TRANSITIONS

IS TIME ON OUR SIDE?

Judging from the increased pedestrian foot traffic, warm spring breeze, flowering trees, the reopening of restaurants and entertainment venues to pre-pandemic levels, spring breathes anticipation of enthusiasm, hopefulness, and hints of some semblance of normalcy as we once knew it. For many, life is starting to look and feel normal again. What a difference a year can make.

Commensurate with a brightened economic and market outlook, equity markets continue to rally, and most indices are at or near all-time highs. Valuations have remained elevated despite rising interest rates as both investors and analysts are very optimistic about the strength and trajectory of our global economic recovery. Could the strong bull market performance that we have seen over the last several months seemingly mean a continuation of these positive trends or are we headed for the next stock market apocalypse? Reminiscent of the catchy theme song by Mick Jagger of *The Rolling Stones*, "Time Is on My Side," Is time on our side?... Or are we running out of time?

When determining whether the stock market is overvalued or not and to fully understand if the market is heading on the right trajectory, it is important to use a valuation metric. Some are arguing that the stock market is eerily expensive. As a proxy for the market, if we use the S&P 500 Index Price-to-Sales ratio (P/S) or the Price-to-Earnings ratio (P/E), both metrics are near historic highs. The S&P 500 closed at near all-times highs in January, around 3,800 and closed mid-May around 4,100. We use the P/E of one stock relative to another to help determine which company might be overvalued or undervalued. This is defined as the ratio between a current share price and per-share earnings using reported earnings for the trailing twelve months. A higher P/E means that we are paying more for each unit of net income, making it more expensive to purchase than a stock with a lower P/E. Historically, lower P/E stocks tend to provide higher returns than higher P/E stocks.

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Sheila Morgan, AAMS®
PORTFOLIO MANAGER

DIAMANT
ASSET MANAGEMENT

440 Main Street, Suite 201
Ridgefield, CT 06877
(203) 661-6410

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Why is this important? History suggests that when valuations are this high, future forward returns are a lot lower. Based on the current metrics for example, the market is relatively expensive, but it is not as expensive as we once thought. The ratio can be calculated in two ways, either forward or trailing. The trailing P/E uses a company's historical earnings data, while the forward P/E uses an estimate of future earnings, based on a consensus earnings forecast for the projected 12 months. The disconnect we have found is many use the trailing twelve months earnings in their calculations. Last year's earnings were horrendous. We were in the midst of a catastrophic and deadly pandemic that the world has never seen the likes of since the 1918 Influenza Pandemic. A better metric to value a stock is the forward earnings ratio. In our opinion, we believe this calculation serves more useful.

Reminiscent of the catchy theme song by Mick Jagger of The Rolling Stones, "Time Is on My Side," Is time on our side?... Or are we running out of time?

The lingering chorus of "Time Is on My Side," dawdles in my ear. The answer is Yes, time is on our side. Life will get back to normal and this is the truth of the stock market today. Life and corporate earnings should be back to normal in 2022 or 2023. High valuations and highly uncertain economic conditions likely suggest caution, but not panic. Markets are trading near all-time highs, particularly as the economy bounces back, as it seems to be expected by today's relative prices. The combination of improvements on the vaccination front has also led the economy to a 6.4% increase in GDP growth during the first quarter of 2021. Yes, it normal to see headlines concerning today's lofty valuations and there are certainly frothy speculations in corners of the market. But as wise investors and prudent advisors, we understand that history has shown us that equity markets are cyclical. We will continue to be faced with many types of risk and uncertainty. We believe a well-diversified portfolio can help mitigate the effects of any unanticipated risks we may face in the near future.

Visit our Resource Center for more market commentary and insights.

Written by: **Sheila Morgan, AAMS®**, Portfolio Manager
Please feel free to contact us with any questions or comments at **(203) 661-6410** or email Sheila directly at **sheila@portfolioadvisor.com**

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