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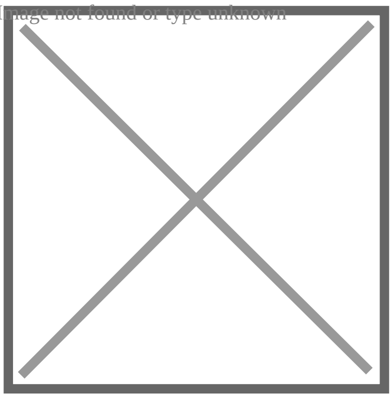

Warren Buffett’s Top Indicator Is Flashing RED: Don’t Panic

Description

Warren Buffett is one of the greatest investors of our time. Whenever the man speaks, it can pay to be all ears, and whenever the man acts, you can bet that his disciples will follow in his footsteps. But what about when the Oracle of Omaha’s favourite indicator is flashing red? Should you run to the hills, as others are greedy? Or should Warren Buffett’s greed indicator act as a supplement to your analysis?

Before you panic and think about hitting the “sell” button with your portfolio, it’s important to remember that Warren Buffett is not going to take on an extreme stance, regardless of what his favourite indicator says.

As such, it’s wise to treat the indicator as more of a market thermometre rather than a crystal ball that’ll reveal when the stock market will crash and how painful it’s going to be.

Warren Buffett isn’t panicking yet: Neither should you

The market cap of the U.S. stock market is currently sitting at 195% of America’s GDP (gross domestic product). That’s nothing short of alarming, but the indicator itself, I believe, doesn’t tell the full story.

We’re currently navigating through one of the worst crises in recent memory. The COVID-19 pandemic has weighed heavily on the world economy, applying pressure to national GDP numbers and corporate earnings. The stock market has recovered in a V-shaped fashion, and investors expect an abrupt recovery that could rival that of recoveries from past recessions. Once COVID-19 is conquered, people expect things to return to normal, or at the very least some form of normal.

Some industries have been hit harder than others. Some may take longer to recover, and others, like **Shopify**, have actually benefited from the crisis. As vaccines continue to be rolled out, the end of the pandemic will get closer and closer.

Eventually, the weight will be lifted off the shoulders of industries most affected, and we could be at the start of the so-called roaring 20s that could see consumers make up for lost time, as consumer sentiment and employment both look to bounce back in a big way. With an accommodative U.S.

Federal Reserve and unprecedented stimulus, there's no question that the recovery could overshoot. And if that's the case, you should expect Warren Buffett's greed indicator to face a considerable amount of compression, assuming all else the same.

Higher stock valuations are justified

Fellow Fool contributor Chris MacDonald noted in his prior piece that stocks have never been this richly valued, not even during the lead-up to the dot-com bubble bust. While true, I don't think investors should be running to the hills in anticipation of another such market crash.

While bubbles are floating around there (think EV stocks like **Tesla** and cryptocurrencies like Bitcoin), I ultimately think that a correction in such overvalued areas of the market will largely be isolated. With the right context, the "flashing red" Warren Buffett indicator, I believe, is nothing to panic about.

Many experts have argued that higher valuations are warranted given the "lower-for-longer" rate environment we find ourselves in and how unrewarding bonds have become. Others argue that we're long overdue for a correction. The tug-of-war will likely continue, as the markets continue roaring higher over the next 18 months. A garden-variety correction can be expected, but ultimately, I don't think you need to hit the panic button over the market froth, at least not yet.

Time to play defence like Warren Buffett?

MacDonald recommends playing defence like Warren Buffett himself, with gold miners like **Barrick Gold**. While I am a huge fan of allocating at least 5-10% of your portfolio to precious metals, I wouldn't make any rash decisions solely because of the overheated Warren Buffett indicator, as it doesn't suggest a market crash is nigh.

So, don't sell everything to up your stake in either gold or Bitcoin. Stay the course with your investments and insist on wide margins of safety. And remember, context is everything when it comes to economic indicators.

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