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The Dow Jones Industrial Average (the Dow, for short) recently closed above the 20,000 level for the first time in history. You probably heard about it, mostly because the crossing of a milestone number like 20,000 gets a lot of press. The close above 20,000 has been accompanied by record high closes for two other well-known indexes, the S&P 500 Index and the NASDAQ Composite Index. These three indexes represent the bulk of the U.S. stock market, and many companies appear on both the NASDAQ and S&P 500. The Dow is more focused, being limited to 30 blue-chip companies.

Having all three close at record highs together is significant. While the Dow and the S&P 500 have often closed at records together, it has been more than 15 years since the NASDAQ has been part of this record effort. The NASDAQ closed at an extraordinarily high level in March of 2000, and the ensuing collapse of the dot-com bubble of the late 1990's took nearly 80% out of the value of that index. Most of the companies in the 2000 version of the NASDAQ index were nascent technology companies (this is still true today), but the values of those companies were in the stratosphere, and they have largely disappeared from the scene through bankruptcy. A few survived to become giants of the tech world, and there are many smaller tech companies in the NASDAQ that didn't even exist in 2000.

When the markets reach all-time highs, many people think about whether stocks are overvalued. This sentiment is common today mostly because we remember how we didn't pay attention to values in the late 1990s, when stock buyers were really speculating rather than investing. This psychological phenomenon of "recency bias" ensures that we think about value now, having been burned in the recent past. One can call it fighting the last war. After the Dow closed above 20,000, the press was full of articles about valuations being stretched, and how the underpinnings of this rally might be a little thin.

The price to earnings, or P/E ratio comes into play in our look at valuations. It is a tricky subject, because there are almost as many ways of calculating the market's P/E ratio as there are analysts writing on the subject. One method will show a very high valuation, and naturally analysts who believe in that method will sound the alarm bells. Another method may show a more reasonable number, and that might produce cautious optimism. I personally rely on a P/E calculated by someone whose judgment I trust.

Regardless of how you calculate the P/E valuation of the market, P/E ratios have been consistently higher since 1987 than they were from the end of World War II up to that point. Values of stocks are partly related to the values of competing investments. If a long-term bond is yielding 5%, investors will pay a certain premium (let's call it "x") for stocks that have the promise of a higher return. If the yield on that same bond drops to 3%, the stock buyer will now be willing to pay "x+", or a higher premium for stocks. Bond yields have been declining since the early 1980s, so (as the theory goes), stocks will be worth more to investors.

Inflation has a large role in this. The early 1980s was marked by Federal Reserve Chairman Paul Volcker's efforts to wring inflation (and expectations of inflation, which are just as important) out of our economy. Mr. Volcker succeeded, and interest rates declined along with inflation.

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Since the November election, investors have been making bets on whether inflation will be increasing in the near future. Our new President campaigned on boosting the economy through improvements in the business climate and spending on infrastructure, and the hotter economy that could develop might spark a bout of inflation as well. Trade protectionism could also add to inflation, as high import tariffs would relieve the downward pressure on the prices of goods made here.

While the jury is still out on what Mr. Trump's actions will do to the economy, we are still looking at the economy as it is today, not what we hope (or fear) it will look like. The 2016 3rd quarter GDP growth rate was reported at 3.5%, a number that made many think the economy might already be on the way up. Not so fast, said the economy, as the 4th quarter GDP growth rate came in at 1.9%, in line with what we have been seeing for the past several years.

Today's jobs report is also contributing to the notion that the economy is OK but isn't really heating up yet. The economy added 227,000 jobs, well above expectations, but the unemployment rate rose 0.1% to 4.8%. The report also confirmed that wages are rising at a lower rate than we would expect if we were truly at full employment. The greater number of jobs added combined with the bump up in the unemployment rate suggests that previously discouraged job seekers are returning to the market, which tends to keep wages from rising. If this trend continues, slower wage growth should keep inflation in check. One observer called today's jobs report a "goldilocks" report suggesting the economy still has room to grow. The Federal Reserve is undoubtedly paying lots of attention, as this could affect decisions on interest rates. In December, the Fed penciled in three 0.25% increases for 2017, but the press release from this week's Fed meeting didn't even mention rate increases.

Sentiment is important in the investing world, and growth with low inflation may mean that we are still willing to pay up for stocks. We saw the alternative in the 1970s, when inflation rose, growth slowed and stocks suffered through a lost decade. Investors became so bearish that BusinessWeek had a cover story in August 1979 titled "The Death Of Equities". The article talked about how stocks were doing so poorly that we may as well invest in other things, like diamonds and artwork. Fortunately for us, the article was wrong about many things, including future inflation. When that BusinessWeek hit our mailboxes in 1979, Paul Volcker had been Chairman of the Federal Reserve for exactly one week, and his historic fight to corral inflation was just around the corner.

Pessimism is often a contrarian indicator, and we see examples of this throughout the market's history. Perhaps the current handwringing over the future of our economy and stocks is just that, and no more. As usual, only time will tell. My Magic 8 ball is refusing to say anything.

Thomas E. Dexter, CFP®

All indices are unmanaged and are not illustrative of any particular investment.
The Dow Jones Industrial Average is a price-weighted index of 30 actively traded blue-chip stocks.
The NASDAQ Composite Index is an unmanaged, market-weighted index of all over-the-counter common stocks traded on the National Association of Securities Dealers Automated Quotation System.
The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.

It is not possible to invest directly in an index.