American Heritage Financial

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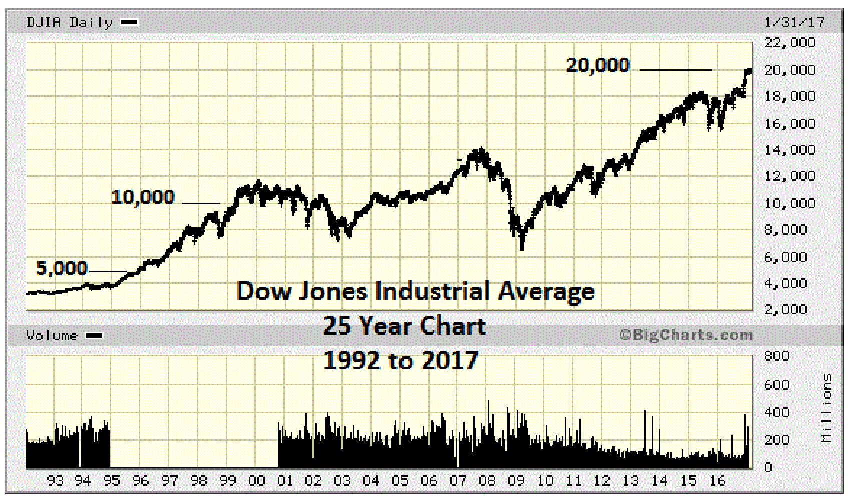
The Age of Dow 20K and Trumponomics

After teasing investors for several weeks, the Dow Jones Industrial Average finally crossed above 20,000 on January 25, 2017. While the media went into overdrive hyping the milestone, investors should be asking, ***Is this a reason to celebrate or a reason for concern?*** Overcoming this technical barrier has raised the usual questions. Is the market too expensive? Will future growth and earnings justify +20,000 on the Dow? And, if this is a Trump Rally, what comes next? Before diving into these questions, let's take a look at exactly what the Dow Jones Industrial Average (DJIA) is, what it means, and some history.



Invented by Charles Dow in 1896, the DJIA is a **price-weighted average of 30 stocks**. Originally, the index included only *industrial* companies listed on the New York Stock Exchange, but it now represents a diversified group of large companies. Because the index is price-weighted, stocks with higher share prices have a greater influence on the index. For example, Goldman Sachs (8.1% weighting) has the same impact on the index as the six lowest priced stocks combined. Or, McDonalds, at a share price of $122 has about four times the impact of GE which is $30 per share. This price-weighted methodology and 30 stock composition is in stark contrast to the market capitalization calculation of the 500 stocks in the S&P 500 Index. Yet, long term returns of both indices show amazingly similar results and both, generally, reflect the overall strength of the entire stock market and U.S. economy. It is interesting to consider the differences between these two most followed benchmarks. The Dow is definitely the most "popular" although professional investors prefer the more broadly diversified S&P 500 Index.

There have been many significant milestones for the Dow over the last quarter century, as can be seen in the accompanying chart. In November of 1995, the DJIA crossed 5,000 for the first time. It took only three years and four months to double and cross 10,000 in March of 1999. That milestone was the culmination of the technology bubble of the late 1990's when day-trading was at its peak and Alan Greenspan coined the term "irrational exuberance" in December 1996 to warn of excessive valuations. Stock prices of internet companies with no earnings doubled in weeks, not years; and stocks traded in fractions instead of cents. It has taken nearly 18 years for the DJIA to double again and reach 20,000. Our world is very different from that in the late 90's, and the stock market also is very different than it was when the DJIA crossed 10,000. (While we focused on the upward trend of the past 25 years, the chart also shows notable declines in 2000-2002 and 2007-2008.)

This leads to the questions about the valuation and justification of the current levels of the equity markets. One way to determine whether or not a stock or an index is too expensive is to look at the price to earnings ratio (P/E). The P/E ratio simply divides the stock/index price by the earnings per share. In 1999 the DJIA reached a high forward P/E of 44.2. Currently, the forward P/E is about 18. Although the P/E ratio is much lower than 1999, it is above the historical average of about 15. Stocks aren't cheap; however, strong corporate earning can justify current prices and make a case for future market growth. So far we are about one-third of the way through the Q4 2016 earnings season, and we are encouraged by the early results. Time will tell if Dow 20,000 or maybe higher is justified.

So, is Trump the reason for this rally? One's answer might depend on their political views. Many people would say "Yes." Optimism that President Trump will fulfill promises to reduce taxes, cut regulations and increase spending on infrastructure is the reason for the recent market rally. Many others would answer, "No way." The U.S. economy was already improving and the reason for the rally is the former administration's economic policies. There is actually truth to both viewpoints. The economy was gaining significant momentum before the election but there is no denying that business leaders and investors are dramatically more optimistic based on expectations of a more business friendly environment. That psychology is critical but also fragile. High expectations have been built into the current market and those expectations are becoming increasingly sensitive to reality. The progress of the economy and corporate earnings along with Federal Reserve policy will continue to affect the market. But we are in a "Trump Rally" and the market will also react to political, policy and, yes, personality news as well as economic news. Expect the market to be very sensitive to the over-hyped news cycle—unfortunately it is impossible to predict if the balance of those news events will be positive or negative for the financial markets.

Whatever the near-term may bring**, investors should expect the longer term bull market to continue;** especially because it has moved into a different phase with new leadership. A major change that has taken place over recent months is the out-performance of value and cyclical stocks relative to big growth favorites of recent years. There has also been a pick-up in smaller stocks over the big-capitalization issues. These are normal trends in a late stage bull market and an improving economy; they also fit "Trumponomics," which are expected to favor smaller, U.S. focused companies.

We don't manage assets based on short-term expectations but we think it is interesting to note that, since 1952, the S&P 500 has gained, on average, 1.6% during a president's first 100 days in office. If President Trump's next 90 days are anything like the first ten, we could be in for a wild ride! Returns might be consistent with historical returns but how we get there will be anything but normal. We have already seen significant swings in the market since the inauguration on January 20th. As more executive orders are signed and policies are discussed or implemented, the markets will react in both directions. We will use any negative market reactions to take advantage of what we feel is still an excellent long-term opportunity in stocks.

Best regards,

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Questions or comments?
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