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## AN UPDATE FROM PAUL DIETRICH

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# THE STOCK MARKET BUBBLE IS ABOUT TO BURST – LOOK OUT!

Some call it the "*Fear of Missing Out*" or FOMO. Psychologists call it the "*Madness of Crowds*."

Evidently, scholars have written doctoral dissertations on this "*Madness of Crowds*" theory with regard to lotteries. It seems that people don't maniacally start buying lottery tickets until the lottery jackpot goes over $750 million. That's when the office pools start buying and people are willing to wait in line for hours to get a ticket.

That's when everyone starts to go insane—stock market bubbles are no different.

I have a friend, who in the last few months, just could NOT help himself. He had most of his money safely invested in short-term U.S. Treasury bonds paying 4% to 5% annually.

It was like a gambling addiction, he just couldn't resist the excitement and adrenalin rush of investing in the stock market and in all the hype and speculation of the new breakthrough technology, artificial intelligence, and gambling on when the Federal Reserve would start to lower interest rates.

He had no idea when the Fed would lower rates, other than the guesses of his 30-year-old financial advisor. Last month, everyone was betting the Fed would cut rates six times this year starting in March. No one believes that now. The stock market betting pool has now decided there will only be two or three cuts this year starting in the fall.

A year ago, my friend had never heard of artificial intelligence, but he thought he had seen a segment about it on "60 Minutes."

So armed with the information he gleaned from "60 Minutes" and the excited and overcaffeinated opinions of business cable TV hosts and analysts, he sold out of his safe Treasury bonds and jumped into the stock market in the last couple of months.

He knew he was investing in a bubble—but he just couldn't stop himself.

I am certain he currently has paper gains in his stock portfolio, but when the inevitable correction comes, I would not want to be there when he explains to his wife the losses after selling out of their safe U.S. Treasury investments.

I finally told my friend, who is now enamored by the hyped up Magnificent Seven tech companies, that he might want to rewatch the 1960's Western starring Steve McQueen and James Coburn from which this tech group gets its name.

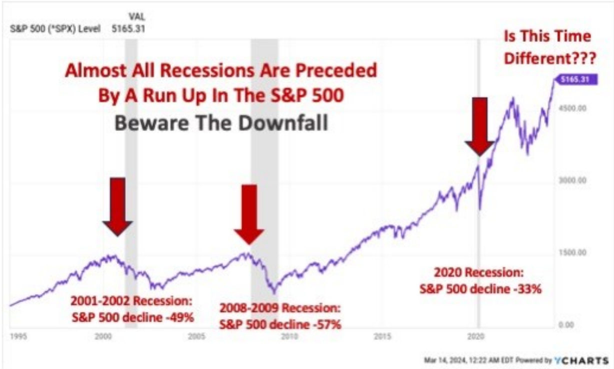
**Spoiler Alert:** Four of the seven are dead at the end of the movie.

## What Goes Up Must Eventually Come Down

Remember what your grandmother told you as a child, "buy low and sell high." That was always good advice.

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 runup—and sometimes a dramatic runup—in the stock market just before it crashes.

Is this time different? Please see chart below.




Second, like now, these explosive runups 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.

Trends are important so I want to provide an update on just how overvalued the stock market is today.

## Price Earnings Ratio

This is one of the most widely used methods. Investors compare the current 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.

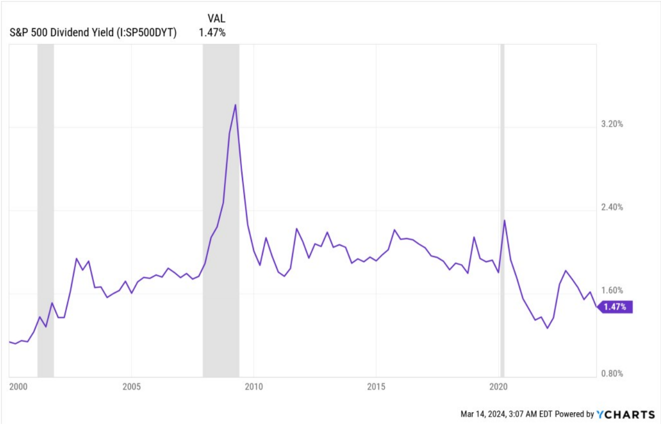
One of the first things you learn in any college Economics 101 course is that in the short term, the stock market can be influenced by almost anything. But in the long term, the stock market always reverts back to the long term directional trend of the underlying economy. Corporate earnings are one of the key elements of the directional trend of the underlying economy.

The chart below shows the current gap between the S&P 500 Index price and the P/E ratio of the S&P 500.

In the last almost 30 years, including the last three recessions, the P/E ratio of the S&P 500 Index has NEVER been so historically out of alignment with the S&P 500 Index market price.


## 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 looking at the S&P 500 Index's 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 30 years.

It is interesting to note that today, it would take a stock market drop of over -13% for the S&P 500 Index to revert to its current 200 day moving average.

I still believe there is a strong possibility the economy will go into a mild recession this year. If that is the case, historically the S&P 500 Index has gone down on average -36% in a recession.

If there is a recession, you can add the -13% above, plus the average recession drop of -36%. That means it is possible we could see a total drop from the current overvalued stock market of -49%.


## The Warren Buffett Indicator

Over the past few months, the legendary investor, Warren Buffett, has been selling stocks and raising cash. He now is holding an all-time record high of $168 billion in short-term treasuries and cash alternatives.

In recent interviews, he has stated that he believes the stock market today is massively overvalued. How does he know that?

Warren Buffett invented his own stock market indicator, commonly called the “Buffett Indicator.”

The Buffett Indicator is currently ringing alarm bells for Buffett’s investment firm, Berkshire Hathaway.

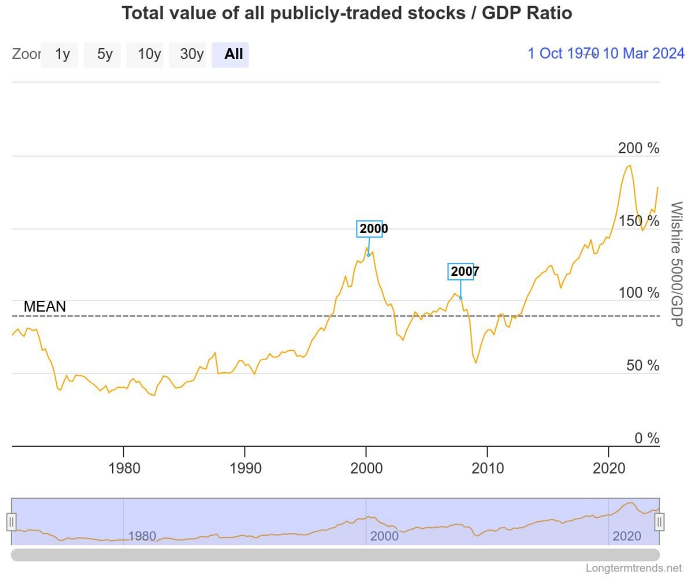
Over the years, he has said that the Buffett Indicator was "probably the best single measure of where stock market valuations stand at any given moment."

The indicator takes the 5,000 stocks in the Wiltshire 5000 Index, which is just about every stock traded in the United States, and divides it by the latest estimate of quarterly Gross Domestic Product (GDP). This gauge essentially takes the total stock market capitalization of all actively-traded U.S. stocks and divides it by the size of the U.S. national economy.

The indicator is now above every extreme reading prior to the beginnings of past recessions like 2000 and 2007.

The Indicator has historically averaged around 65%. The ratio peaked at 88.3% prior to the 1929 crash, and hit its highest reading late last year of nearly 200%. At the peak of the dot.com bubble the ratio was 140%. At the peak of the 2008-2009 Recession the ratio was 105%. Currently the ratio is 185%.

Buffett wrote in a *Fortune Magazine* article in 2001 that when the indicator soared during the dot-com bubble, it was a "very strong warning signal" of an impending stock market crash.




He suggested that stocks would be cheap at a 70% or 80% reading, and offer fair value at 100%, but it would be "playing with fire" to buy when the gauge was around where it is now at 185%.

## Gold

Gold just hit an historic all-time record high of $2,171 an ounce. Over the trailing 12 months, gold is up +20%.

Smart and sophisticated investors both here in the U.S. and abroad buy gold as a hedge against a market correction, a recession, and geo-political risk like we see in Russia-Ukraine, Israel-Gaza, China-Taiwan, U.S. elections, etc.

I believe the recent surge in gold prices is because many institutional investors believe there will be a major correction or stock market crash due to our wildly overvalued stock market and a slowing underlying economy.

## The David Rosenberg Valuation Method:

David Rosenberg is the former Chief Economist at Merrill Lynch.

He has a valuation method for the stock market that determines what the normalized forward Price Earnings Ratio (P/E) multiple is when U.S. Treasury yields are between 4.0% and 4.5%, as they are now. The current P/E ratio multiple comes out to be 16x, which means that for the S&P 500 Index to make any sense here from a value standpoint, the S&P 500 would need to see 2024 earnings per share (EPS) at $322, instead of the current consensus of ~$242.

Right now, the consensus FactSet forecast growth in 2024 S&P 500 earnings is +11%.

But if you use David Rosenberg's calculation above, the S&P 500 earnings would have to grow in 2024 by +45%. **That is NOT Going to happen!**

This is how far this bubble has gone. The stock market is basically priced for earnings growth that has only happened 3% in the past, and that percentage has generally happened when the economy was coming out of a severe recession.

This stock market has moved into the bizarrely overvalued.

## What do Jeff Bezos, Bill Gates, Mark Zuckerberg, Jamie Dimon, The Walton Family & Warren Buffet Know That We Don't Know?

With the stock market hitting all-time highs, corporate insider share sales have surged at top-performing companies.

This quarter alone, Jeff Bezos sold about $9 billion in Amazon stock and Mark Zuckerberg's net sales of Meta Platforms Inc. amounted to almost $1 billion.

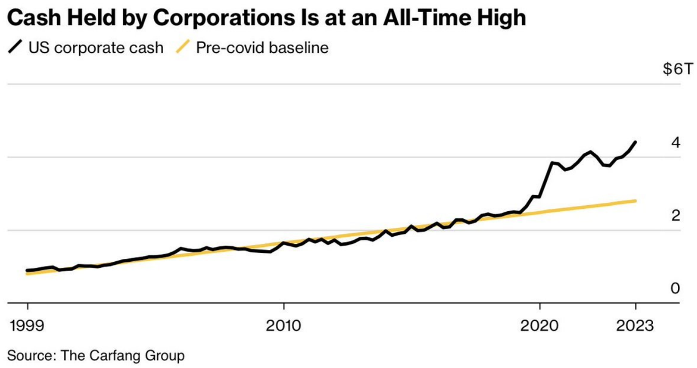
Jamie Dimon, the CEO of JP Morgan, sold $150 million of his stock in JP Morgan.

Walmart's Walton family just sold $4.5 billion of their Walmart stock.

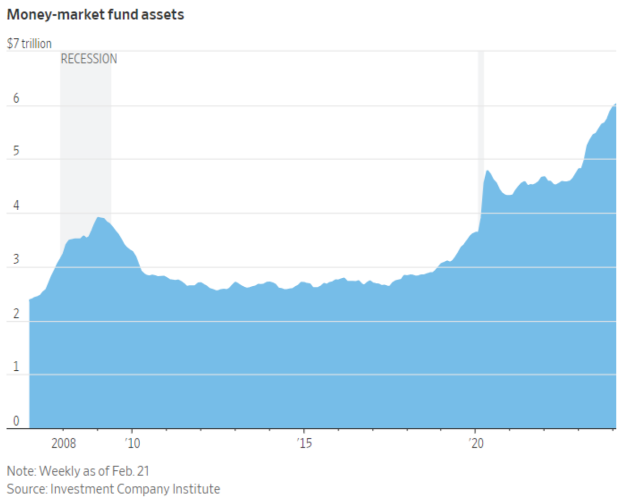
Bill Gates has also been selling billions of his Microsoft stock.

And Warren Buffett has sold stock and created a $168 billion cash hoard because he says he expects a possible recession and a major stock market correction.

Other corporations are following Buffett's example. U.S. corporations now hold $4.4 trillion in cash—an all-time high.




Other institutional investors are also heading for the hills. Total assets in money market funds have recently hit a record $6 trillion, increasing by $1.2 trillion over the past year and nearly doubling over the past five years.




When the Smart Money is selling out as the market is hitting record highs—they are telling us something.

**WHAT DO THEY KNOW THAT WE DON'T?**

NOTE: Next month, I will discuss Fed rates, inflation, unemployment, and how the U.S. economy is slowing more rapidly than is being reported. I will also 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.*