—New Albany—
Investment Management

October 26, 2016

Market Insight: When the Fog Clears…

October often brings volatility back to the market as the convergence of new economic data and surprising earnings reports give investors their cue for the expected trajectory of the market for the rest of the year and the first quarter of next year. This time however, the markets have been in a drowsy slumber and have remained in a tight trading range since mid-August. Investors appear indifferent (or perhaps grown numb) to the current state of affairs. Visceral political messages and vacillating Central Bank rhetoric have only brought more uncertainty and created a cloudy investing environment. Though the stagnate climate may remain through the election, eventually the fog will clear and the markets will once again take direction from the fundamentals. Economic growth, interest rate policy, and the prospects of future earnings growth will be key drivers.

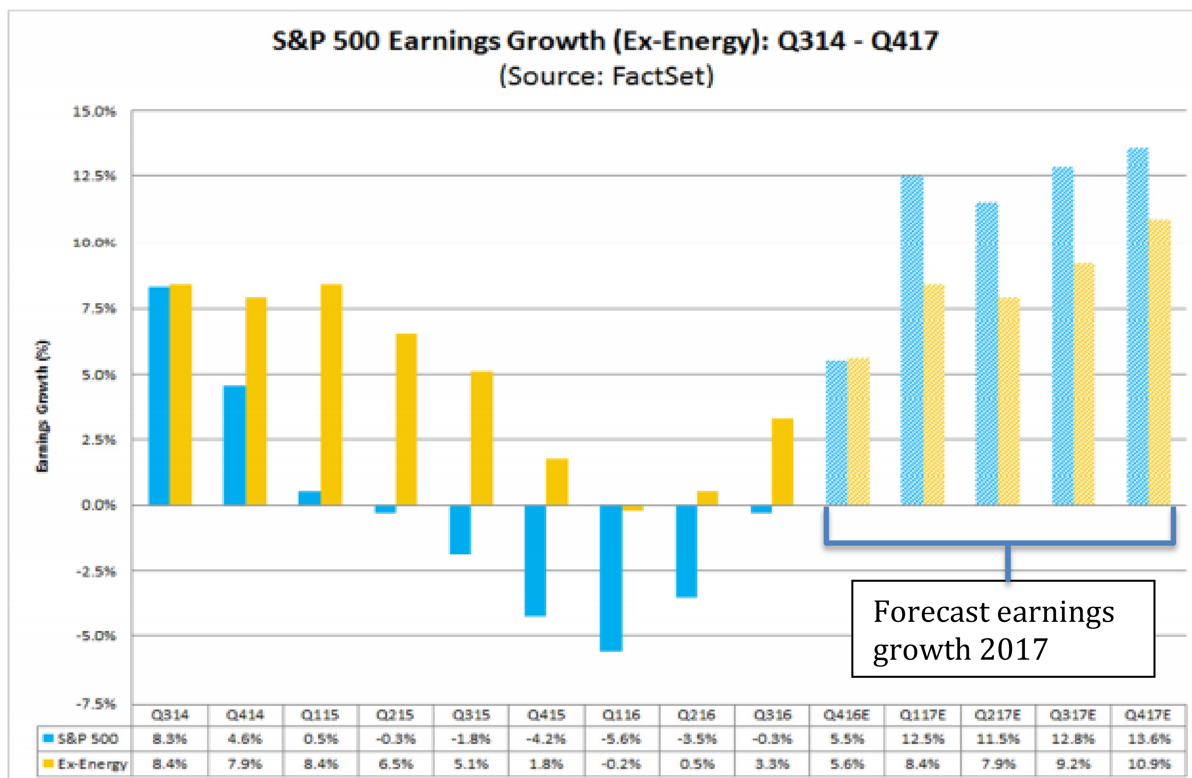
As investors, our time horizon is much beyond this year or even next. Hence understanding the long term fundamentals is essential to preserving and growing wealth. The analysis below takes a look these fundamentals:

Economic Growth: **Solid but slow.** According to Forbes, "the U.S. economy will enjoy a mild cyclical rebound in 2017 (up from 1.7% in 2016) then return to a lower growth rate and more in line with long-term potential." Goldman Sachs concurs with this view. They see "pressingly low growth of roughly 2% through 2019." (This is nearly half of what was experienced up until 2008 where growth was 3.5-4 %.) **So the good news is that growth appears fairly solid at or around 2%; the concern is that the labor market is tightening, productivity is falling, and inflation is creeping higher.**

Some economist have labeled the current economic environment as 'stagflationary'. Stagflation is a condition in which costs are rising but growth is not, and was last experienced during 1970s. Back then, inflation was significantly higher and mainly driven by rising oil prices. Today, inflation is creeping back, and is now near the Fed's target of 2% as measured by CPI. However, items such as shelter (rent/home prices) and healthcare are rising much faster. At some point, the Fed will have to respond with higher rates which will be a new paradigm for the markets. Additionally, if oil prices were to begin a rapid accent, it would have a significant impact on consumption. Rising prices (of commodities or cost of money) can be a significant headwind for earnings and the stock prices down the road.

Earnings: **Warning Ahead!** For the last 18months**,** the S&P 500 has experienced an 'earnings recession', where earnings growth has declined. Much of the decline can be attributed to the sharp drop in energy prices. However, even without the energy sector, earnings growth for the remaining S&P companies has been declining. Yet investors seemed to have dismissed this fact and instead are pinning their hopes on a recovery in 2017. This mindset has created a floor for stock prices.

The chart below shows the earnings growth of the S&P in total (Blue bar) and ex-energy (yellow bar) and how it has been declining since late 4Q14. **Also of note is the significant rise in forecasted of earnings for 2017 of over 12%!** <u>This raises a warning flag that current the current level of stock prices is dependent upon significant improvement in earnings for next year.</u>

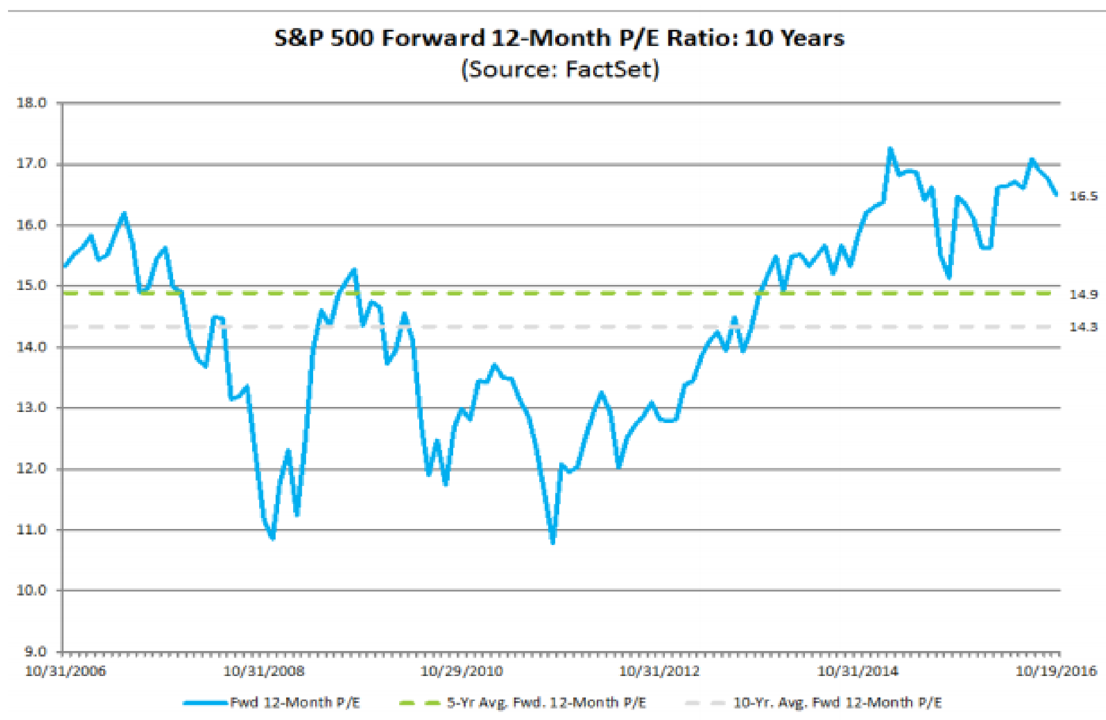


	Q314	Q414	Q115	Q215	Q315	Q415	Q116	Q216	Q316	Q416E	Q117E	Q217E	Q317E	Q417E
S&P 500	8.3%	4.6%	0.5%	-0.3%	-1.8%	-4.2%	-5.6%	-3.5%	-0.3%	5.5%	12.5%	11.5%	12.8%	13.6%
Ex-Energy	8.4%	7.9%	8.4%	6.5%	5.1%	1.8%	-0.2%	0.5%	3.3%	5.6%	8.4%	7.9%	9.2%	10.9%

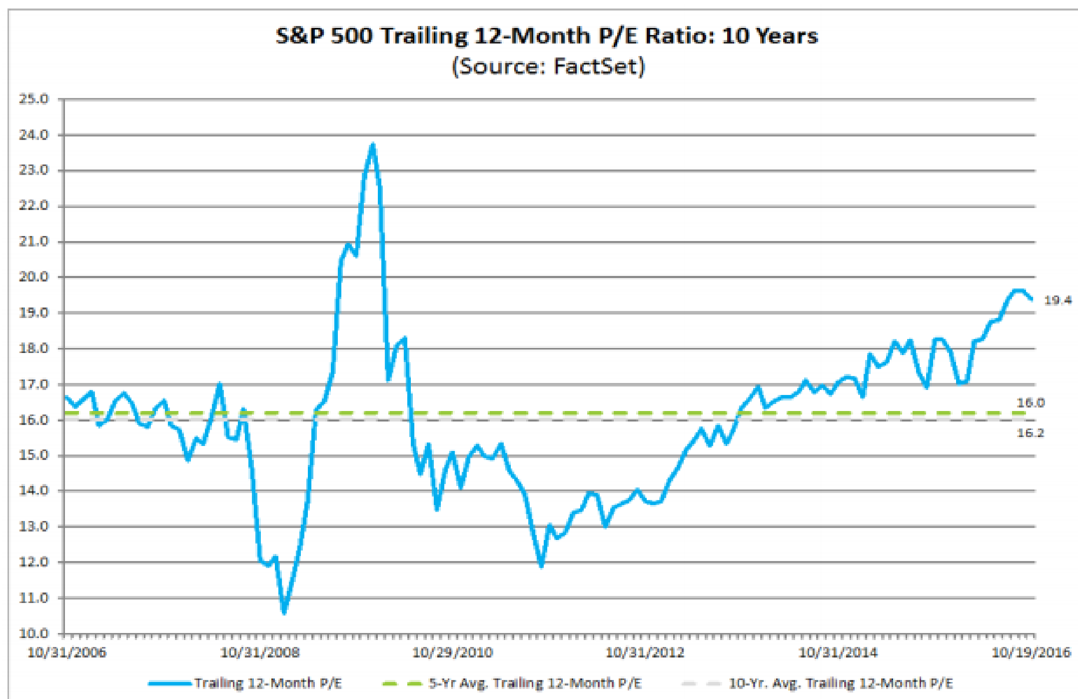
As year-end has approached, however, some strategist have begun to revise down their expectation of growth, saying the 12%-13% earnings growth for 2017 is somewhere between "irrationally exuberant" and "grossly enthusiastic." Indeed, Goldman Sachs analyst have cut their forecast for earnings growth through 2018 due to what they see as secular stagnation. They <u>expect profit margins to be pressured *by 'limited pricing power, rising labor costs, and falling margins*</u> *in the IT sector." The stock prices typically reflect expectations of earning growth six months down the road and thus*, as we move into 2017, earnings growth will become a key market driver. **The positive is that earnings are expected to grow and so this will still be supportive to the market. But if expectations are too high, it may mean that price appreciation will be limited for a while.**

Valuation according to P/E: High. The P/E ratio is a relative measure of value. Though there are several ways to measure the P/E, the two most common are on a 'forward' (forecasted) and 'trailing' (actual) earnings basis. The charts below show both perspectives:

The current forward P/E Ratio is 16.5, above the 5-year average of 14.9 and 10-Year Average of 14.3.



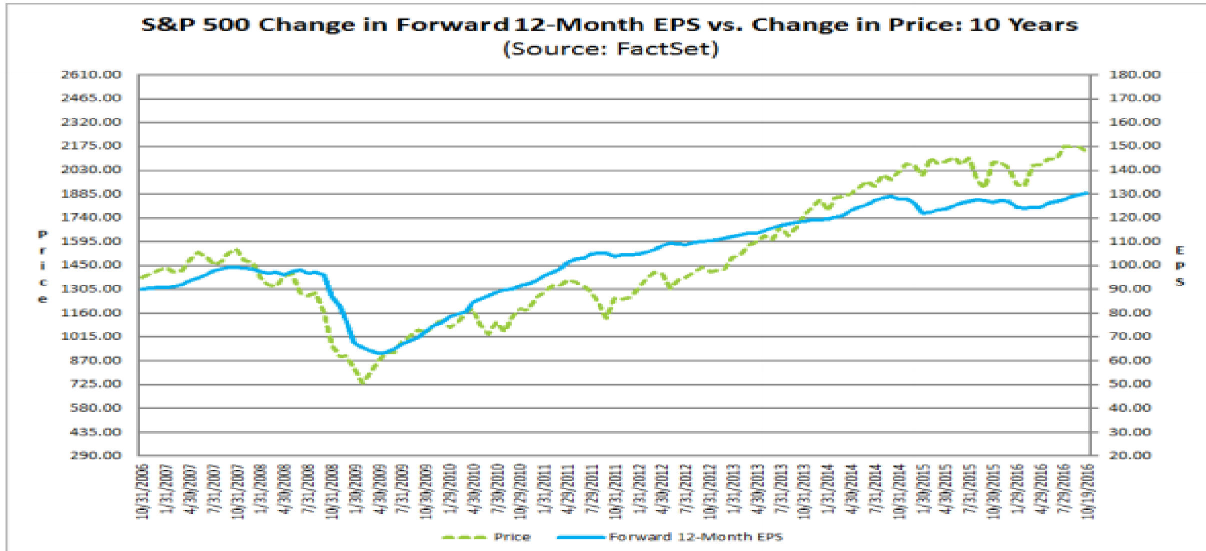
The current trailing P/E is 19.4, and above the 10yrs average of 16.2



Stock Prices verses Earnings: **High.** Another way to look at valuation is how the market has behaved relative to forecasted future and actual earnings. Since 4thQtr14, stock prices have vacillated near their all-time highs despite declining earnings growth. <u>This phenomenon means something else is driving stock prices, because it is not earnings.</u>

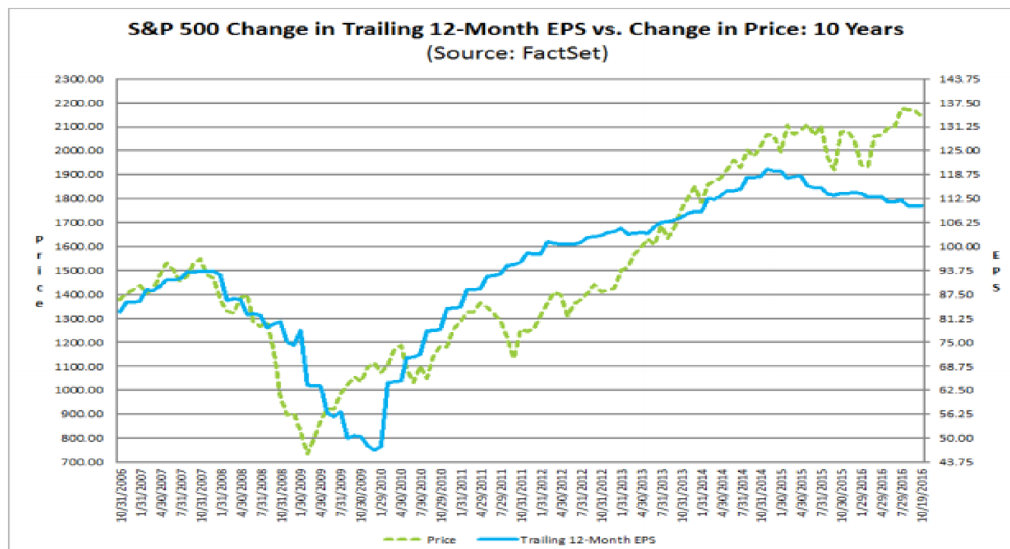
The first chart below shows the S&P 500 price (green line) compared to <u>forward or forecasted earnings</u> (blue line). Notice how stock prices have risen much faster than earnings. This is why the current P/E is so high. The last time this occurred was in 2007-08. **High valuation alone will not push prices down, but it does make the current investment environment more vulnerable.**

Forward 12M Price / Earnings Ratio: Long-Term Averages



The next chart shows the S&P relative to actual or <u>trailing or actual earnings</u>. Notice how the S&P (green line) has risen despite a decline in actual earnings (blue line) and how the gap has continued to widen. Again, this displays the vulnerability of stock prices.

Trailing 12M Price / Earnings Ratio: Long-Term Averages



Relative Valuation: So why stock are prices holding up so well despite poor earnings? The simple answer is low interest rates. The aggressive yet ineffective ultra-low and negative interest rate policies of Central Banks around the globe have distorted the valuation of all financial assets. Stock prices reflect the present value of future cash flows (earnings and dividends) discounted back by the current interest rate. So the lower the current interest rate, the higher the value (stock price) can be 'justified'.

TINA Another way to understand the impact of lower rates is to consider alternative investments such as bonds. In 2007, a US retiree could earn 4-5% on CD's and 6% on 10yr corporate bonds (assuming held to maturity). Today, CD's offer next to nothing, and a 10yr corporate bond may pay 3%. **Keep in mind inflation is near 2% so the real return is somewhere between -2% to + 1%.** If you live in most European countries or Japan where negative interest rate policy has been in place, you are guaranteed a negative return for +20yrs and have to pay the government to hold your money! Hence, **There Is No Alternative (TINA) but stocks.** It cannot be over stated the huge impact, low interest rates or TINA, has made on inflating and maintaining the current level of stock prices.

Interest Rates: At Historical lows, but for how long. After a significant push to new lows in early July, Central Banks have cooled their heels and have even hinted that further policy action could be delayed indefinitely. Without Central bank intervention, long-term interest rates have begun to rise although still remain extremely low. The Central banks have created a bubble in the bond market and it needs to be watched constantly. Any significant reversal in rates would pull the rug out from the markets.

In sum, economic growth is solid but will likely remain slow for the next several years unless there are meaningful capital investments into the economy. Until companies have confidence in taking risk, growth will be stymied by the ever increasing regulatory and entitlement programs. With valuations on the high side and the effect of low interest rates waning, **investment returns will be more tied to organic growth of the economy than Central Bank intervention. But long term investors should not lose hope, as the market will likely continue to offer solid but not robust returns above inflation. Building wealth will come as much or more from contributing to savings than from market returns.**

As always, please contact me with any questions or concerns.

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