Americas CIO View

S&P 500 at new record, valuation fair but shows some complacency

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In a nutshell

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- Demanding S&P 500 valuations at 2017 end followed by a very turbulent 2018
- Our P/E/Vix barometer shows some signs of complacency in equities
- First quarter 2019 U.S. GDP and S&P 500 EPS growth better than expected and encouraging
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S&P 500 at new record high this spring after December's near bear market

It took only seven months for the S&P 500 to recover from a 19.8% near bear decline and surpass its previous peak reached last September. The S&P 500 rallied more than 25% since the Christmas Eve trough, led by Technology Consumer Discretionary and Communications (Growth sectors). We think subsiding economic and profit recession fears, the U.S. Federal Reserve (the Fed's) dovish pivot, and positive developments with China on a trade deal and more time to negotiate Brexit justify this recovery. At the new high, we examine equity valuations and the outlook for S&P 500 earnings-per-share (EPS) growth. We believe the S&P 500 is at fair value. Yet several macro risks, including interest rates and U.S. fiscal risk, are tame now but have not gone away. This week's U.S. dollar (USD) climb is a reminder that significant interest-rate differentials exist between the United States and the rest of the developed world. An uncertain outlook for magnitude and duration of this differential means foreign exchange (FX) risk still lurks.

Demanding S&P 500 valuations at 2017 end followed by a very turbulent 2018

This sharp S&P 500 recovery is all from price-to-earnings (P/E) expansion as bottom-up 2019 and 2020 consensus S&P 500 EPS have been cut by roughly 3% during this rally. Current S&P 500 P/E multiples are still lower than the highs reached in January 2018: S&P 500 aggregate trailing P/E is 18.0 now vs. 21.2 in January 2018. Median stock trailing P/E is 18.9 vs. 21.0 and 18.3 vs. 21.1 ex Tech sector. The high P/E multiples at the start of 2018, especially ex. Tech, were because of strong 2018 EPS growth expectations from the recently passed U.S. corporate-tax rate cut. We do not think the S&P 500 P/E should go back to January 2018 levels, but today is fair with some upside as today's interest rates do support a fair trailing S&P 500 P/E of 18 to 20. This combined with the collapse in U.S. equity-investment transaction costs supports late cycle P/E expansion. Depending on macro risks, we think a 17 to 18 trailing S&P 500 P/E is reasonable. We think further S&P 500 upside requires higher S&P 500 EPS estimates.

Our P/E/Vix barometer shows some signs of complacency in equities

We use a combination of the observed trailing S&P 500 P/E and options market implied near-term volatility (Vix) expectations to gauge equity investor sentiment.

First quarter 2019 U.S. GDP and S&P 500 EPS growth better than expected and encouraging

229 companies comprising 59% of S&P 500 EPS reported first quarter results. The weighted average beat is 5.1% on EPS and 0% on sales. These results suggest finalized first quarter S&P 500 EPS being flat to up 2%. This EPS growth with better than expected 3.2% preliminary first quarter gross domestic product (GDP), despite some real economy and financial market bumps early in the quarter, gives us greater confidence in our 2019 estimate 169 USD S&P 500 EPS and in the longevity of this economic expansion with healthy ~5% S&P 500 EPS growth this year and next. We introduce our 2020 estimates S&P 500 EPS of 179 USD or up 6%. This estimate will be sensitive to oil prices and FX rates, but core growth should be healthy at 5% or more.

Rate differential likely persists and supports dollar strength

Since the Fed's dovish pivot in January through its March Federal Open Market Committee (FOMC) meeting, the market has priced in a larger than 50% chance of a rate cut by 2019 year end. And the whole yield curve shifted down ~25 basis points (bps). However, USD held its strength and continues to firm against major currencies, especially the Euro of late. We do not think this reflects a flight to safety, as the United States and China economic conditions have been improving. We see the upward dollar grind as being from the large overnight-interest-rate differential between the United States and Europe that incoming data suggests is unlikely to diminish anytime soon. We think the market's probability for a Fed rate cut is too high because the probability of a recession is declining. We know the Fed is considering what to do about inflation not reaching their target, despite a record long expansion, but we do not believe the Fed would use its most blunt of policy tools to manage inflation higher if it stays just a bit shy of their 2% target. The Fed is exploring other tools to manage inflation.

U.S. elections November 2020, 18 months away: Healthcare and tax rates

Elections are important, but there is still time before this becomes crucial to markets. Two big issues to investors are U.S. healthcare policy and fiscal policy, particularly tax rates for corporations and high income individuals. Provided an election outcome that suggests no major changes in U.S. healthcare and taxes, we think this economic expansion likely continues into 2021. The sell-off in Healthcare stocks last week was overdone in our view, but we acknowledge headline risks will increase.

Performance over the past 5 years (12-month periods)

	03/14 - 03/15	03/15 - 03/16	03/16 - 03/17	03/17 - 03/18	03/18 - 03/19
S&P 500	10.4%	-0.4%	14.7%	11.8%	7.3%

Glossary

Basis point

One **basis point** equals 1/100 of a percentage point.

Bear market

Technically, a **bear market** refers to a situation where the index's value falls at least 20% from a recent high.

Brexit

Brexit is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

CBOE Volatility Index (Vix)

The **CBOE Volatility Index (Vix)** is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index. It is a popular measure of the volatility of the S&P 500 as implied in the short term option prices on the index.

Dove

Doves are in favor of an expansive monetary policy.

Earnings per share (EPS)

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Euro (EUR)

The **euro (EUR)** is the common currency of states participating in the Economic and Monetary Union and is the second most held reserve currency in the world after the dollar.

Federal Open Market Committee (FOMC)

The **Federal Open Market Committee (FOMC)** is the committee that oversees the open-market operations (purchases and sales of securities that are intended to steer interest rates and market liquidity) of the U.S. Federal Reserve.

Fiscal policy

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

Foreign exchange

FX or foreign exchange is the currency — literally foreign money — used in the settlement of international trade between countries.

Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Growth stocks

Growth stocks are stocks from companies that are expected to grow significantly above market average for a certain period of time.

Inflation

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Price-to-earnings (P/E) ratio or multiple

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

Recession

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

U.S. dollar (USD)

The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

U.S. Federal Reserve (Fed)

The **U.S. Federal Reserve**, often referred to as "**the Fed**", is the central bank of the United States.

Valuation

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm’s stock price in relation to its earnings.

Yield curve

A **yield curve** shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

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