The markets have enjoyed a tremendous ride since the election. The Dow Jones Industrial Average has advanced over 2,500 points (a 15.1% total return) since then. Most of this “hope” rally has occurred on enthusiasm for anticipated pro-business policies, such as lower taxes and fewer regulations. However, even the best of rallies have an occasional pit stop where excesses are realigned. Today, we suggest stock investors approach the markets with some caution.

Do you remember the story of the Tortoise and the Hare? The Tortoise always wins. Although some pundits suggest these pro-business policies will create a “Reagan Redux”, there are key differences. When Reagan took office valuation levels were relatively cheap. Today, historical valuation methods like Shiller’s Cyclically-Adjusted Price Earnings (CAPE), Stock Market-to-GDP ratio and replacement costs (Tobin’s Q) show stock prices are expensive. While this does not suggest stock prices must decline in the short term, it does leave the market vulnerable to shocks and volatility.

Perhaps a more immediate concern is excessive optimism by institutional investors. Data from Investors Intelligence’s review of institutional commentary is one example. Recently, it presented the highest level of bullishness since 1987.

Another example of exuberance is the record level of margin debt. Margin debt is a form of leverage when investors borrow money from their brokerage firm to buy additional shares. While this can provide higher returns in a rising market, a downturn can produce margin calls and a rapid sell-off.

In addition, we note the action in U.S. equity Exchange Traded Funds (ETFs). Since Election Day, fund flows into ETFs have
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jumped by an incredible $164.4 billion. The Volatility Index (VIX), often considered a gauge of fear, is relatively low, suggesting investors are showing little restraint. Such excessive moves are often reversed, at least in the short run. Already some evidence of this is occurring. We note the cumulative advance – decline line peaked on March 1st revealing most stocks on the NYSE are now heading lower, not higher.

Market tops are renowned for their long life and can continue for weeks or even months. Risk levels are much easier to detect. As we stated in our 12 February 2017 Stock Market Commentary, “Given the high level of optimism by Wall Street and the unfavorable configuration of our leading intermediate and short term indicators, we would suggest risk levels are somewhat elevated.” Stock prices could go higher in the short term as the market may be entering a topping region. Prudence suggests investors be cautious.

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