Economic Views Brief

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WHAT DO MARKET MILESTONES TELL US ABOUT ECONOMIC PROSPECTS? NOT MUCH.

- The stock market recently attained two major milestones. Last week the current "bull market" became the longest in history, and a few days later the S&P 500 hit a new all-time high. Such milestones, however, are just that, milestones. Index levels have no interpretive value without knowledge of related underlying fundamentals.
- Corporate profits are also at an all-time high.
- The current economic expansion may be old, but it's still pretty healthy.

A record bull-market run! But does it really matter?

On Wednesday, August 22nd, the current stock market expansion was heralded as having achieved a new record for its longevity. The S&P 500 had gone 3,453 days since its last decline of 20% or more. (A 20% decline from its most recent high is the widely-accepted definition of a "bear market.") In Wall Street terms, the current "bull market" was now seen as the longest in recorded history. Later that same week, the S&P 500 also reached a new all-time closing high of 2875.

What do these major milestones mean for the outlook? Not much, in our view.

To illustrate: If you paid $400,000 for your home, but your sister paid $250,000 for hers, would you automatically think you over-paid? If this is the only information you had, of course not. As we all know, factors such as location, square footage, condition, amenities, age, local taxes, and a multitude of others, are the primary factors in determining a property's reasonable value.

Just as it would be ridiculous to compare the value of two separate properties based simply on price; so too is it ridiculous to evaluate stocks based simply on index levels.

The value of the S&P 500, the Dow Jones Industrial Average, or any other aggregate index, is meaningless without a perspective of the cash generation capabilities of its underlying constituents. And although determining the proper value for an asset may offer room for subjectivity, the intrinsic value of any business is most simply determined by its current and expected financial results.

S&P 500 Price Index - January 1989 to present

Shaded areas represent recession periods

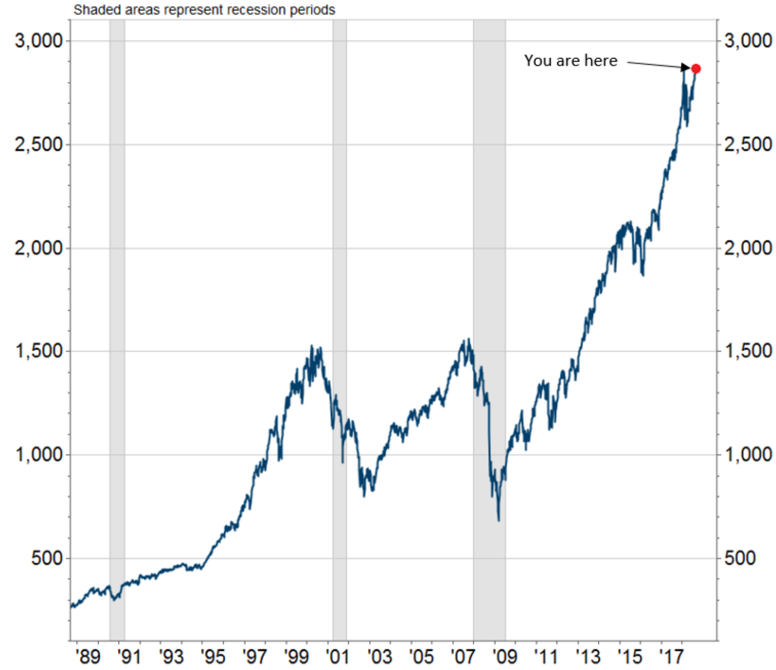

Chart source: FactSet

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To that end, we note that **corporate profits are also at an all-time high**.

In fact, if we look back 25 years (August 31, 1993), the S&P 500 Index is 521% higher (Aug. 31, 1993 to Aug. 22, 2018), and trailing 12-month S&P 500 earnings per share (EPS) (based on blended EPS through Q2-2018, as reported by FactSet) are a nearly identical 515% higher over the same period (since Q2-1993, per FactSet).

Further, although not directly comparable to any equity index, total after-tax corporate profits (with adjustments for inventory calculation methodologies and constant currency) for <u>all</u> U.S. corporations were 475% higher from Q1-1993 to Q1-2018, according to the U.S. Bureau of Economic Analysis as based on data from the IRS (see chart at right). This percentage looks likely to grow over the next few quarters, in our view, as 2018 business profits continue to benefit from recently enacted tax cuts.

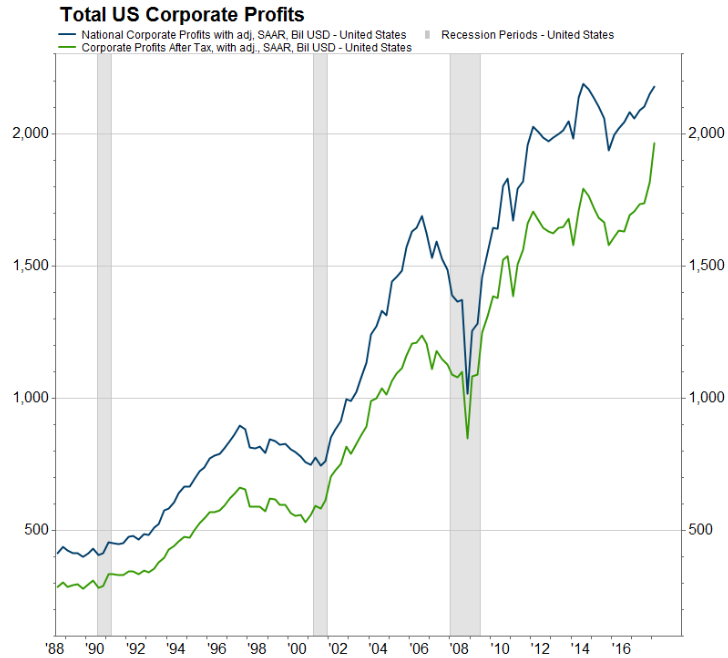


Chart source: FactSet

But are investors ignoring this year's elevated risks? Not necessarily. It might be easy to assume that investors are "whistling past the graveyard," given that the S&P 500 is at record highs despite this year's heightened risks. The S&P 500 is 7.0% higher year-to-date (through August 22nd) despite the emergence of nearly unprecedented trade turmoil, rising interest rates, percolating inflation, and geopolitical tensions the likes of which we may not have seen in decades.

However, a deeper look suggests investors have indeed considered these risks (at least partially).

The chart at right shows the trailing 12-month Price to Earnings (P/E) ratio for the S&P 500. The P/E started 2018 at 21.82 before reaching a high of 23.0 in late January. The emergence of trade turmoil helped push the metric lower after that point, and it is currently 19.73.

This decline says that investors are not willing to pay as high a multiple for each dollar of corporate earnings as they once were. In other words, they have incorporated greater risk into their views. Though the P/E's 2.1 point decline since year-end may not seem like much, but it is quite material.

If the valuation metric (P/E) had remained static at its January 1st level of 21.82, the S&P 500 would be 3165 today (theoretically) based on actual corporate earnings reported through Q2. This represents a 303 point difference from the actual S&P 500 level as of August 22, of 2863, or +10.6%.

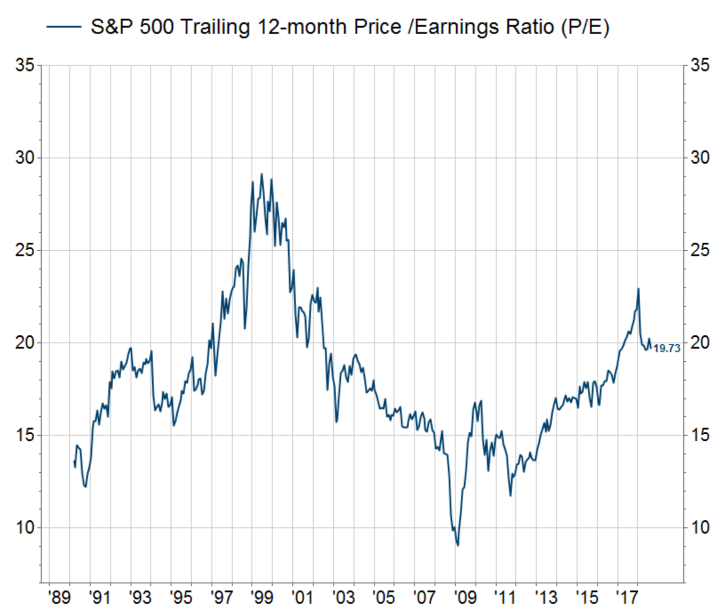


Chart source: FactSet

The math:

	Actuals		What if the valuation multiple remained steady?			
	01/01/18	08/22/18	theoretically:			
P/E multiple	21.82	19.73	21.82	*Where the P/E was on Jan. 1, 2018*		
* trailing 12-mo. EPS	$122.53	$145.05	$145.05	*Current trailing EPS for S&P 500*		
equals	=	=	=			
S&P 500 Index	**2673.61**	**2861.82**	3164.97	which is...	303.15	point difference versus 8/22
					10.6%	percentage difference versus 8/22

EPS: Earnings per share

Actual data sourced from FactSet

This evaluation should not be construed as a commentary on whether current valuations are reasonable or not, but it does, in our view at least, show that investors have become more cautious about risk, and /or forward corporate earnings prospects. Given that corporate earnings forecasts remain strong, we believe heightened risk is the dominate factor behind this decline in investor sentiment.

So, are we near the end of the line for the current bull-run? Only time will tell. But deep into expansions is when investors should be most wary of the pundits that shout "the end is near" at every opportunity. Some commentators, often those that yell the loudest, do so out of their own self-interest rather than the interest of less informed investors that may take their advice. Such commentators want desperately to claim: "I called it!" when the next downturn eventually does arrive, even though, more often than not, it may have nothing to do with the reasons they cited.

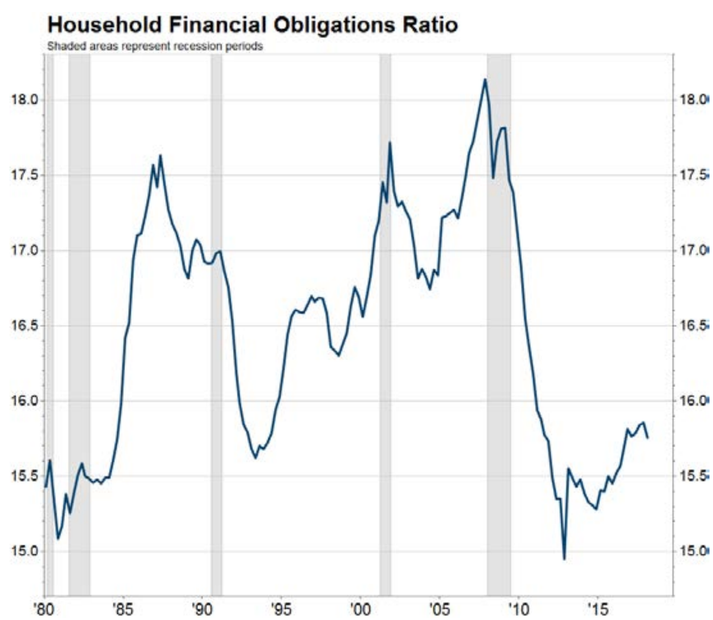
The next economic downturn WILL eventually come, and risk factors, particularly geopolitical risks, have become elevated and could yet lead to sudden economic troubles and financial market disruptions. But despite its old age, the U.S. economy is still in pretty good shape, in our view.

Consider: On average, stock market "corrections" of more than 10% occur about once a year, according to Bespoke Investment Group. The -10.2% correction that occurred in February of this year, however, was the first in approximately two years (since February 11, 2016).

However, declines of 20% or more are almost always associated with an economic downturn (i.e., recession).

In today's modern financial world, U.S. economic cycles are most often related to debt imbalances. This is particularly true when its consumers that have too much debt as they account for 70% of U.S. economy activity (based on Commerce Department data). In considering current recession risks, we note our belief that consumer finances are currently in strong condition.

In Q1-2018, consumer financial obligations (as measured by the Federal Reserve's Financial Obligations Ratio) amounted to 15.75% of consumer disposable income. At its cycle low in Q2-1993, with many years of economic expansion lying ahead, the ratio was a nearly identical 15.60%.



Source: FactSet

Summary: Market milestones often make for opportune fanfare within the financial media. Such technical information may be nice to know, but investors should be strongly cautioned about making investment decisions simply based on such.

Market, economic and geopolitical risks, have increased this year and developments related to such should be closely watched. Absent worst-case scenarios related to these issues, we still believe economic fundamentals offer a supportive foundation for further economic expansion over the intermate-term, at least. Please see our latest Economic Perspective reports for more on our view of economic fundamentals and the intermediate-term outlook.

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