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Market Update

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As the third quarter comes to a close, there is significant angst about the valuation of the stock market. The economic environment raises questions about the possible implications for future performance of the stock market. That is the topic of this issue of Partner Talk.

This examination is particularly relevant given the political environment. A major concern is the potential impact of the current trade disputes. My colleague, Marshall Blume, tackled this "trade war" in the last edition of Partner Talk. As Marshall noted last month, the trade disputes have not yet resulted in a significant drop in the stock market. That observation remains true today – one month later. For the third quarter of this year, the return of the S&P 500 Index is 7.7%. This quarterly return represents the strongest quarterly market performance since the fourth quarter of 2013. It is difficult to argue that such performance is consistent with the trade issue dragging down the market.

One part of the trade disputes has been tentatively resolved with the Canadians agreeing to join the basic structure of the previously agreed to U.S. - Mexico agreement. The proposed agreement to replace NAFTA, termed "USMCA", still requires acceptance by the member country governments. Nonetheless, its mere existence has reduced political uncertainty. This is a plus for markets.

Trade negotiations with Europe have been ongoing and a settlement appears to be within reach – another positive. However, from the U.S. perspective, negotiating with China has been difficult. The dispute goes beyond the trade deficit and includes intellectual property and national security issues. It is not clear that an agreement is near. These trade frictions with China do increase market uncertainty. While acknowledging that, recent market behavior suggests that investors forecast that the disruptions to the U.S. economy will be modest.

Looking beyond the trade issues, there is still considerable disagreement on the appropriateness of the current valuation of the market. There are those who think the market is overvalued and likely to decline. Others think the market is fairly or undervalued and are optimistic about future performance. A recent debate at a Wharton School conference nicely illustrates contrasting views. The participants were Yale economist Robert Shiller and Wharton School Finance Department faculty member Jeremy Siegel (see our inserts for a news article about this debate).

Approximately thirty years ago, Professor Shiller developed a market valuation measure he named the cyclicality-adjusted price to earnings ratio (CAPE). He argues that this measure empirically can forecast long-run returns in the stock market. The current value of CAPE is very high on an historical basis suggesting that prices are high relative to past earnings. In Shiller's analysis, this high CAPE value leads to forecast low returns over the next ten years for the U.S. stock market.

Professor Siegel has done research that questions the validity of Shiller's CAPE measure as a forecasting variable. One input to CAPE is a ten-year average of reported earnings aggregated across the market. Siegel argues that due to accounting rule changes over the past thirty years, this measure now understates earnings and creates an upward bias in Shiller's calculations. Further, Siegel notes that a low interest rate environment supports higher CAPE values. Taking into account these observations, Professor Siegel concludes that on an historical basis current price to earnings ratios are reasonable and that the market is not overvalued.

This debate suggests that coming to a firm conclusion about market valuation is inherently difficult. The inconclusive result about valuation is consistent with the view that it is not possible to predict future market movements. While risk assessments in the marketplace can be useful, any attempt to categorize the market as being under-valued or over-valued is a futile exercise.

To characterize the current state of the market, one can examine economic measures that historically have related to the value of the market. If these measures are extreme and are not in line with historical norms concerns about market valuation can arise. Economic growth, corporate earnings and interest rates are relevant measures.

Economic growth has been surprisingly strong. For the second quarter of this year, GDP increased at an annual rate of 4.2%. This value represents the strongest quarterly growth since the third quarter of 2014. While expectations are that a 4% plus growth rate will not continue, solid growth is still expected. For the third and fourth quarters of this year, forecasters anticipate a growth rate near 4% and for the year 2019, a rate between 2.5% and 3.0%. These forecasts represent reasonable growth and suggest that the likelihood of a sharp decline in economic activity is small. Therefore, this measurement indicates that there is a low risk of an economic downturn with a significant negative impact on the value of the market.

The level and growth of corporate earnings are key determinants of the value of a corporation. Thus, when assessing market valuation, we should consider the current state of the earnings of the corporate sector. According to Thomson Reuters, the estimated third quarter year-over-year earnings growth for the companies in the S&P 500 index is 21.7%. The estimate is 20.3% for the fourth quarter. If realized, these estimates will represent strong economic performance and also do not signal imminent stock market weakness.

What about interest rates – another key valuation factor? In September, the Federal Reserve increased the federal funds rate by .25% and the Fed projects that there will be another increase later this year. Since interest rates on bonds issued by the government move in the same direction as the level of the federal funds rate, interest rate increases are to be expected. Such interest rate increases will exert downward pressure on the prices of both equities and bonds. For equities, it is possible that strong economic growth will offset the downward price pressure from increasing interest rates. For bonds, the impact of rate increases can be mitigated by focusing on shorter maturities and on corporate bonds. Thus, the implications of increasing rates need not necessarily be a significant negative for the market since solid economic performance will likely accompany such increases.

What valuation metrics do raise concerns about current values? One measure, related to our earlier discussion of the Shiller CAPE variable, is the long run price to earnings ratio. For the U.S. stock market, the CAPE ratio is approximately 33. This value is high on a historical basis. However, previously mentioned considerations can reduce concern. In a low interest rate environment, higher CAPE ratios can be economically justified. In addition, an economy with strong expected earnings growth can support higher price to earnings ratios.

The valuation of stocks and bonds is indeed complex. Many factors need consideration as part of the investment process. While the indicators discussed above are currently favorable, they are not full-proof, and surprises can and do happen. At PMA we consider these factors as we strive to control risk and to achieve high risk-adjusted performance.