CAUBLE & HARRE
WEALTH MANAGEMENT

12977 NORTH 40 DRIVE, SUITE 213
ST. LOUIS, MO 63141
314-576-1112 | CAUBLEHARRE.COM

Market Overview, January 2018

When I wrote the third quarter note a few months ago, I stated that I thought the market was at least 10% overvalued. I noted that corporate earnings had been improving, but that the market was rising faster than earnings, and so the market was becoming even more expensive. Three months later I find myself wanting to say the same things.

Stocks follow earnings over time, and it is difficult to bet against stocks when earnings are in an uptrend. Stronger economic growth is the theme across the globe today, and this is expected to continue. At some point, however, the market will need to come to terms with its valuation. A too high valuation can be ‘fixed’ through the market falling, earnings rising, or some combination of both. With earnings rising, it is certainly possible for valuations to come down while the market remains close to current levels.

For the year, the S&P500 rose about 20%. Earnings are expected to rise about 17%. The market, therefore, rose more than earnings, making the market more expensive. The market’s expensive valuation has been developing over time. Through 2015, 2016 and 2017, earnings rose about 11% cumulatively. The S&P500 rose over 36% over the same period. Currently, the market is selling at a Price Earnings ratio of 18.3 times by the measure I review (from J.P. Morgan). The 25 year average is 16 times.

The market follows earnings, but investor attitude about those earnings has an impact (largely in the Price Earnings ratio assigned to the actual earnings). A very approximate description would be that when investors are feeling negative/pessimistic/doubtful, they may pay 12 times earnings. When they are feeling optimistic/euphoric/everything is awesome, they may pay 19 times earnings. Reality is probably somewhere in between. The 15 year average is 16 times. Again, we are currently a bit over 18 times.

When might things change? I will note that a year ago, earnings were expected to rise 20% this year. That has declined to expectations of 17% as of today (and we will get final results as companies report during January). Today, expectations for 2018 are for earnings to rise by 14%. So the market expects good earnings growth, but at a slower rate than this year. This perceived slowdown in growth rates could be enough to make the market rethink higher and higher PE multiples. Tax reform late this year has clouded the predictive lens a bit. We may get some clarity on this from company earnings reports during January, as they comment more thoroughly on what they expect this year. I would note that while earnings may theoretically increase from the reduction in tax rate, to the extent they spend/invest this extra money on higher payroll or more equipment purchases, after tax earnings may not improve as much as expected by some.

The return on fixed income was muted for the year. It seems that interest rates are beginning to rise. The interest rate on the 2 year Treasury started the year just below 1.25%, and rose to over 1.85% by the end of the year. This is a rise in rates of almost 50%.

LIZ H. CAUBLE, CFP
liz@caubleharre.com

PETER B. HARRE, CFA
peter@caubleharre.com

The interest rate on the 5 year Treasury also rose, from 1.93% to about 2.22%. The rise in rates detracted from the coupon received and caused total returns for fixed income to be small. The return for the 1-3 year Credit iShares ETF (CSJ) was about 1.24% for the year, and the return for the 1-5 year Gov't Bond Ladder iShares ETF (CLF) was 0%.

A recession does not seem likely for 2018, and that is good news. International markets outperformed domestic markets during 2017, and I would not be surprised to see this continue for the next few years. Overseas, valuations are lower and growth prospects are solid. I would not be surprised if international markets were the source of positive returns for 2018, and domestic markets held their own, with small but positive returns.

The risks that were present 3 months ago are still with us. Margin debt is high. Other forms of leverage are starting to build. And the Federal Reserve is beginning to implement a more restrictive monetary policy, both by raising interest rates and starting the process of reducing their balance sheet. This also underscores the importance of tax reform. The positive economic impact from tax reform could offset the restrictive nature of the Federal Reserve's new policy.

Our economy is growing, however. Wages should continue to improve, and we could see capital spending continue to improve this year. But I do think that the valuation has to come down a bit. We will remain diversified and attentive.

I will comment on Bitcoin for those that are interested. If so, let me know. The first and last sentences will likely be 'Buyer Beware'.

Please call with any questions or concerns.

Regards,

Peter B. Harre, CFA

LIZ H. CAUBLE, CFP
liz@caubleharre.com

PETER B. HARRE, CFA
peter@caubleharre.com