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Would you accept an 80% chance to earn 10% on your money if there were a 20% chance of losing 40%? Such percentages may or may not be precisely descriptive of the current situation in the equity market, but they frame the dilemma today's investors face.

As we have discussed frequently over the past year, stocks are extremely overvalued by traditional measures of valuation. In fact, a composite of the most commonly employed measures of value show today's stocks more overpriced than ever before but for the period of the dot.com mania. Should stocks suddenly revert to historically normal valuation levels, prices would plummet. On the other hand, our Fed and the world's other major central bankers have resolutely prevented any significant stock or bond market decline for the past eight years. As long as investors stay confident that central bankers will remain both willing and able to support securities prices, investors accepting equity market risk can continue to profit.

What happens to equities is extremely important, because other asset classes have been non-productive for years and likely will remain so over the near-term. While the Fed has begun to "normalize" its monetary policy by very tentatively raising short-term interest rates, risk-free investments still offer almost nothing. Because central bankers have aggressively poured newly created money into longer maturity fixed income securities, those yields have been suppressed for years. Nonetheless, interest rates have been rising, albeit slowly. Since interest rates bottomed in July 2012, the ten-year U.S. Treasury yield has risen from 1.39% to 2.30% at quarter-end. Total returns on such holdings have been barely 1% per year for almost five years. With the Fed and most analysts forecasting higher rates, returns on existing fixed income securities are likely to be minimal over the next several years as well.

We have long maintained that today's investors are faced with making a "bet". Will stock prices revert to their traditional valuation means, which they have always ultimately done, or will the Fed and other world central bankers continue to prevent significant declines in stock and bond prices, a task they have executed most effectively for the for the past eight years?

Investors who stay abreast of financial news and opinion have frequently heard analysts justify their forecasts of continuing price gains by pointing out that the economy is good, that corporate profits are growing nicely and that valuations are reasonable. Not one of these points is accurate.

The economy is growing, but very slowly. Despite more monetary stimulus than ever before, the domestic and world economies are slogging through the slowest recovery from recession in modern times. While there are intermittent spurts of growth in one economic segment or another, domestic and world economic growth is significantly below its historic norm. Notwithstanding optimistic consumer and investor sentiment, the International Monetary Fund, the Organization for Economic Cooperation and Development and the Federal Open Market Committee are forecasting minimal economic growth over the next few years. The majority of forecasters expect long-term U.S. growth to fall just above or below 2%--far below typical past levels.

The Bank for International Settlements has recently voiced serious concerns about downside risks. In the Bank's 2017 Annual Report, head of the Monetary and Economic Department, Claudio Borio said: "[T]he risky trinity are still with us: unusually low productivity growth, unusually high debt, and unusually narrow room for policy maneuver." Also "Leading indicators of financial distress point to financial booms that in a number of economies look qualitatively similar to those that preceded the Great Financial Crisis."

Corporate profits of domestic companies showed significant growth in 2017's first quarter on a year-over-year basis, largely because profits in the first quarter of 2016 were so heavily penalized by severe losses at major oil companies. Financial engineering has also magnified the appearance of corporate profits. Because companies are having a very difficult time finding attractive projects for which to make capital expenditures, they have borrowed heavily to buy back huge amounts of their outstanding shares. Reducing the number of shares outstanding has the effect of boosting earnings per share despite the overall level of company profits remaining constant. Since 2009, earnings per share have grown by 221% with corporate revenues up a mere 28%. And despite significant earnings per share growth, total corporate profits in 2016 were the same as in 2011. Over that same period of time, the S&P 500 rose by 87%. All is not what it seems.

Securities analysts and strategists have a habit of picking and choosing data that justify their almost always bullish conclusions. While almost no one contends that stocks are cheap, most commentators skip over discussions of valuation with a kind of off-handed remark that stocks are reasonably priced. The reality is that they remain screamingly overvalued. As mentioned earlier, by a composite of the most commonly employed measures of value, they are more overvalued than ever before but for the period immediately surrounding the dot.com mania. From lower levels of overvaluation, stocks declined by 89% from the peak in 1929, 45% from 1973 and 57% from 2007. From the peak of the dot.com bubble in early 2000, stocks fell 50% and, after a recovery and an even bigger decline, were 57% lower nine years later. Prices were back to 1996 levels, having erased 13 years of price change. From even lower levels of overvaluation, there are no examples of investors permanently escaping severe declines taking prices back to historically normal valuations.

Compounding the problems of a sluggish economy, moderate (at best) corporate profit growth and severe overvaluation is the unprecedented overindebtedness throughout most of the world. While economies and securities markets don't fall simply because they are over-leveraged, that condition creates the environment in which even relatively small disturbances can quickly devolve into crises. We are currently on shaky ground.

Standing in the way of apocalyptic consequences is our Federal Reserve Board and other major central banks which have assumed as a mandate the prevention of anything more than minor price dips in either stock or bond markets. With monetary printing presses rolling more industriously than ever before over the past eight-plus years, they have warded off even normal price corrections, much less bear markets.

So confident are investors that central bankers will continue that support, they buy every dip. If that confidence remains strong, there is no upside limit to the current rally. Should that confidence wane, however, prices could seek more historically normal levels very quickly. By way of illustrating the danger, imagine all central banks suddenly pledging no more support in any form for stock and bond prices. The rush for the exits would be breathtaking, and exit doors would prove far too small. We could be faced with market holidays, as in 1914 or 1933. While central bankers are not going to suddenly swear off all support for markets, the level of investor complacency is unjustified in an environment of economic and monetary uncertainty and great geopolitical instability.

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