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CAPITAL MANAGEMENT | INVESTMENT ADVISORS

MARKET INSIGHTS

From RiverPoint Capital Management

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Like everything we do, it is designed to bring you talented resources and proactive advice with a single purpose in mind – to help our clients achieve financial security and peace of mind.

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April Sound Bites on the Market and Economy

After a fantastic start to the year in which the market advanced more than 7% in January and February, the S&P 500 stalled a bit in the March/April time period—no great swoon; it just seems like those oft cited "animal spirits" are a bit less animalistic in nature for the moment. That's probably very healthy from our perspective. As of this writing in late April, the S&P 500 has taken a breather and is off a modest 2 % from the March 1st peak. In this month's Sound Bites, **we'll address our thoughts about the likelihood of a market correction of more normal magnitude**--something larger than 2%--and whether or not such an occurrence might change our positive view on stocks for 2017. We'll also discuss two other items that more pessimistic investors are focusing on and how we view these "wall of worry" issues…namely: 1. **Stock market valuation** that some say is too expensive at this juncture; and 2. **The latest trends in policy out of Washington** and relevancy to the direction of the market. Our perspective on each is as follows:

All corrections are cut from the same cloth? Not!

One thing that all corrections (defined as a short lived market declines of between 10% and 20%) have in common is that they tend to happen quite frequently. In fact, they happen on average about one time per year AND they often occur as intra-year adjustments within very healthy calendar year return periods. They are just a normal part of secular bull market advances…the market pauses and purges any temporary price excesses and sets itself up nicely for further advancement based on solid fundamental corporate earnings growth. Yet, we've only averaged one correction every two years over the past 6 years or so and going into March, the S&P 500 had gone more than 100 consecutive trading day without even a +/- 1% price wiggle. This is the 9th longest period in history of such market calm. So, from this perspective, we are due for a normal correction if history indeed rhymes. That said, there is a HUGE difference in investor and market impact when corrections/pullbacks occur during periods unassociated with recessions versus those that occur during a recession. Those unassociated with recession are shorter, shallower in magnitude, and not worth acting on. In fact, taking action to sell equities in any significant manner during such periods may cost you money. Rather smart investors hold positions or reposition by BUYING great companies that have been unduly punished during these corrective phases. The table below illustrates the metrics for the 10 corrections UNASSOCIATED WITH RECESSION in the last 25 years versus the 10 ASSOCIATED WITH RECESSIONS.

	% Decline	Length (months)	% Gain (3 months after)
Correction Type:			
Unassociated w/recession	13.7%	2.5	16.2%
Associated w/recession	23.6%	3.6	11.5%

Source: Strategas

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On average, markets retreat 13.7% during such periods, last 2.5 months, and you more than make up what you lost in the decline within three months of its' end. Contrast this with market pullbacks ASSOCIATED WITH RECESSION. In such environments, stocks decline more than 23% on average, the period of challenge lasts almost 120 days and you are still well down in your portfolio three months after it ends. In the latter case, the weak economic and earnings fundamentals are a signal that a bear market is underway and a more defensive posture via raising some cash and moving to the low end of your targeted equity range is appropriate. We do not see such warning signals at present. If we do, we will respond appropriately.

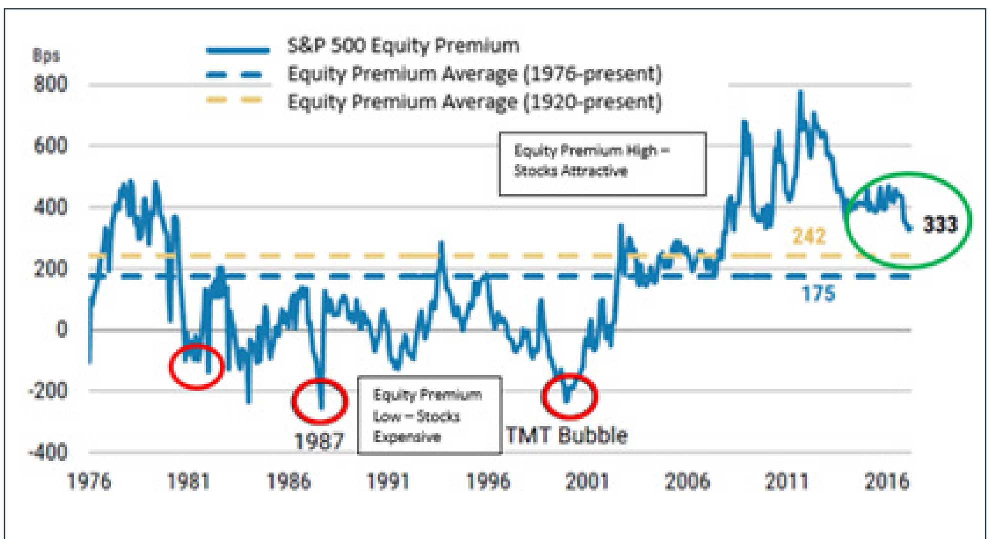
Is the Stock Market Expensive?

In short, it is not as cheap as it was when this bull market began back in 2009, but, **no, we would not label it as expensive**. We would call it fairly valued, but investors can make significant money in markets that are REASONABLY priced when fundamentals are positive. So reasonably priced in this favorable period for fundamentals is just fine.

Those that label the S&P 500 as categorically expensive primarily cite one primary ratio—the P/E multiple of the market. It is trading at roughly 18 times 2017 earnings of $130 per share at current levels. In a vacuum, one could say that this is above average and leaning to the expensive side compared to the long term historical average of roughly 16 times (but, even so, well below crazy levels of 27 times earnings we saw back in 2000). So we must acknowledge this. However, this conclusion fails to take into account the record low levels of interest rates in effect today. Comparing current P/E ratios to those back in, say, in the early 1980's, when the 10 year treasury was approaching 15% (that's correct, 15%!) is like comparing apples to oranges. Clearly, at moments like that savers might say to themselves: " hey, I can make 15% on lower risk bonds, who needs stocks?" In that environment P/E levels are low…as they were in the early 80's at ten times earnings or below. That's not what savers say today when the ten year treasury is priced such that it pays a 2.3% yield and the dividend alone on a stock is almost the same, forget the fact that a stock can appreciate in price. Stocks look very attractive to bonds right now. So, another measure that can be used to account for the impact of the level of interest rates on stock valuations is to examine the earnings yield of stocks (calculated as S&P 500's earnings divided by its' price as a measure of profitability) versus the "earnings" yield of bonds (simply the interest yield of intermediate maturity corporate bonds). The difference between these two measures is called the equity premium and normally it averages only 175 basis points. But since stocks are posting solid profit margins and thus have attractive earnings yields while bonds sport disappointing low yields at present, the equity premium is a much larger 330 basis points at present. Thus stocks look very attractive versus bonds on this measure.

Chart 1

- **Equity premium plunged during period of high interest rates in early 1980's and the tech bubble in the late 1990's.**
- **Premiums today are attractive at these low levels of interest rates. Stocks are attractive over bonds.**



Source: FactSet, Bloomberg, Robert Shiller, Morgan Stanley Research as of April 7, 2017. Note: S&P 500 fundamental data used post March 1993; Top 500 by market cap data used before 1993. LTM equity risk premium average is since 1920. ERP based on forward earnings yield and 10-year Treasury Yield.

Some combination of rising stock prices/ falling profits or rising interest rates would have to happen for stocks to look expensive on this valuation metric. Based on this equity premium metric, the S&P could rise handsomely above 2600 before stocks would be considered expensive. We do recognize that interest rates could and should rise from these low levels, but we also know that based on history, stocks do well as rates rise until the Treasury hits the 5% level, the marking point at which interest rates tend to slow the economy and earnings… we're far away from that. We're just say'in you want to be careful to take a comprehensive thoughtful view before jumping to valuation conclusions, and we think it's premature to call the market expensive.

How about those First 100 days?

The first 100 days is always hyped for new White House Administrations. As an investment team, we stay away from judging style points for political/policy leaders and maintain focus on likely economic and market impact. From an economic policy standpoint, there were high hopes for action in President Trump's and the GOP troika's (GOP control of all three chambers) early days. Like most new Presidents, there has been disappointment on this front. From our perspective, we were NOT counting on significant policy adjustments, but instead felt the fundamentals were inflecting positively even prior to the election and that this would drive the market. You can see this positive inflection in the acceleration in earnings growth in the second half of 2016 that have continued in to 2017.

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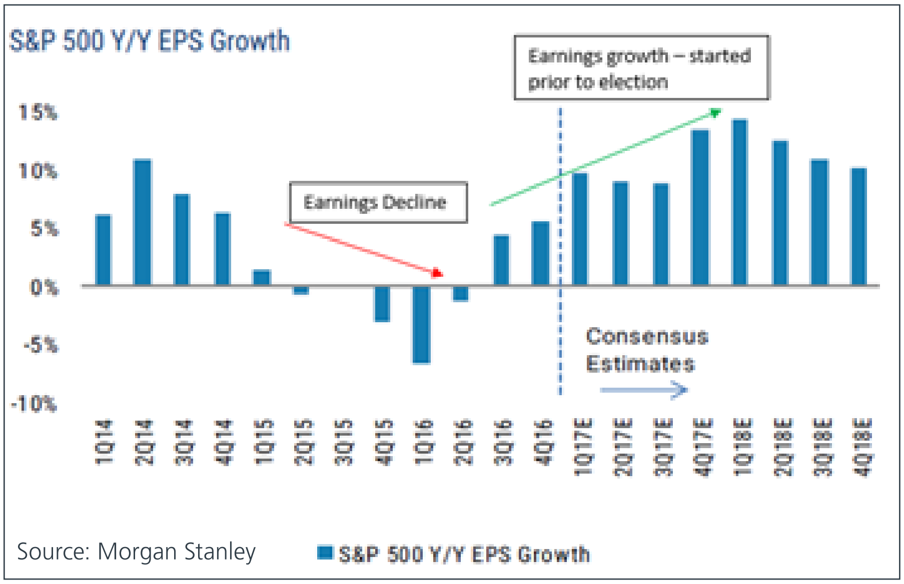
EPS Growth Recovering Pre-Election



We felt growth policy victories would only be additive. The market did advance post-election, we think based more on true earnings growth versus hopes and dreams of major legislative victories on the tax reform front. At this juncture, valuation is now reasonable and reflective of this fundamental improvement. Significant gains above the 2400 level for the S&P 500 will probably need to include some policy wins, so we will be watching this closely going forward.

How do we view the first 100 days from a potential market impact basis? We would say this chapter ended on a better note than the first 30 days. Like most Presidents, it appears there is some positive tacking/adjustment going on here to become more predictable and Presidential. Others such as Clinton and Obama made similar tacks in their first 100 days, learning from some early mistakes. Such adjustments can reduce political uncertainty and the market appreciates this. What are some recent examples of this?:

- Recent public White House administration acceptance of NATO as a vital organization
- Not declaring China as a currency manipulator
- Playing nice with XI Jinping at the successful summit at Mara Lago
- Not playing so nice, after all, with Putin and Syria following recent events—this won bi-partisan praise
- Tilting favor to the more moderate leaders in his administration staff versus more extremist players
- Reaching out to Janet Yellen and associated endorsement of low interest rate policy—looks like he will re-appoint her; removes a BIG unknown
- Formal support of Export-Import Bank

If Trump continues to tack in this direction and reduce extremist Tweets, this should slow the momentum in the policy uncertainty index and benefit investors. Again don't count on it, but we are watching and listening.

Conclusion

We will stay vigilant in monitoring the fundamental trends, valuation levels and technical backdrop of the market and keep you informed. Thanks for your confidence and support. Stay tuned!

Thanks,
RiverPoint Capital Management