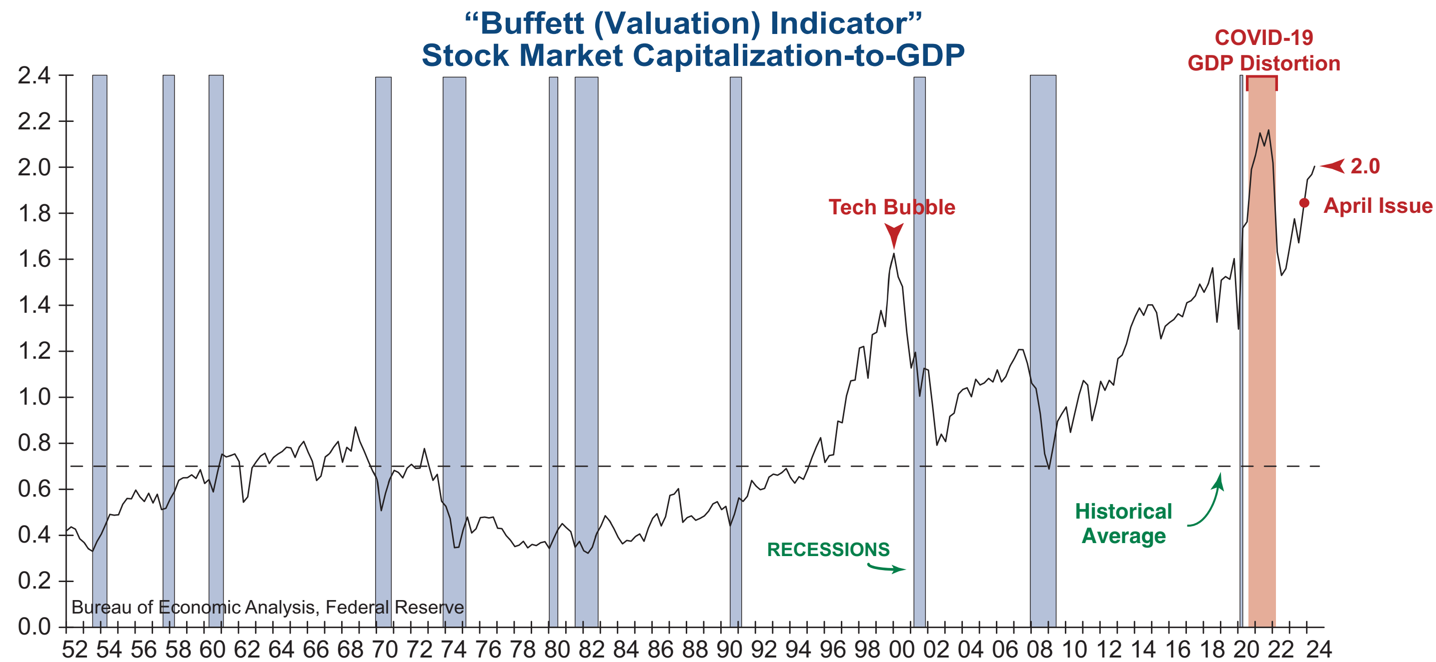
Extreme Market Valuations – Too Big to Ignore

"A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful." **– Warren Buffett**

Warren Buffett's sage advice offers timeless guidance. Bull markets that incite investor frenzy can drive stocks to extremes that are supported merely by hype and the promise of future gains. When this occurs, prices become disconnected from fundamentals, which creates an overvalued and dangerous environment.

Today's stock market is trading at one of the most expensive levels in history, posing a considerable challenge for safety-first investors. While overvaluation does not cause bear markets, there are significant implications for long-term portfolio health. When stock prices become so detached from fundamentals, they can fall just as rapidly as they rose and the potential downside risk increases dramatically.

The Stock Market Capitalization-to-GDP ratio, often referred to as the Buffett Indicator, serves as a crucial measure of whether stock prices align with economic fundamentals. Buffett himself has praised this ratio as the "best single measure" of valuation at any given time. A ratio above 1.0 signals overvaluation. Today, this ratio sits at a staggering 2.0, up from 1.8 in April and one of the highest readings in history. This means that the stock market is trading at twice the level of the economy's total output, a clear indication that prices are detached from economic reality.



To put this into perspective, a significant market correction would be required to bring valuations back in line with historic norms. The current figure suggests that a drop of over -60% may be necessary to get close to long-term average valuations, which underscores today's extreme risk.

While the Buffett Indicator is just one valuation measure, the stock market is expensive today no matter how you slice it. As shown in the table at right, the potential risk has seldom been higher than it is right now. Whether you look at the Price-to-Sales, Price-to-Earnings, or Shiller Price-to-Earnings ratios, the story remains the same – all are in the top 6% of valuation extremes.

Stock Market Valuation Metrics

Valuation Indicator	Current Value	Historical Average	Percentile
Buffett Indicator* *(1925 – curr.)*	2.0	0.7	99th
Price-to-Sales *(1990 – curr.)*	3.0	1.6	100th
Price-to-Earnings *(1928 – curr.)*	28.5	17.6	94th
Shiller Price-to-Earnings *(1920 – curr.)*	35.2	18.2	96th

*Stock Market Capitalization-to-GDP

Regardless of the economic scenario you are betting on –a hard or soft landing– don't lose sight of the elevated risk surrounding today's record-breaking stock market valuations. In fact, the upside may be limited even in the best economic outcome, and if an unexpected recession occurs, inflated valuations could lead to sharp declines and the results would be devastating.