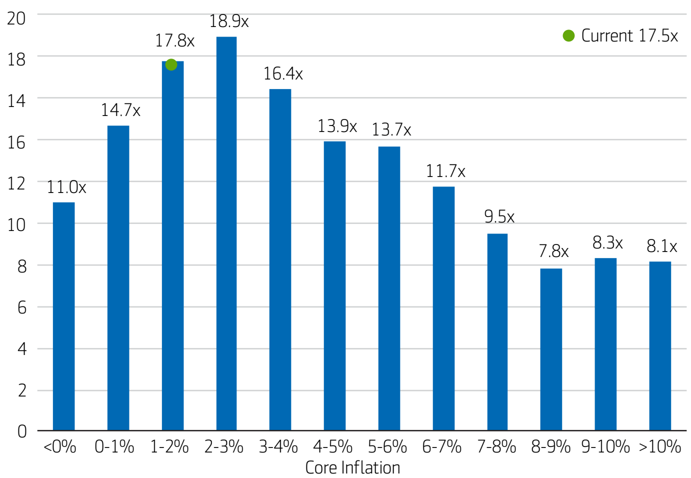
TAKING STOCK OF THE EQUITY MARKET PLUNGE

By Gary Black, Chief Executive Officer, US

The 8% US stock market correction that culminated with the February 5 collapse that wiped out gains for the year is part of a normal cycle. More importantly, it was likely needed to give the stock market the pause that refreshes before moving to new heights. Our view is that the combination of massive US fiscal stimulus, continued coordinated global monetary policy, synchronous global economic recovery with limited inflation, combined with reasonable valuations, suggest that this correction is yet another in a long list of buying opportunities over the past eight years.

The S&P 500's current forward P/E of 17.5x after the February 6 rebound is slightly below the 17.8x average since 1950, when core inflation (ex-food and energy) is in the 1-2% range. With core inflation in the 2-3% range, which is the Federal Reserve's target range, the average P/E on forward earnings over the past 60-plus years is 18.9x (Exhibit 1).

Exhibit 1: The S&P 500 Average Trailing P/E Ratios by Core Inflation[1]
1950 through 2017



Source: Federal Reserve Board, Standard & Poor's, Bureau of Labor Statistics, Empirical Research Partners Analysis.
[1]Core CPI. Prior to 1958, overall CPI is used

The increase in P/Es as inflation and interest rates rise, and then the more logical subsequent decline in P/Es as inflation and rates continue to rise, can be explained. Initially, as markets fear deflation and a lack of growth, anything that creates inflation and creates an escape velocity from recessionary pressures is seen as a good thing—up to a point. Once inflation reaches a more normal level (2-3%), further increases in inflationary expectations trigger fears that the Fed may raise rates too quickly, increasing the risks of a future recession or slowdown in growth. When the Fed raises short-term rates, longer-term risk-free rates correspondingly rise, which under normal circumstances push down P/E multiples.

Strategists and economists who assert that the current S&P 500 P/E multiple of 17.5x on 2018 earnings is high relative to the 14-15x average multiple over the past 67 years are ignoring that inflation now is low, depressed by the scars and deflationary forces of the worst recession since the 1930s. These deflationary forces, combined with so-called "TAG" secular drivers—transparency of prices, automation, and global sourcing—reduce labor's power to increase wages and should increase productivity for all manufacturers. Applying a 14-15x multiple to S&P 500's 2018 earnings without considering an expected inflation rate of 2-3% would be akin to putting a 14-15x multiple on Amazon without regard to its much higher expected growth rate.

Two other thoughts

First, the current Street estimate for 2018 S&P 500 EPS is $153, based on strategists' top-down estimates of what the reduced corporate tax rate implies relative to last year's S&P earnings. With year-end earnings season now in full swing, many companies have updated their guidance for 2018. We believe the bottom-up S&P 500 estimates are likely to wind up much higher than the $153 earnings estimate, since individual companies will also guide investors on their plans for repatriated cash from overseas. Of course, neither the strategists' top-down estimates nor individual company's bottom-up estimates includes the expected effects of higher economic growth resulting from the tax cuts.

Second, there are several built-in stabilizers that cause increased demand for equities when prices fall precipitously as they did February 2 and 5. For one, pension plans that were rebalancing away from equities following their sharp advance last year may reverse course and either stop allocating away from equities or add more equities to adjust for the most recent downturn. Also, fundamental hedge funds that run with a 20-60% net exposure will find they must buy more equities to reposition themselves back within their target range. Finally, companies that are in the middle of share buyback programs—particularly those expecting repatriated cash later this year—may increase their buybacks with equities now on sale.

Taking the current S&P 500 earnings estimate of $153 and applying the average 18.9x forward multiple observed over the past 67 years when core inflation was 2-3% implies an S&P 500 fair value of 2900—8% above the February 6 close. If estimates continue to move higher as individual companies update 2018 guidance or as the effect of the tax cuts causes estimates of GDP growth to accelerate, we could see upside to the 2900 price level.

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