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Trees Growing to the Sky

Looking at the investment landscape of late, one cannot help but be awed by the seemingly limitless upward potential, with stocks reaching ever-higher, like trees growing to the sky. While it is tempting to sit back and to enjoy the shade of that growth, now is actually the time to consider not just the trees, but the whole forest.

Eleven months into the latest phase of a very long 2009 bull market, there continues to be much speculation surrounding the cause of the market's current strength, the thought being that if the cause of the strength is known, its likely end will be easier to spot when it occurs. In reality, there are a number of factors at play in the market's parabolic sprint higher since last year's presidential election.

Since November 2016 all three major stock market indicators, the Dow Jones Industrial Average, the S&P 500, and the NASDAQ Composite have reached new all-time highs.

This move into uncharted territory has been dubbed by some as the "Trump Effect" based on the president's well known goals of reducing individual and corporate tax rates, paring regulations, and boosting infrastructure spending.

Others believe the market's rise is the result of the gridlock that has accompanied Trump in Washington, leading to the enactment of no significant new legislation to-date. Some investors have come to believe that the government's inability to pass new legislation may be just the laissez-faire environment CEOs need to keep the bottom line growing.

Corporate Profits Drive the Market

Both theories may be true and both may be beneficial to equity investors. However, it is clear that if the Administration's agenda actually materializes, particularly in the area of taxes, corporate profits will benefit, as will shareholders. The ability of corporations to grow profits is the third and most reliable factor at play in the stock market's rise. Stock prices are tied directly to earnings growth.

Corporate profits, as measured by S&P500 earnings, are estimated to rise by over 9% this year. That would be a meaningful acceleration over 2016's positive +7% and 2015's negative -16%. Since corporate earnings cycles tend to span multiple years and sometimes multiple presidencies,

the earnings cycle we are seeing now broadly has its roots in the post-Great Recession period which started in 2009. Barring a legislative hit to earnings, the profits cycle could be expected to continue until the next recession.

Valuations Are High And Could Go Higher

Along with a soaring stock market has come a sharp increase in equity valuations. The chart below demonstrates the market's precarious position. At 31 times 10 year trailing earnings, the P/E of the S&P 500, as measured by the Shiller PE, is now well above its long-term historical average of 16 times. It is higher than it was in both 2000 and 2007 just before the market began its descent of more than 50% in each period.

The conundrum to high valuations, however, is that while they act as a warning signal of possible trouble ahead in the market, they can actually persist at high levels for very long periods of time during which stocks continue to rise as if all is well. We are in that scenario at the moment. Stocks are rising despite high valuations.

The increasing optimism appears to finally be attracting more retail investors. That is normally not a good sign in the latter stages of a bull market, but it is not yet necessarily a bad sign either considering that retail investors have been unenthusiastic for a number of years, and the 2009 bull market may not be finished yet. When headlines in the popular press speak about the outsized gains made by small mom and pop investors, or when news articles talk about the ease with which those gains have been achieved, then it will be time to worry. We are not there just yet.

Expect a Correction

As the U.S. economy stands at the moment, there appears to be very little risk of a recession that would produce a full-fledged bear market. In the latest Commerce Department report, the U.S. economy grew at a +3% rate in the third quarter of 2017 and consumer spending was up +2.4%. Both are signs of continued economic health. Adding to the economy's positive prospects, unemployment, inflation, and interest rates all remain low.

A recession aside, because equity valuations are extended well above their historical averages, we should expect a stock market correction of perhaps 10 to 20 percent. A correction of that magnitude could be positive for valuations and may allow the 2009 bull market to continue until the next economic recession materializes. A correction may also take a sideways path, with the stock market indices trading flat for a period of time until earnings catch up and valuations become more reasonable. As always, timing these events is more a matter of generalities than specifics, but the possibility is real and needs to be watched.

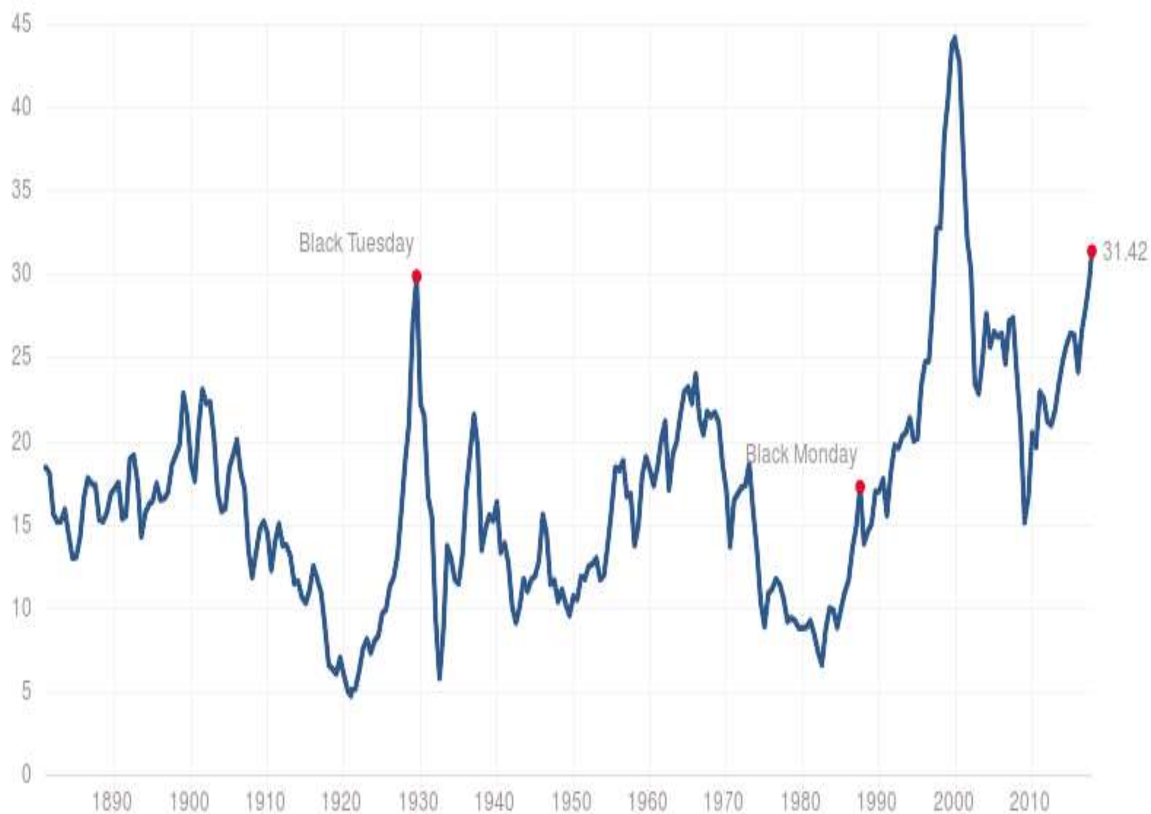
Remain Conservatively Positioned

In light of the market's high valuations, on a composite basis Waterstone's portfolios continue to be conservatively positioned with an average asset mix of roughly 67% equities and 33% in a combination of fixed income and cash. Individual portfolios often differ from this mix and are dependent on each client's preferences and cash flows. Waterstone's role as a fiduciary advisor

is to help preserve clients' capital while simultaneously capturing a portion of the broad market's growth for their portfolios.

Watchful Progress

As the stock market rises and as valuations become evermore stretched, Waterstone's strategy continues to be straightforward: buy where bottom-up company prospects and valuations indicate good potential; sell where company growth prospects have declined or profits have run their course; and mitigate risk, bearing in mind that trees do not grow to the sky.



Source: multpl.com, Shiller P/E

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