Why Today's Stock Market Looks Dangerously Overvalued

After the S&P 500 surged past 7,000 in January 2026, many investors are feeling optimistic. But as an advisor, I'm concerned. The data suggests we're in rare territory — the kind that has historically preceded long, painful periods for stocks.

1. **The Shiller CAPE Ratio Is Flashing Red**

The cyclically adjusted price-to-earnings ratio, or Shiller CAPE, smooths out 10 years of inflation-adjusted earnings to gauge long-term valuation. Right now, it sits around **40.5**, more than **double the 155-year average of 16-18**.
This has only happened once before: December 1999, at the peak of the dot-com bubble. What followed was a "lost decade" — from Dec 1999 to Dec 2009, the S&P 500 delivered **-0.9% annualized total return**.
As of late 2025, the CAPE hit 40.46, just below its dot-com high of 44.19. History shows that when the CAPE tops 30, **all five prior instances since 1871 were followed by 20%+ declines** in the S&P 500. If it reverts just to 27 — the highest level any bear market has ended at — the index would need to fall roughly one-third from current levels.

2. **P/E10 Data Confirms the Overvaluation**

Monthly valuation updates continue to conclude that "**US stock indexes are significantly overvalued**". The P/E10 average since 1881 is **17.7**, yet current levels are far above that benchmark. The tech bubble period of 1997-2002 was arbitrarily defined as P/E10 > 25 — we're well past that now.

3. **Forward Returns Look Grim**

A high starting valuation is strongly correlated with poor future returns. Analysis cited by Invesco shows that at current CAPE levels, investors should expect **flat to slightly negative annualized returns over the next 10 years**. Another study notes that annualized returns over the next decade could be negative.

4. **Investor Psychology vs. Reality**

The market's elevated valuation reflects optimism around AI and strong corporate earnings. But CAPE strips out short-term noise. When investors pay 40x for 10-year average earnings, history says they're pricing in perfection — and perfection is hard to sustain.

What This Means for Canadian Investors

1. **Risk of Capital Loss**: If we follow the 2000-2009 playbook, a buy-and-hold approach could mean a decade of going nowhere, or worse.

1. **Currency Risk**: Canadians investing in U.S. markets also face CAD/USD swings. A market decline + CAD appreciation would double the pain.

1. **Opportunity Cost**: With GICs and bonds yielding 2.5%+ in Canada today, the "equity risk premium" — the extra return you demand for owning stocks — is getting thin.

1. **Sequence Risk**: For clients nearing retirement, a protracted drawdown early in retirement can permanently impair portfolios.

My Approach Right Now

I'm not saying, "sell everything." But I am:

- **Reducing equity exposure** for conservative/retirement clients
- **Raising quality**: favouring companies with strong balance sheets, pricing power, and dividends
- **Adding defense**: increasing allocations to short-term bonds, GICs, and alternative assets less correlated to stocks
- **Staying global**: Canada's TSX has a different sector mix and often lower valuations than the S&P 500
- **Dollar-cost averaging out**: taking profits systematically rather than trying to time a top

Markets can stay irrational longer than you can stay solvent. But when a valuation metric that's only been this high once in 155 years is flashing, prudence isn't pessimism — it's discipline.

Disclosures: This is my opinion as of May 12, 2026. Investing involves risk.

Sincerely,
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