LPL FINANCIAL RESEARCH

Weekly Market Commentary

August 4, 2014

Stock Market Valuations Suggest That This Bull Market Still Has Teeth

Burt White
Chief Investment Officer
LPL Financial

Jeffrey Buchbinder, CFA
Market Strategist
LPL Financial

Highlights

Losing under 3% in a week seems a minor concern given historical market ups and downs; nevertheless, investors may begin to wonder if stock market valuations are signaling a decline.

Since the end of the last significant sell-off for stocks, the market has been in a pretty consistent upward trend.

Valuation is a poor market-timing indicator; while valuation should always be considered, it is a blunt tool that should be taken into broader context.

After hitting another all-time high on July 24, the S&P 500 Index fell for six consecutive trading days, leading to a 2.7% drop for stocks for the week ending August 1, 2014. Losing under 3% in a week seems a minor concern given historical market ups and downs, especially in the face of a strong bull market that has seen a 220% gain since the market's low point in 2009. Nonetheless, investors may begin to wonder if stock market valuations are signaling a larger impending market decline and possibly even the end of this bull market cycle.

Part of the fear over last week's sell-off is that investors have not been accustomed to drops in stock prices over the past two years. After all, it's been a long while since we have seen a significant pullback. In fact, this week marks the third anniversary of the last 10% or greater correction in the S&P 500, which happened in the late summer of 2011 (July 22, 2011 – August 8, 2011). The catalyst at the time was the debt ceiling debacle in Congress and the resulting downgrade of the United States' credit rating by Standard & Poor's alongside the increased risk of a break-up of the Eurozone. The stock market fell 17% during this two-and-a-half week period (and dropped 19% peak to trough from the April 2011 high through the October 2011 low).

Three years seems like a very long time without a 10% correction, and frankly, it is. But it is not without precedent. Economic expansions periodically offer long stretches of remarkably low volatility and a preponderance of up days for stocks. Since the end of the last significant sell-off for stocks (October 3, 2011), the market has been in a pretty consistent upward trend. The result is that it has been 1033 days since the end of a period culminating in a double-digit drop for the S&P 500.

1 In Strong Bull Markets, Double-Digit Corrections Can Be Rare

Periods of No Double-Digit Declines for the S&P 500 Index	Number of Days
October 11, 1990 – October 7, 1997	2553
March 11, 2003 – October 9, 2007	1673
July 24, 1984 – August 25, 1987	1127
October 3, 2011 – Present	1033

Source: LPL Financial Research 08/04/14

Since 1980, three periods have gone longer without a double-digit decline [Figure 1]. Keep in mind we came very close to that 10% mark in 2012, with a loss of just under 10% in April through June of that year, and during that time a number of market segments did lose more than 10%.

In a typical year, the S&P 500 endures an average of four 5% pullbacks. Against this backdrop, we see this latest bout of volatility (roughly a 3% drop in the S&P 500 since July 24) as normal, overdue, and frankly, healthy. While we do not necessarily believe this latest bout of volatility is the start of a 10% market correction — though it is possible — it is worth noting that we have had only one 5% pullback so far this year (January 22 – February 5,

LPL Financial

2014). As we move later in the business cycle, an increase in volatility is to be expected. But at this point, based on our economic and market outlook, we would view this slight sell-off and any more pronounced weakness as a potential buying opportunity.

Valuations Not Overly Stretched

The current pullback has led to slightly more attractive valuations. With the bull market having produced a total cumulative return of over 220% since it began on March 9, 2009, it is no surprise that many investors and stock market pundits have begun expressing concerns about stock valuations. We highlighted the importance of valuations, looking specifically at price-to-earnings ratios (PE), in our *Mid-Year Outlook 2014: Investor's Almanac Field Notes* publication, where it is included as one of our five "forecasters." These five key indicators, which include valuations, have consistently and reliably signaled the increasing fragility of the economy. Furthermore, they have marked the transition to the late stage of the business cycle and have foreshadowed the likelihood of a recession.

PEs are the most commonly cited metric when measuring stock market valuations. PEs measure the price of a stock market index, or single stock, relative to corporate profits, or earnings. Observing the PE ratio of a broad index such as the S&P 500 can measure how expensive the broad market may be. The lower the PE, the more attractive stocks are and vice versa. However, there are three very different versions:

- Trailing PE, the price divided by the past four quarters' earnings per share for companies in the S&P 500 — currently at about 16.9 (and our preferred measure);
- Forward PE, the price divided by the Wall Street analyst consensus estimate for the next four quarters' earnings per share — currently at 15.2;
- Cyclically adjusted PE, or CAPE, the price divided by the average of 10 years of earnings, adjusted for inflation — currently about 26. As a note, we rarely use the CAPE, which has been saying for five years now that stocks are overvalued even as one of the most powerful bull markets ever seen has taken place. It is our opinion that the CAPE fails as an investing tool for several reasons, among them the arbitrary 10-year adjustment period, which is longer than most actual cycles and therefore distorts the "cycle" average for earnings. In addition, huge changes to the index constituents over the past 10 years almost render the CAPE useless. So many big companies weren't even in the S&P 500 Index 10 years ago, like Google (added in 2006) and Amazon (2005), while AIG was one of the largest constituents and Lehman Brothers was in there as well (and obviously is not now).

Valuation Is a Useful but Blunt Tool

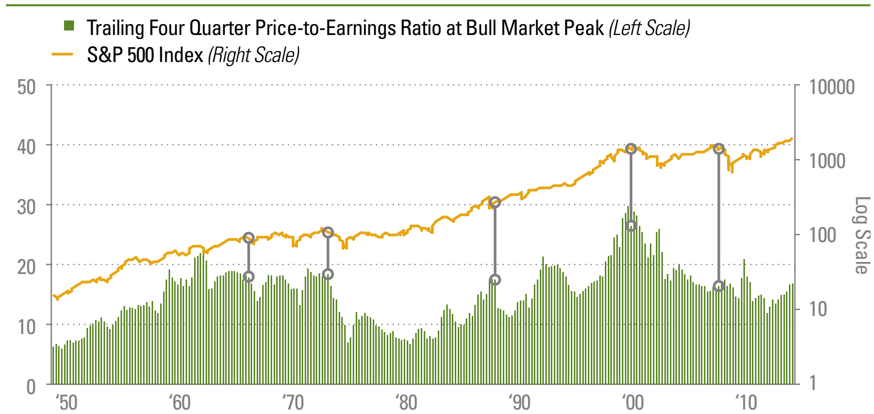
While of paramount importance to investment returns over the long term, there is no relationship over the short term between the level of the PE and stock market performance over the following year. As a result, valuation is a poor market-timing indicator. In other words, valuation is like brushing your

While of paramount importance to investment returns over the long term, there is no relationship over the short term between the level of the PE and stock market performance over the following year. As a result, valuation is a poor market-timing indicator.

teeth—you know it is important over the long term, but its significance and impact is at some time in the uncertain future. Like regular brushing, monitoring valuation can help you take care of the health of your portfolio in the long term, but it won't tell you what's going to happen in the next year. Thus, while valuation should always be considered, it is a blunt tool—like a toothbrush—that should be taken into broader context.

The current trailing PE of 16.9 is above the long-term average (since 1927) of about 15, but it is far from the peak of 2000, and it remains in line with the average since 1980. Nevertheless, it is approaching an important range. Since WWII, every bull market has ended with a PE between 17 and 18, with the exception of the bull market that ended in 2000, which peaked much higher. This is not to suggest the PE could not go higher than it is today. In past cycles, PEs did reach higher levels before ending up between 17 and 18 as the stock market peaked. We also note that earnings are on pace for the high-single-digit gains that we forecast for this year, and as a result, very little, if any, PE multiple expansion is required for the S&P 500 to reach our targeted return range for 2014 of 10–15%.

2 PE Ratios Provide Context, Not Timing, on When the Market May Be Vulnerable



Source: LPL Financial Research, Bloomberg data 08/04/14

The S&P 500 is an unmanaged index and cannot be invested into directly. Past performance is no guarantee of future results.

The price-to-earnings ratio (PE) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share.

As noted in our *Outlook 2014: The Investor's Almanac*, the stock market may produce a total return in the low double digits (10–15%). This gain is derived from earnings per share (EPS) for S&P 500 companies growing 5–10% and a rise in the price-to-earnings ratio (PE) of about half a point from just under 16 to 16.5, leaving more room to grow. The PE gain is due to increased confidence in improved growth allowing the ratio to slowly move toward the higher levels that marked the end of every bull market since World War II (WWII).

Weeks like last week drive investors to search for a reason to justify the modest sell-off. Although there are many potential culprits, valuation is likely not one of them. Stock valuations remain slightly elevated but not at levels to spark selling pressure or concern. That said, valuations at current levels do suggest that the bar for growth has been raised and that stocks are likely more vulnerable to any economic deterioration if growth does not materialize in the second half. However, amid the equity market losses of last week, economic data continued to validate a strengthening economic backdrop, including a healthy July jobs report, above-consensus second quarter gross domestic product (GDP) results, and a better-than-expected ISM report for July (please see this week's *Weekly Economic Commentary* for details). These strong results are important since solid growth, not valuations, remains the most important catalyst for fueling stock market gains for the remainder of the year. So keep brushing those teeth and looking out for market "cavities," but, for now, we would not be too afraid of the dentist. ■

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stock representing all major industries.

RES 4786 0814
Tracking #1-295951 (Exp. 08/15)