Return to Fundamentals: Earnings and Multiples
November 9, 2016

The markets have been fluctuating from election uncertainties, but now that we know the outcome, we will welcome the attention shifting back to the fundamentals.

For investors, there are two main components of investing in stocks: (1) how much money will a company earn and (2) what should the multiple be for future earnings? All other information will inevitably affect these two basic issues. It is easy to be distracted by the noise, particularly around major elections, but ultimately, fundamentals drive stock prices and stock prices drive markets.

Up to this point lower rates have supported higher multiples on stocks. We measure this by looking at the forward Price-to-Earnings (P/E) on the S&P 500 index. For the last several years, it has expanded approximately 70% during this bull market. Some would argue a continued sustained lower rate environment will support higher multiples into the 20 times range. But valuation multiples are approaching historically high levels, which in prior periods hasn't been able to hold over the long-term. Certain periods, such as the late 90's, had inflated multiples much higher. Of course this ended poorly for investors. We are not at those levels yet, but will need to see earnings continue to rise to support current multiples.

As for interest rates, we continue to believe the majority of the Federal Open Market Committee (FOMC) will want to raise rates this December. Although current survey-based measures are showing little signs of inflation, the shift in yields could be indicating a return of inflation for next year. In addition, there has been a certain complacency in low interest rates. The popular phrase, "lower-for-longer" has become a popular mantra. We are aware when complacency settles in, a reversal always seems to follow. This could lead to the fixed income markets playing catch-up. The fixed income market has been weak, with yields at or above their 200-day moving average, suggesting changes could be on the horizon.

We believe earnings should not change as a result of this presidential outcome. Certain industries will benefit more than others and we acknowledge there has been some delayed consumer spending from this election which could release to some pent up spending. It would not be unreasonable to see companies revising earnings slightly higher in the upcoming quarter to offset the slow 3rd quarter. According to FactSet, the past quarter's blended earnings growth rate for the S&P 500 was just 2.7%. This is consistent with our slow growth call from earlier in the year and makes the current valuation on the equity markets fully priced. However, any uptick in this could support a move higher. The S&P 500 index is trading around 16 times its fiscal 2017 earnings of $130.

But adjusting the earnings multiples to reflect higher rates will affect the markets going forward. Traditionally, rising rates do not automatically mean lower stock prices. If earnings can take some of the slack from rising rates, it may actually create an environment more typical of an expansionary period. Therefore, we will look to increase our price target to approximate 2400 on the S&P 500 (or an 11% increase from today's levels).

It takes time for more expensive capital to affect economic activity and it will take time to fully understand the implications from this presidential election. The potential outcome of any one of these variables can obviously have negative impacts. Therefore, our stance will continue to maintain proper diversification, adjusting positions based upon the fundamentals. Now we will see if the fundamentals will return to the equity markets.

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