



Investor Beware: Are Markets Overvalued or Are Higher Multiples “The New Normal”?

Description

The stock market [hasn't looked back](#) since bottoming out last March. Valuations across the board have seemed to surge to the higher end of the spectrum. While some folks may think that we're long overdue for a “terrible market crash,” I've argued that it's a losing proposition to attempt to time the markets given the possibility that above-average valuations could continue to be the new normal in this pandemic-plagued environment.

In a prior piece, I raised the likelihood that valuations weren't as exorbitant as they seemed, and the stock market wasn't as expensive as most made it out to be given the macro backdrop. That's not to say there aren't any bubbles floating around out there, though. The pockets of severe overvaluation have become even more pronounced in recent months, as the appetite for speculative momentum investments has continued to pick up.

A re-valuation to the upside!

Take **BlackBerry** ([TSX:BB](#))([NYSE:BB](#)) stock, which recently skyrocketed over 300% in a matter of months, jumping from \$5 and change in early-November to nearly \$24, where the stock currently sits today. While I don't view BlackBerry as a bubble, given its valuation remains relatively depressed, such a frenzy in the stock seems to have some thinking that the entire market is in a bubble, as it was in the lead-up to the dot-com bust that hit many retail investors over 20 years ago.

Given valuations have swollen across the board, especially in the tech sector, many investors appear more willing to forget about evaluating companies and are ready to pay Mr. Market whatever price he calls for at any given time. While valuations in some of the “sexier” names like BlackBerry may have gotten out of control, it's a stretch to conclude that this market is overvalued and ripe for a correction.

BlackBerry initially soared on wonderful news, then slightly less exciting news, and now it's continuing to soar on no news. And executives are scratching their heads. While BB stock may seem like it's entering bubble territory, I'd like to consider the possibility that BlackBerry shares are facing a

sustained re-valuation to the upside after hibernating for many years.

Is the stock market due for a correction?

Many [“sexy” stocks](#) that have more than tripled in a matter of months may be dealt an unforgiving correction over the near- to medium-term. But such a correction, I believe, will mostly be isolated and will not stand to drag the entire stock market into the abyss. Just as there are pockets of overvaluation, there are also pockets of severe undervaluation. In this divided market, such extremes, I believe, have just become more pronounced.

Valuation always matters. And while I think it is justifiable to pay multiples for wonderful businesses on the higher end of the valuation spectrum, I would encourage investors to continue evaluating companies on a relative basis if certain valuation metrics are skewed heavily toward the higher end of the historical range.

The “earnings” in the price-to-earnings (P/E) multiple has been impacted by the COVID-19 crisis. Yet, in many instances, the “price” has recovered ahead of the economic recovery that many see in the latter half of 2021. Once the environment normalizes, hard-hit firms are likely to see earnings normalize, and P/E ratios could stand to compress.

Foolish takeaway

When you consider the unrewarding nature of fixed-income securities, however, I ultimately suspect that P/E ratios will remain a tad on the higher end, even after the pandemic falls into the rear-view mirror. As you’ve probably heard before, stocks may be the only game in town with rates at the floor.

As such, I’d continue to urge investors to not give up on valuing companies just because 2020 was a year that profoundly rewarded momentum investors for ignoring value.

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