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TRUST AND INVESTMENT SERVICES

Market Comment: The Reevaluation of Valuations
March 29, 2018

The equity markets are finishing the first quarter of 2018 in the red for the first quarterly decline since 2015. The nine-quarter win streak has been snapped, leaving many investors wondering if this bull market is ending. We cited in earlier Market Comments that valuation levels were elevated and, compared to historic measures, should come down. Accordingly, we believe the markets are simply reevaluating the valuations.

The difficult part of investing is that both overvaluation and undervaluation are emotionally driven. It is a phenomena that provides for both risk and opportunity. When estimating the value of an asset, we look towards the earnings potential of such asset and apply a multiple based upon its potential. With several vastly differing headline news stories recently, investors are left trying to gauge the potential of future earnings. This has directly resulted in higher volatility (or greater market swings) seen in the past several weeks.

Optimism was the driving force for higher valuations that led to a remarkable rally in equity markets in 2017, and one could argue it is still in place. Earnings growth, primarily from the tax cuts, is expected to rise 16% in the first quarter of 2018. In addition, recent data suggests the US economy grew from April through December at 3.1%, far exceeding the previously expected rate.

We also wonder if fewer shares outstanding (supply) in the markets have contributed to valuations. The peak number of publicly traded companies occurred in the dot-com era of the mid-1990's with over 7,000 publicly traded companies listed on US market exchanges. Today that figure is closer to 3,600 companies. In addition, many companies implemented share repurchase programs to further reduce the amount of shares available for public trading. Under simple assumptions, less supply with equal or higher demand should increase prices or, in this case, valuations. There is some debate to the impact of share repurchase programs but we believe this has contributed, along with an increase in the number of buyers, to an increase in valuations.

Toward the end of 2017, we ratcheted-up earnings forecasts in response to the tax cuts. The market and investors were almost euphoric around that time, and we noted the overly optimistic tone coming from the Davos World Economic Forum held in mid-January as a potential short-term market top. So far, this has been the high in equity markets and it coincided with the peak in the Shiller P/E Ratio. At that time, it topped 26, which is historically very high. It has come down somewhat since but we believe it has more room to the downside. In order for this to happen, either earnings will fall from a recession, aggressive monetary policy or some other unforeseen event like trade wars, or time must simply pass in which consolidation will occur, allowing valuations to grow into earnings. We believe the latter has the highest probability of occurring. We do not expect much growth in the coming months as valuations compress into levels that are more historic.

However, we do continue to see opportunities in individual names and believe there is a higher chance that the expansion will continue long-term, perhaps even eclipsing the record-setting 1991-2001 expansion period. However, for the time being, valuations will be reevaluated and should keep stock prices from seeing the types of upward moves we saw in 2017.
