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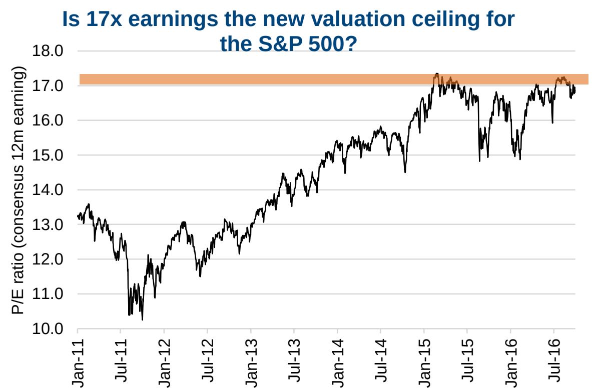
MARKET INSIGHTS

The latest Market Insights
from the Connected Wealth team

17x Isn't Cheap

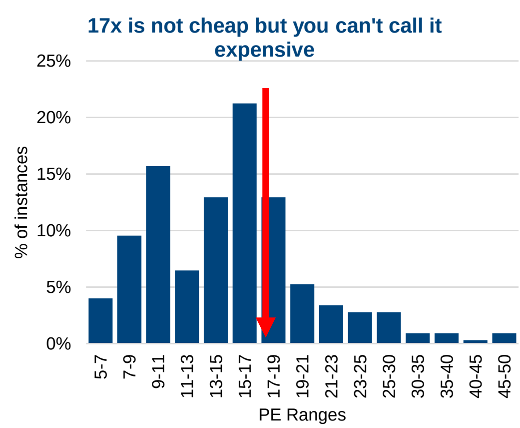
Craig Basinger, CFA



Summary

- Market valuations are not cheap but not overly expensive either.
- In 2016, as with most recent years, gains have come mostly from an expanding market multiple. That is not sustainable.
- We could see a market multiple contraction if bond yields grind higher.
- In a few weeks, Q3 earnings season will start, this is poised to be the first quarter with year-over-year earnings growth in almost two years. That is a good thing.

Valuations



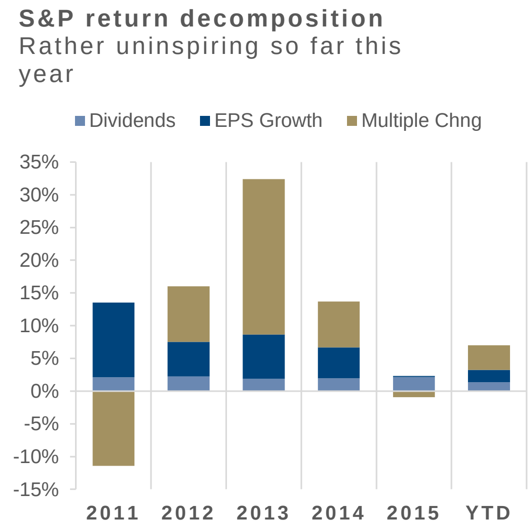
Here we are once again with the S&P 500 trading at 16.9x earnings based on consensus forecasts for the next 12 months. A valuation level that has proven very hard to break through over the past few years, keeping the S&P 500 from making more material new highs. Sure, we saw a new high in August of 2,194 points, but the index had traded as high as 2,135 way back in May of 2015, a year and a half ago. Coincidentally, the S&P/TSX Composite is also trading at 16.9x earnings, and we have seen valuations in both countries follow very similar paths over the past decade.

So is 17x expensive? The quick answer is no, but as with everything there are more layers to this story than a simple number. Based on our S&P 500 earnings model that dates back to the mid-1930s (yes, it's an old one), the average P/E multiple for the S&P has been 15.3x, which would make 17x a little on the pricey side. However, it is well within one standard deviation, meaning this is not an abnormal valuation. The 2nd chart is a breakdown of quarterly valuations for the S&P based on price to earnings. As you can see, the red arrow is hardly outside the bulk of observations.

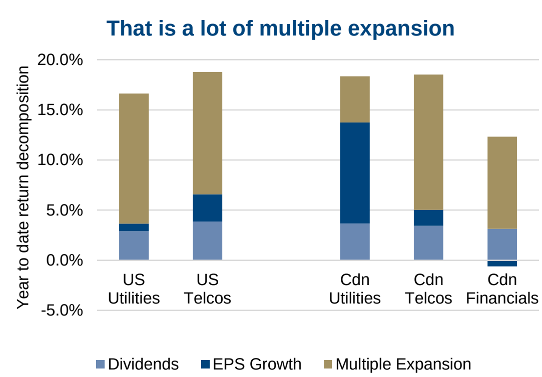
In 2011 and 2012, the market was cheap at 10-12x earnings. Today at 17x it isn't cheap but you would be hard pressed to call it expensive. The big question is where will this multiple move going forward, higher or lower?

Return Decomposition

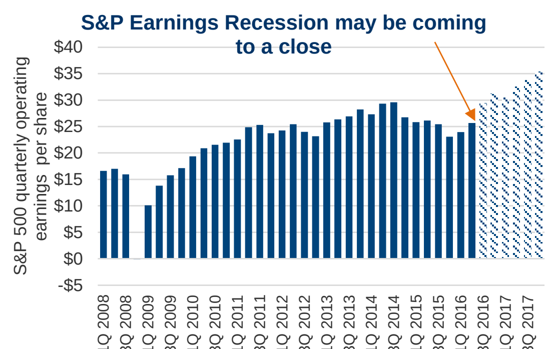
We can break down market returns into a number of contributors. There are dividends and the change in price or index level. This can be further broken down into earnings growth and the change in the market multiple. For instance (top chart) the S&P has gained 7.0% so far this year with dividends contributing 1.3%, earnings growth 1.9% and multiple expansion 3.8%. Typically, dividends at the index level are pretty stable. Earnings growth varies but the biggest mover is usually the market multiple. Just look at 2013 when a rising PE was the primary driver of market returns.



Multiple change is tricky as it is often mean reverting. While 2012 and 2013 saw big market lifts from a rising PE level, 2011 saw a big contraction. There are many contributing factors to changes in the market multiple. The most obvious is market risk or overall confidence. In 2011, we had a flare up in the European crisis, America suffered a credit downgrade, economic growth was soft, the list went on. As these issues lessened, the multiple started to expand.



Another contributing factor to the market multiple is the bond market. Lower bond yields result in a higher market multiple, which has been a contributing factor to the multiple change so far in 2016. This can be most easily seen in market leadership and a return decomposition at the sector level. Telecom and Utilities have been some of the strongest performers this year and they do tend to be the most sensitive to bond yields. The second chart is a return decomposition for a few U.S. and Canadian sectors.



The risk is if much of the returns this year have come from multiple expansion driven by lower bond yields, then if yields rise we could easily see multiple contraction. This would be most acute in the areas of the market that have enjoyed most of the gains of lower bond yields.

Earnings Growth to the rescue?

We do believe that yields are poised to grind higher and that will be a big headwind to the market multiple and the market itself. But there could be a hero to this tale in the form of returning earnings growth. One of the headwinds for the market over the past couple years has been the earnings contraction.

The S&P 500 has experienced negative earnings growth for almost two years now and that has certainly made it difficult for the index to move materially higher. It also explains why the gains have come in the form of multiple expansion. However, this ‘earnings recession’ appears to be ending. The bottom chart is the quarterly earnings with the lightly shaded bars as forecasts. Earnings have been rising for a couple quarters now, but they were still down relative to the same quarter a year ago, as is the normal measure for earnings growth. This appears poised to change in the Q3 earnings season that kicks off in a couple weeks.

Given the near constant recurring trend of earnings coming in a bit better than consensus estimates, this does bode well for the market. At least we could see market gains from a more fundamental basis of higher earnings and not rely so much on the temporary lift from a changing market multiple. We are not saying earnings growth will offset any negative headwind from higher yields or uncertainty over, say an upcoming election, and the effect on the market multiple. But it will be a welcome change

Charts are sourced to Bloomberg unless otherwise noted.