A TALE OF THE S&P 500 P/E RATIOS OVER 75 YEARS

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The purpose of this essay is to show just how distorted (overpriced) the US stock markets have become during the last decade. The main exhibit to prove this point is the relationship between the price of the S&P 500 Index and the P/E ratios for this index. Please look at Chart 1 below and study the information in the box that describes each colored line. You cannot grasp the message this essay contains unless you understand these lines and the information they convey.

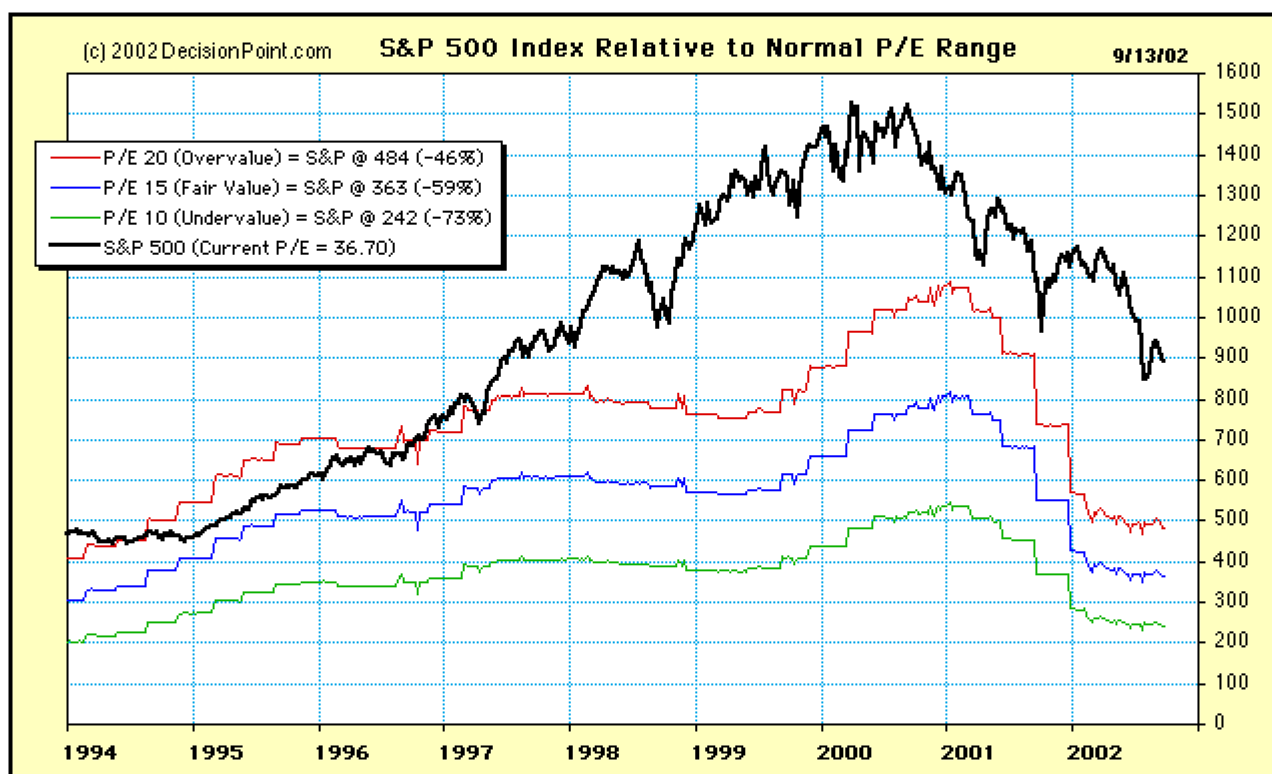

Chart 1
Chart provided courtesy of www.decisionpoint.com

The main message of this chart is that the price of the S&P Index has been at or above the red line (overvalued) since 1996. In addition this chart tells us that to return just to a normal overvalued condition the S&P Index will have to fall under the 500 mark (an additional drop of about 46%). Worse still to return to fair value a drop to about 370 is required (a drop of about 59%).

Bad as the above picture seems, it does not tell the whole story because several market experts are predicting that before this bear market ends many years from now, P/E ratios will drop back to the green line or below (a P/E of 8-10). That means an additional drop from the current level near 870 to near 250 (an additional drop of over 70 % from current levels).

This first chart has more to tell us, but additional charts will help us understand the vitally important message of this essay. So we will proceed to Chart 2 and return to Chart 1 later.

Chart 1 gave us an 8-year perspective. Chart 2 gives us a broader perspective of 30 years and shows us some additional important facts. The first thing we should notice is that from 1974 until 1983 the P/E ratio stayed at or below the green line (Undervalued). Over the next 4 bullish years S&P prices rose first above the blue line (Fair

Value), and then above the red line (Overvalued), and that precipitated the crash of 1987 which brought prices only back to fair value. Another important point to realize from this chart is that from 1992 until now S&P prices have been above fair value and from 1996 prices have been above the red overvalued line.

Looking at 1996 and beyond we are reminded that Alan Greenspan knew at that point that prices had reached a danger point (similar to the point that precipitated the 1987 crash) and he gave the world at that time the term "Irrational Exuberance" in a speech, but all he did was jawbone the market, he did not take any action to temper the enthusiasm for stock ownership. In fact in the years after his 1996 speech it appeared he became a champion of stock ownership. Thus the stock market bubble of 1996-2000 was born.

I am now going to digress for a moment and discuss the Elliott Wave Principle as it pertains to the current essay. A number of Elliott Wave practitioners (this author included) in the middle 1990's saw that we were nearing the end of a fifth wave that should produce a healthy correction and vocally told this to the world. They have since been castigated for this and accused of incompetence. What happened is that Alan Greenspan allowed the fifth wave to go into an extension (a normal occurrence in an overactive bull market); this made it impossible for a normal correction to occur when it should have. What then occurred was the biggest stock market bubble since John Law in France in the 1720's, and this chain of events has brought us to the beginning of a much longer and harder correction than would have been the case had it started in the middle 1990's. In no way has the Elliott Principle failed or been proven wrong. (A full discussion of this is available on the Internet. Anyone who is unfamiliar with this analysis may request the address from the author at the email address listed at the end of this essay.)

Now let's move along to Chart 3 which shows what happened from 1950 to 1981. The main thing we can learn from this period is the way the S&P 500 reacted between the colored lines and that when it got near or above the red line there was a correction sooner or later. It is important to notice and realize that when prices finally bottomed out in 1974 they did so well below the green line. Heaven help us if prices go below the green line in our current bear market correction because that would mean prices and economic activity so low not even I can contemplate them (however it is possible because bear markets feed on themselves).

Now we are ready to view our last chart, and it conveys a sobering message. The first message is that prices only climbed to the red line and not above prior to the 1929 stock crash. Why is that so ominous? Simply because when we contrast this picture with the 1996-2002 era (Chart 1) we see that the latest stock bubble is much more severe than the 1929 one (prices have gone way above the red line and stayed there for years), and that suggests a longer and deeper correction this time around. The other message is that prices did fall back to the green line in the bear market of 1929-1932. If that happens again this time, a look back at Chart 1 shows us that we will have to drop to the mid 200 level on the S&P 500 average to reach that point this time around. If these are not sobering thoughts I do not know what would be.

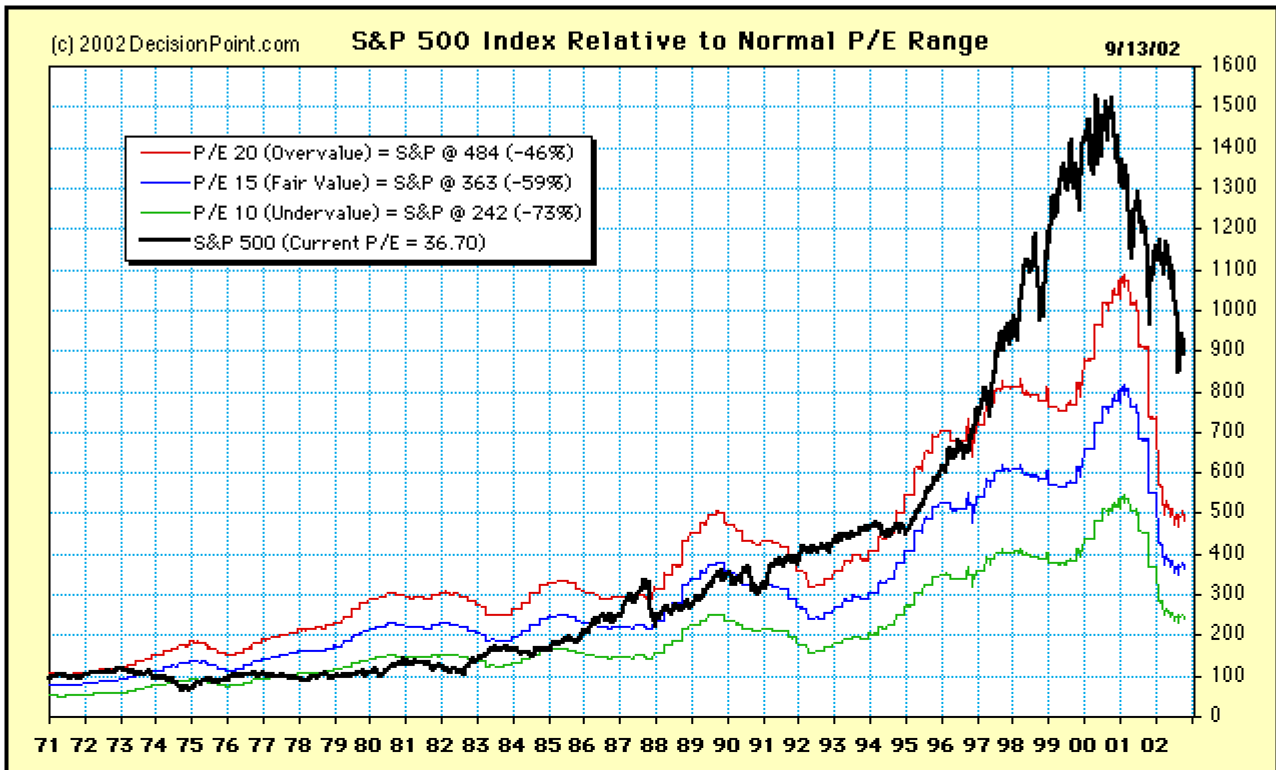

Chart 2

Chart provided courtesy of www.decisionpoint.com

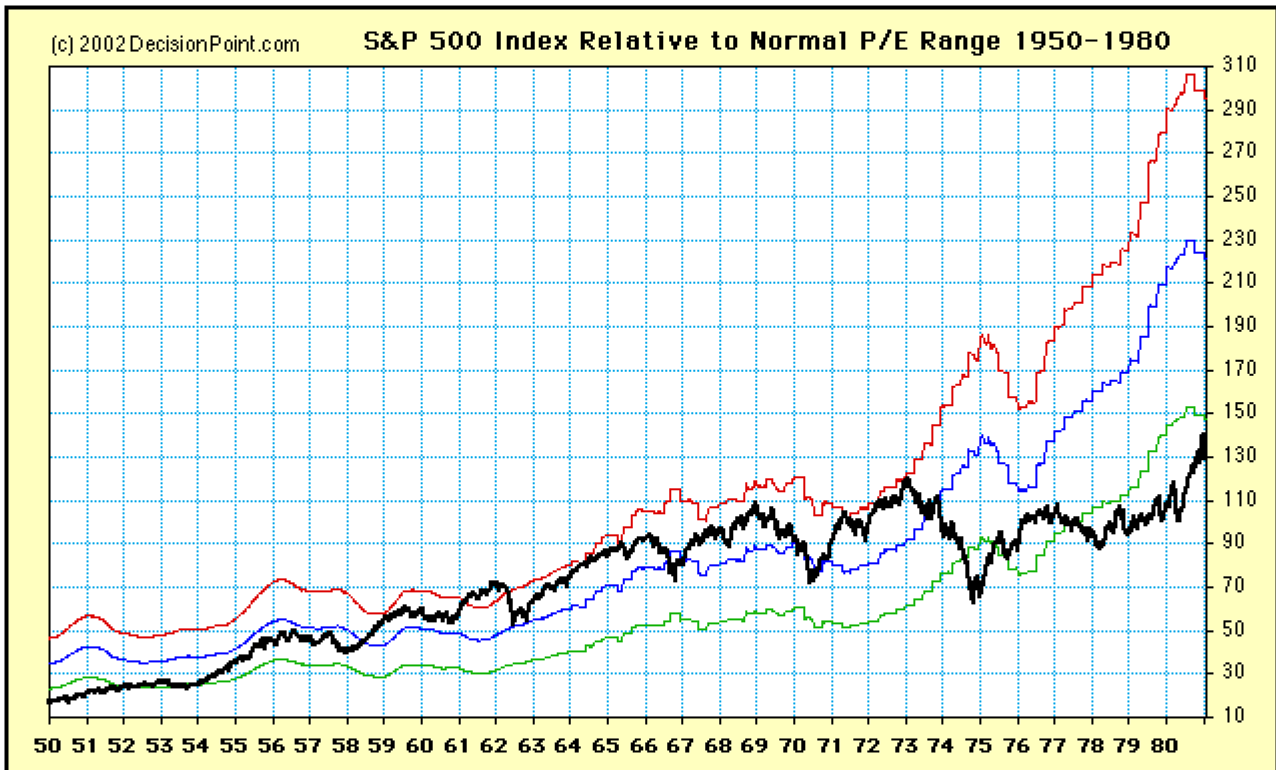

Chart 3

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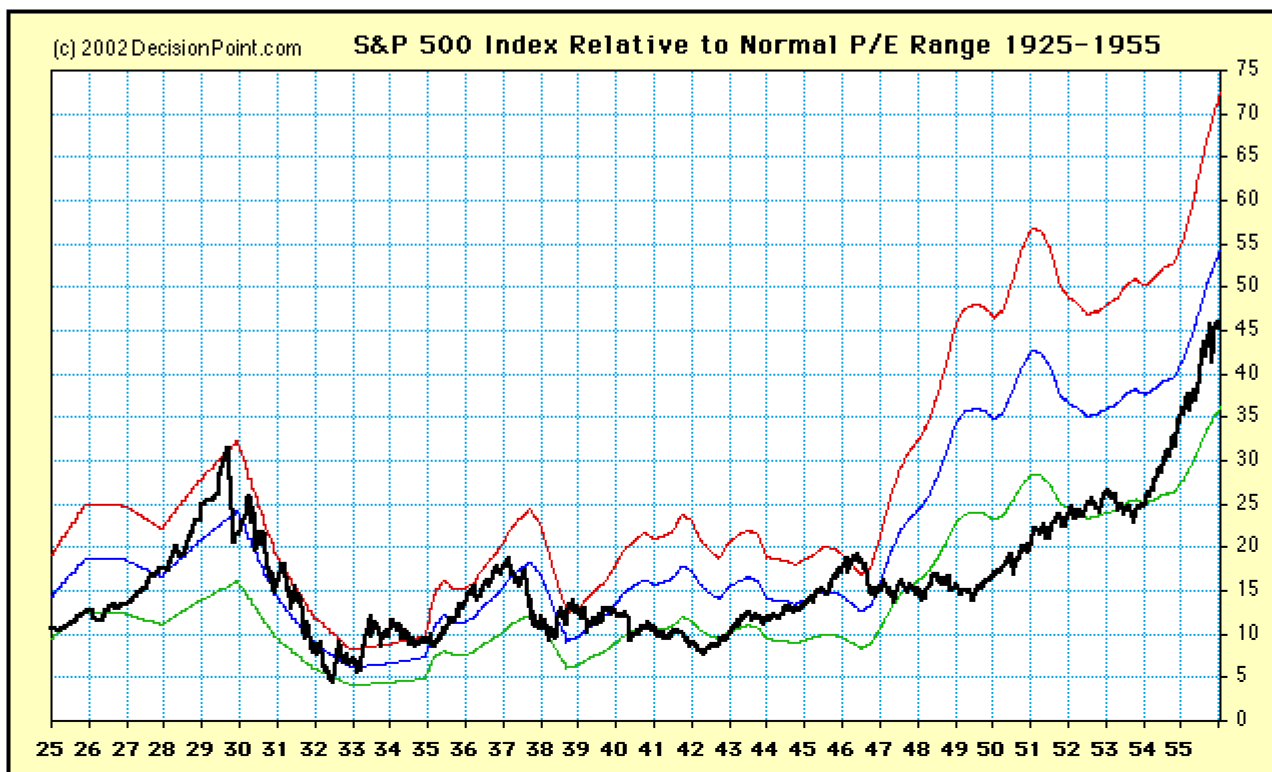

Chart 4

Chart provided courtesy of www.decisionpoint.com

SUMMARY

A reasonable and common-sense person can logically come away from a reading of this essay with the idea that we have completed a very large bull market top in the period from 1996 to 2002, and that we are now only in the early stages of a long and deep bear market that potentially has a very long way still to fall before prices reach fair value again.

ABOUT THE AUTHOR

Joseph M. Miller is a 70-year-old retired investment professional who has been a student of and a participant in the financial markets since the 1950's. He earned a MBA degree from the University of Chicago and is a retired member of one of the large US financial exchanges. He lives in the Great Smoky Mountains and concentrates on handling his personal financial portfolio.

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