

Thank God It's Friday!

May 18, 2007

“Bubble” is such an overused term on Wall Street these days. It was accurate when describing the **dot.com days** of the late 90's and the real estate frenzy of late. [We refer you below to two great reads on bubble phenomena.](#)

With stocks closing today at a 7-year high, it's time to pose the question: Will the stock market of 2007 join the bubble club and burst? It probably SHOULD over the short term but WON'T over the long term. Stocks are absolutely due for an overdue correction..... How do we know this? The economy tells us so! Gas prices at the pump tell us so. Geopolitical tensions tell us so. Stock market history tells us so. The bond market tells us so.

In Spring of year 2000, the S&P-500 Index topped-out at 1527 trading at **32 times its earnings**. That is twice the historical average, which is 16. Two years later, it bottomed out at 850. Fast forward to today when the S&P- 500 Index has once again eclipsed 1500, and has reached the pre-bubble highs reached 7 years ago. The difference this time is that the S&P is trading at **17 times its earnings**. That's no bubble as long as these earnings are solid. Companies buying-back their own shares to inflate their earnings-per-share may be fooling us that earnings only APPEAR to be trading at a historically reasonable Price/Earnings multiple.

To avoid being caught off-guard by a bubble burst, we use technical indicators to measure **investor sentiment which is a contrary indicator**. Chart reading is an integral part of our decision-making process in our basic approach to the stock market. Today, we are observing a sense of euphoria in certain areas which translates to a sign for a short-term correction to be heading our way. Historically, we should experience a 3 to 5% correction which should lead us into a Summer Rally in stocks.....unless.....the other shoe drops in Iran or Nigeria or Iraq. Skyrocketing energy prices tell us that geopolitical risk is code-red.

**The bottom line is the disconnect we see between soaring stocks and a sinking economy.** There is no doubt the US economy has been slowing while stocks are growing. They are clearly out of sync. We anticipate this near-term decoupling could lead to a correction of US stock prices which in our global marketplace would pre-curse a correction worldwide. A sell off in Asia like we saw in February would negatively impact the US markets again. And vice versa! The good news to this realistic scenario is that a stock market correction would shakeout these excesses and could very well set the table for a continuation of the bull market. That's no bubble!

By: Mike Frazier and Jude Bedell

References:

1. Mackay's *Extraordinary Popular Delusions & the Madness of Crowds*
2. John Kenneth Galbraith's *A Short History of Financial Euphoria*

INDEX	05.18.2007	12.31.2006	%Change
DOW JONES	13,556	12,463	+8.7%
S&P 500	1,522	1,418	+7.3%
NASDAQ	2,558	2,415	+5.9%
Bond YIELD	4.80%	4.71%	+1.9%*

Bond Prices  Bond Yield % 