



2/8/2024

AN UPDATE FROM PAUL DIETRICH**CAN THE STOCK MARKET GO UP FOREVER?**

Of course not!

Everyone knows that “what goes up, eventually comes down.”

But even rational investors can sometimes be tempted by media hype to jump into a wildly overvalued stock market that is driven only by momentum and no underlying economic fundamentals.

Investing In This Type Of Stock Market Is Always A Mistake!

Anyone even thinking of investing new money in a stock market that is hitting new record highs should stop for a moment and remember the advice they received from their grandmother when they were children -- “buy low and sell high.”

Investing new money into a stock market hitting record highs is by definition—buying high.

We all know that your grandmother’s advice was right, but so many investors get caught up in the excitement, momentum, and enthusiasm of a stock market that is running like the Kentucky Derby.

It is that irrational Fear Of Missing Out, or “FOMO”, that fuels this behavior.

What Is Driving The Stock Market Up? There HAS Been Some Selective Good News.

- Inflation is coming down.
- Unemployment remains very low.
- Consumers spent all their pandemic savings and then started to run up their credit card debt for one “last hurrah” of spending over the holidays.
- The Federal Reserve has announced they intend to lower their 5.25%- 5.50% rates three times later this year by a total of 0.75%.

All of that is welcome news.

If You Look Below The Surface In These Reports—All Is Not Well In Wonderland!**INFLATION**

If you look at inflation over the past 25 years, it has ranged between 2% to 3.5%, which is about what the inflation rate is now.

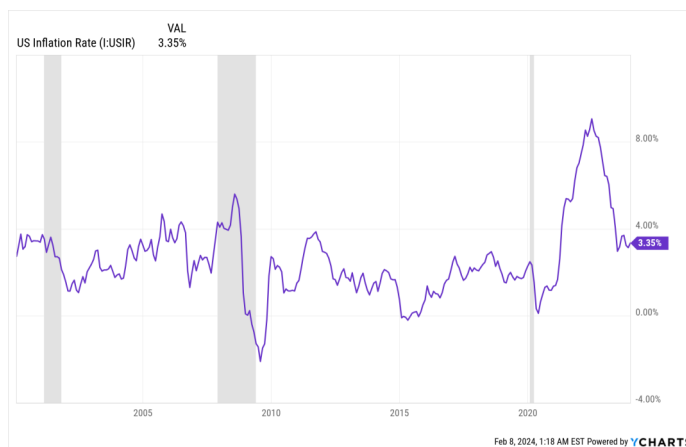
During recessions over the last 25 years, inflation wasn’t much of an issue.

While inflation can exacerbate the pain of a recession, the stock market can still drop by half in a recession—even if there is no inflation.

People forget that during the Dot.com Recession in 2001-2002, the S&P 500 dropped [peak to bottom] by -49%. In the Great Recession of 2008-2009, the S&P 500 dropped [peak to bottom] by -57%. In the Covid Recession of 2020, the S&P 500 dropped [peak to bottom] by -33%.

The definition of a recession has nothing to do with inflation. The definition simply states that recession is a business cycle change where the economy starts to slow and contract for approximately six to 18 months, before resuming a growth and expansion phase that usually lasts six to nine years. That’s all it is.

From an investor’s perspective, they should remember that once a recession starts, the average drop in the S&P 500 Index is -36%.



Even in a mild recession, investors holding the S&P 500 Index should expect to lose over a third of their retirement investments in stocks.

Bottom Line: This is why it is so important that when the economy is telling investors that it is starting to slow and contract, that investors take a defensive investment posture and become very cautious and conservative.

UNEMPLOYMENT & JOBS

Since the first of the year, every day there are headlines in the press of major corporations in tech, manufacturing, transportation, banking and the media that are laying off tens of thousands of workers.

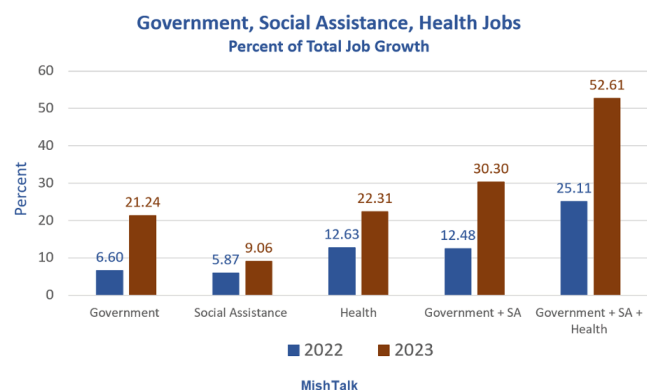
But everyone seemed to be stunned by the January Jobs Report released by the Bureau of Labor Statistics. It stated that the economy in January created +353k new jobs, even though a week earlier, the usually reliable ADP Report said only +107k jobs were created in January.

Something doesn't make sense here, so don't be surprised if these numbers are revised by the BLS sometime in the future.

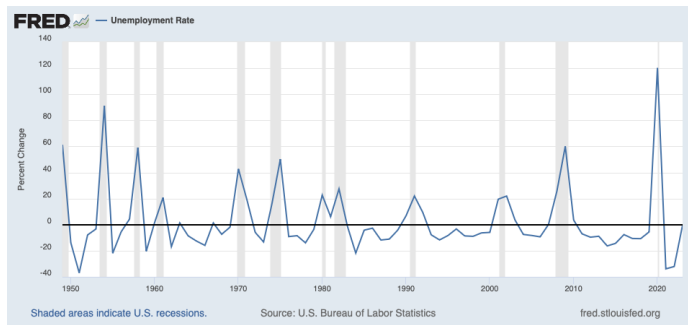
However, if you dive into the details of the job growth numbers there may be a partial explanation.

A record number of full-time workers moved to part-time jobs, and then secured a second part-time job. The rise in part-time jobs was a large element in the surprising increase.

The second big takeaway was the rise in new government jobs in 2023 as a result of the various Biden stimulus programs. Look at the chart below.



Bottom Line: While the unemployment rate is historically low, layoffs are increasing and unemployment is starting to go up as you can see by the recent Federal Reserve chart.



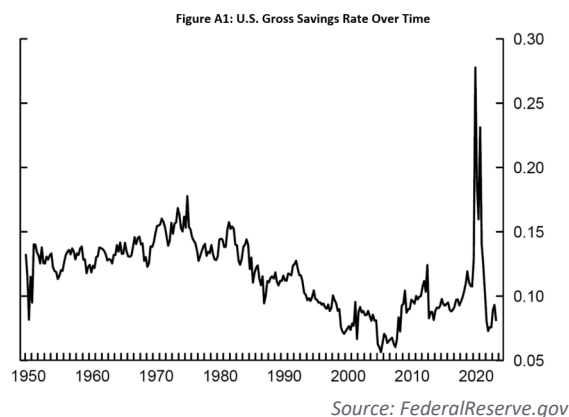
CONSUMER SPENDING

Consumer spending makes up about 70% of the U.S. economy. When consumers stop spending, the economy slows dramatically.

Because of government stimulus payments, Americans came out of the pandemic with a record amount of excess savings. But as Covid restrictions were lifted, consumers went on an historic spending spree.

According to the Federal Reserve, almost all excess savings have been spent, and Americans are using their credit cards and are now bumping up against their credit card limits.

The chart below shows the rise and fall of American excess savings from government stimulus payments.



As Americans turn to their credit cards to cover everyday expenses, credit card debt hit a new all-time record high at the end of December, according to the New York Federal Reserve.

Total credit card debt has now surged to \$1.13 trillion, rising 14.5% in 2023. This marks the highest level on record at the Federal Reserve. It is also the ninth consecutive annual increase.

In addition, over the course of 2023, 8.5% of credit card loan balances moved into delinquency. This is the highest since the aftermath of the global financial crisis.

The average interest rate on U.S. credit card balances has moved up to 21.5%. This is also the highest average rate on record.

Twenty years ago, total U.S. household debt was at just \$8 trillion—it is now at a new record of \$17.5 trillion.

Debt has become the short-term solution to many consumers' problems.

Here is a breakdown of debt growth by category over 20 years:

- Mortgage Debt: +\$112 billion to \$12.25 trillion
- Auto Loans: +\$12 billion to \$1.61 trillion
- Student Loans: +\$2 billion to \$1.60 trillion
- Credit Card Debt: +\$50 billion to \$1.13 trillion

Total household debt in the U.S. is now up ~23% in three years and rising rapidly.

If a significant number of consumers lose their jobs and actual “employed workers” hit their credit card limits—that is basically the definition of a recession.

Bottom Line: Americans are “fighting” inflation with debt. Similarly in 2000 and 2008, a large percentage of consumers hit their credit limits and consumer spending dropped dramatically. This cannot end well.

U.S. GOVERNMENT DEFICIT SPENDING

A growing number of economists have come to the conclusion that the reason a recession did not occur as predicted in 2023, and has now been pushed out into 2024, is because of the unprecedented printing of money through the growth of U.S. deficits to fund the \$4 trillion of pandemic stimulus in 2020, the Biden \$2 trillion stimulus in 2021, and now the additional printing of almost \$3 trillion in 2022 – 2023 that we just spent for no reason other than on Congress’s whims.

The U.S. National Debt entered the year 2024 at \$34 trillion and increased \$190 billion in January. At that pace we could see another \$2 trillion of debt this year.

To say the U.S. government is spending money like a “drunken sailor” would be an insult to drunken sailors who at least spend their own money and quit when they run out of funds.

According to the bipartisan Congressional Budget Office, under current fiscal policies, the Debt to GDP ratio in the U.S. is projected to hit 200% within 20 years.

Prior to 2020, Debt to GDP in the U.S. was ~100% and prior to 2008 it was ~60%.

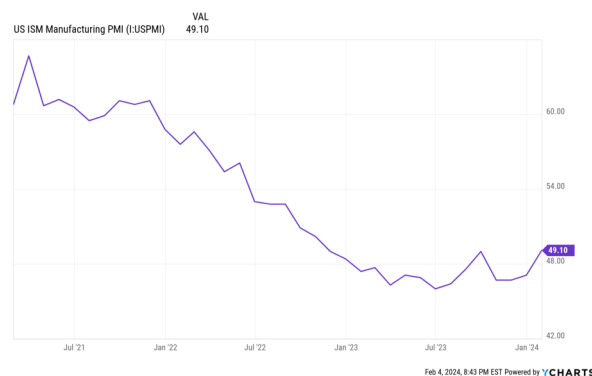
Current estimates show the U.S. hitting \$50 trillion in total debt by 2033.

This means that the U.S. will add \$218 million in debt EVERY HOUR until 2033.

Bottom Line: Just imagine what would happen if the Federal Reserve doesn't achieve a “soft landing.” We are borrowing money from future generations to fund our issues today. This is unsustainable.

U.S. MANUFACTURING

Below is the latest chart on the current state of U.S. manufacturing.



Bottom Line: It is clearly slowing. Manufacturers are also laying off more workers.

GEO-POLITICAL RISKS

- Russia
- Ukraine
- Israel – Gaza – Iran – Oil Shipping Risks – Suez Supply Chains
- China
- U.S. Election

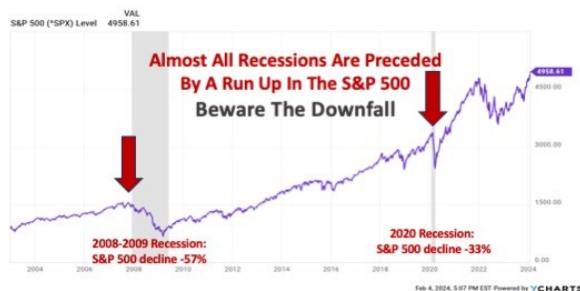
Bottom Line: What could go wrong?

How Overvalued Is The Stock Market?

The two biggest risks in putting new money into this stock market right now are first, right before the beginning of almost all recessions, there is a run-up—and sometimes a dramatic run-up—in the stock market just before it crashes. See chart below.

Second, these explosive run-ups in the stock market are often driven by emotion and momentum, and little regard for economic fundamentals.

Remember the dot.com and internet hysteria in 2000 and the mortgage-backed securities euphoria in 2008? No economic fundamentals—just mindless emotions and momentum.



This current run-up in the stock market is based on the strength of 7 mega-cap tech stocks and the excited betting on when the Fed will lower rates.

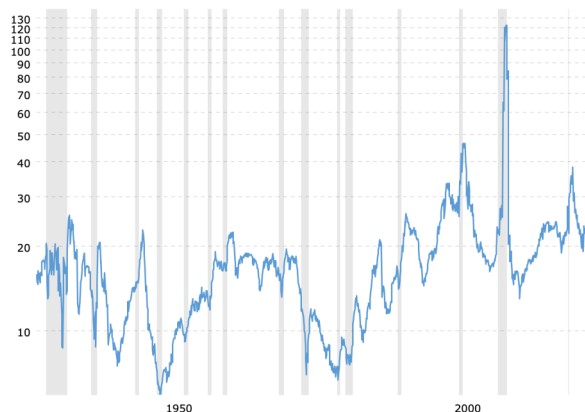
No one seems to notice that the economy is cooling and there are risks to the economy everywhere.

Let's review some of the more common methods investors use to determine whether the stock market is over- or undervalued.

Price Earnings Ratio:

This is one of the most widely used methods. Investors compare the current Price Earnings Ratio (P/E ratio) of the S&P 500 to historical averages. A significantly higher P/E ratio usually suggests the market is overvalued, whereas a lower ratio indicates it is undervalued.

The next chart shows the historical P/E ratio for the S&P 500 Index over the past 100 years. You can see that except for one instance in the 1990s, the current P/E ratio is higher than every other P/E ratio for 100 years, except for the past three recessions.



Sources: Standard & Poor's, FactSet

The Shiller P/E Ratio is a slightly different way to look at historical P/E's. The Shiller P/E Ratio, also known as the Cyclically Adjusted Price-to-Earnings Ratio or CAPE Ratio, looks at the S&P 500's P/E ratio based on average inflation-adjusted earnings from the previous 10 years. This helps smooth out fluctuations from economic cycles.

The chart below goes back 153 years. As you can see, the current Shiller P/E Ratio is at its highest level ever, other than during the Dot.com Recession of 2001-2002 and the Covid Recession in 2020.

Shiller PE Ratio for the S&P 500: 33.39 (As of 2024-01-01)

Shiller PE Ratio for the S&P 500



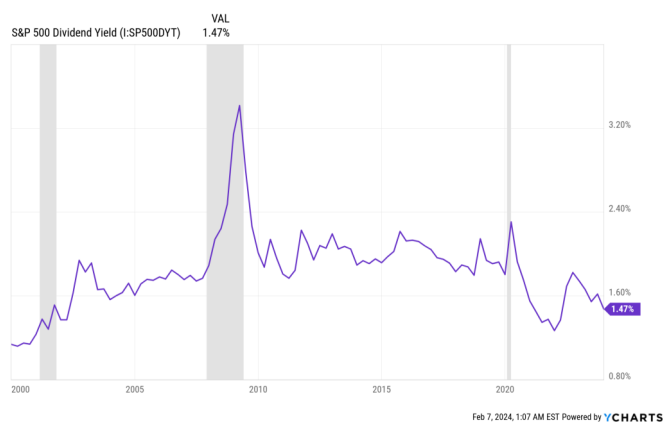
Sources: Standard & Poor's, FactSet

Dividend Yield:

The Dividend Yield compares the current dividend yield of the S&P 500 Index to historical averages. A lower-than-average dividend yield usually indicates that the market is overvalued, while a higher yield suggests undervaluation.

The current dividend yield is historically low at 1.47%. Since investors can get a safe short-term U.S. Treasury yield that pays 4%-5%, this indicates that the stock

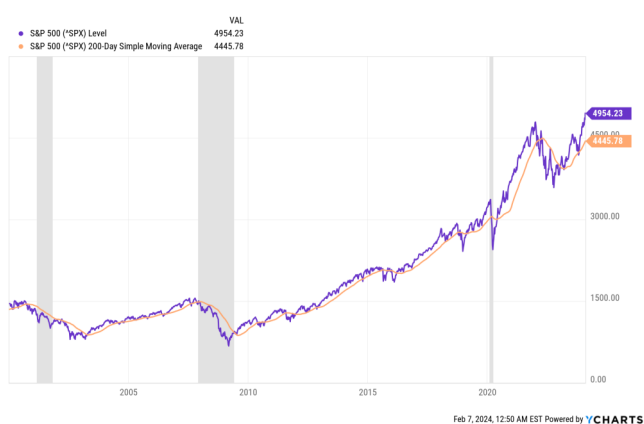
market is very overvalued using the dividend yield valuation.



Technical Indicators:

Technical analysis looks at charts and patterns to predict future movements and assess whether the market is overvalued or undervalued. The most common method is by comparing the S&P 500 Index with its 200-day Moving Average, which is its long-term trend. If the S&P 500 is significantly above its long-term average, most investors consider that overvalued.

Even compared to previous recessions, the S&P 500 Index is trading above its long-term average more than at any time in the last 25 years.



Diversification:

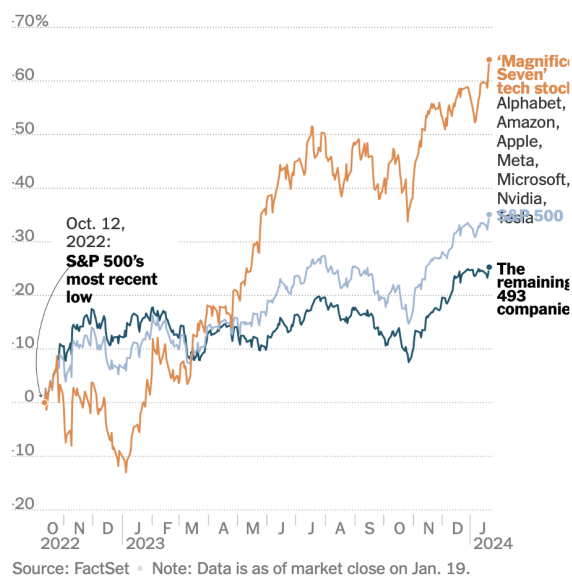
What makes investing in the S&P 500 Index so risky right now is that only seven stocks, in only one economic sector [the tech sector—a notoriously volatile sector], are completely driving both the S&P 500 and the NASDAQ.

The stock market often moves in a three-phase cycle.

Once a trend, like AI technology gains broad recognition, there is an initial fear of missing out, and then mindless piling in. That phase is followed by a pull-back [which can range from mild to catastrophic]. This pattern tends to be most evident in technology — remember the period before and after the dot-com boom or the progression of the fintech and biotech investment trends. The third phase is when the high-flying stocks with outrageously high P/E ratios revert to their long-term fair market value and trends.

This is where the S&P 500 Index is right now.

Change in total market value since Oct. 12, 2022



The S&P 500 Index gained 24.2% in 2023 while S&P 500 Index earnings grew +7.8%, leading to a 15.3 multiple expansion and a year-end P/E ratio of 22.5. This is above the historical 18-19 times the ratio's average.

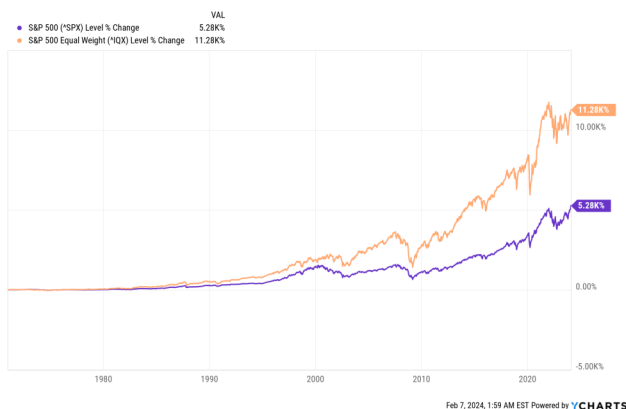
The next chart shows how the Magnificent 7 tech stocks have done against every other market index.

Exhibit 8: The Mag 7 and Everyone Else



*Magnificent 7 data is cap weighted and refers to the following set of stocks: Microsoft (MSFT), Amazon (AMZN), Meta (META), Apple (AAPL), Google parent Alphabet (GOOGL), Nvidia (NVDA), and Tesla (TSLA). Data as of Dec. 31, 2023. Sources: FactSet, Russell, S&P

If you look at the S&P 500 Index, which is a cap-weighted index, versus the S&P 500 Equal Weighted Index, you can see how those seven tech stocks dominate. They now represent 30% of the weighting of the S&P 500. The other 493 stocks only make up 70% of the weighting.



Last Thoughts On The Stock Market

I was actively investing client portfolios in the late 1990's running up to the beginning of the Dot.com Recession.

I remember appearing as a commentator on the Financial News Network (now CNBC) in 2000. I announced after the Conference Board's Leading Economic Indicators signaled a recession in the next nine to twelve months, that I was moving my clients into a defensive investment strategy of mainly bonds, cash and gold.

At the time, the Dot.com stock market boom was in full swing. The television anchors thought I had lost my

mind when I told them I was moving my clients out of the market and internet stocks and into a defensive portfolio of bonds, gold and cash.

About seven months later, the S&P 500 Index lost [peak to bottom] -49%.

The NASDAQ lost -78% and most of the NASDAQ stocks were delisted or just went out of business.

The point of all this is the Internet changed our lives, like the invention of the combustion engine, electricity, the telephone, and cars. I am sure that Artificial Intelligence will also change our lives in the future.

But not every company with a dot.com in its name was going to make it. I suggest the same is true with AI.

Having managed investments through three recessions over the past 30 years, this feels to me very similar to the run-up to the Dot.com Recession of 2001-2002.

It was a very mild recession. GDP never went below -1%. BUT, the S&P 500 fell -49% and the NASDAQ fell -78%.

In retrospect, a lot of retirement investments were lost just to participate in the stock market hysteria of the day.

I hope this time will be different!

NOTE: I will update all of the Leading Economic Indicator charts next month.

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Paul Dietrich is focused on managing investments for private investors, retirement funds and private institutions throughout the United States. He also serves as an on-air commentator and contributes market analysis to business and financial media including *CNBC*, *Fox Business*, *Bloomberg TV*, *CNN*, *The Wall Street Journal*, *Yahoo! Finance*, *Reuters* and *The Washington Post*.

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