal -.9% in the first half 1994.

The question now is not whether the Dow Jones will break 4,000 but 5,000? At 4600, is the stock market significantly overvalued or is it on its way through 5,000?

Dow Jones of 1,000 in 1968 = 4,600 in 1995

In answering this question, we believe that an historical perspective is important. After all, how high is a 4,600 Dow? On an inflation adjusted basis, the Dow Jones Industrial Average of 4,600 is no different than a Dow Jones of 1,000 in 1968. In other words, inflation (as measured by Consumer Price Index) has increased by approximately 450% over the past 27 years. So the actual size of the number should not frighten us. What should worry us is that the Dow, having reached 1,000 in 1968, spent the next 14 years trying to breach that barrier. The combination of high inflation, low productivity and high marginal tax rates made the 1970's one of the most difficult decades in the history of the stock market.

Price/ Earnings Ratio Valuation

According to the well-known rule of thumb, "the rule of 20", the stock market appears to be fairly valued or even undervalued. With inflation running at 3% annually, the rule of 20 postulates that the stock market's price/earnings ratio should be 17 (20 less the inflation rate = the market P/E ratio). In fact, the price/earnings ratio of the Standard & Poor 500 Index is 16.5 times estimated 1995 earnings and 15 times forecasted 1996 earnings. The price/earnings ratio of the Dow Jones on 1995 estimated earnings of 12.9 (and 11.2 times 1996 estimated earnings) actually points towards an undervaluation of the stock market. Clearly this valuation method depends heavily on the inflation rate, and if inflation were to ratchet up to 5% or more, the market would be highly vulnerable to a correction. However many observers are more fearful of deflation, which Japan is experiencing, than inflation.

Corporate Earnings

While the "price" part of the price/earnings ratio may be reasonable based upon the rule of 20 and other methodologies, a further advance of the stock market through 5,000 will depend upon the earnings part of the equation, as it is unlikely that the P/E ratio will expand beyond the current level under present economic circumstances. The good news is that corporate earnings have been very strong over the past 3 years. We expect corporate earnings to increase by 8-10% this year, and we think that skeptics of "soft landing" of the U.S. economy, engineered by the Fed, will be wrong. Indeed we see moderate growth next year brought about by lower interest rates, no significant excesses in the economy, lower taxes, lower government spending and low inflation. Many analysts believe that U.S. industry is more favorably positioned to compete on a global scene than at any time since the 1960's. The painful corporate restructuring that has taken place over the past 5 years is reaping rewards.

Technical Market Factors

One of the key features of a good stock market is strong liquidity available to move into the market. This new buying power causes prices to advance.There is good reason to believe that interest rates may go lower, as the Fed reduces them to ensure that the soft landing does not turn into a recession. Funds should continue to move into the stock market from bank accounts, short term bonds and money market funds in search of higher returns. Additionally, regular monthly contributions from burgeoning individual 401 (k) retirement plans from the baby boomer generation should continue to give the market a firm underpinning. Finally foreign investors have avoided the U.S. stock market thus far this year because of the weak dollar, and we expect foreign investors to enter the market as the dollar strengthens.

On the supply side, significant corporate stock repurchase plans have shrunk the amount of available equities, while the level of new stock offerings has not become excessive. Accordingly, there is a reasonable balance between the supply and demand for equities.

The Technological Age and Global Economy

One of Newt Gingrich's oft repeated observations is that we are in the midst of a New Technological Age - the Information Age, which is replacing the Industrial Age. It is the era of huge productivity increases as information is distributed by telefaxes, cellular telephones and satellites through networks to office and home, and processed by computers large and small, guided by sophisticated software. We believe that this is an accurate observation. An example of this is that 60 million personal computers will be sold in 1995 around the globe, and this will increase dramatically in the coming years. We think that this technological revolution will help to drive strong corporate earnings over the next few years.

In addition, world trade is booming, and the NAFTA and GATT initiatives should increase global economic activity unless the Clinton's administration's efforts to force Japan to open its markets further backfire, resulting in a trade war. In fact one of the reasons for the widespread optimism by international firms is the fact that capitalism has broken out all over the world - China, India, Russia, Eastern Europe and Latin America. There are enormous opportunities for multi-national companies prepared to take advantage of their global expertise, well known brands and strong balance sheets. The weak dollar has also been a short term trading advantage, although it is clear that on a sustained basis, a strong and stable dollar is a necessity for a well ordered global economy.

U.S. Political and Fiscal Environment

We are convinced that one of the reasons for the stock market's powerful advance is the change in the political environment in Washington since November 1994. Sparked by the Republican revolution and the Contract with America, both parties are now moving towards a return to fiscal responsibility evidenced by attempts to cut government spending, pass a balanced budget, and cut capital gains and income taxes. The more of this agenda which is enacted, the more likely it is that the Dow will break 5,000.

Global Political Situation

The international political scene continues to be dominated by the absence of the Cold War, lower levels of defense spending globally and the movement toward democracy in Russia, Eastern Europe and Latin America. These are very positive and exciting signs and contribute towards the international investment of capital and the acceleration of global trade. In some regions, there seem to be power vacuums which have the potential to escalate into dangerous conflagrations such as Bosnia. However, the world on balance is moving towards democracy and multi-lateral approaches to conflict, and the absence of Soviet money funding various causes has contributed to potentially fruitful negotiations toward peace in both the Middle East and Ireland.

Summary: Risks - Seen and Unseen

It is clear that there are many positive factors at work in the stock market. There are many reasons for investor optimism, and this has produced a certain degree of complacency. Many investors see little risk in the market which means that the true risk level is higher than perceived.

The most frequently mentioned risk is the low dividend yield on the S&P 500. Historically, this has been a sign for overvaluation. The dividend yield is now as low as it was in the 1920's and 1960's. There are many arguments advanced as to why "things are different this time", but are things really different? The other major risk is that investors have not seen a single year when the S&P 500 Index dropped more than 10% since 1981. Unaccustomed to a tough bear market, how will the individual investor in a mutual fund as well as the young mutual fund manager react in this environment? Many shudder to contemplate this scenario. In 1987, the individual investor reacted more rationally and coolly than the institutional manager.

Ultimately there are probably risks which have yet to be picked up on the radar screen, and market corrections will happen. However, we believe that the many positive forces enumerated above outweigh the negative factors. And most importantly, we believe that inflation will stay under control. If we are right in this, then interest rates will remain low and even decline. This will give the Dow Jones a good shot at breaking through the 5,000 level during the next 6 months as strong corporate earnings lift the market higher.

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