Market Insights

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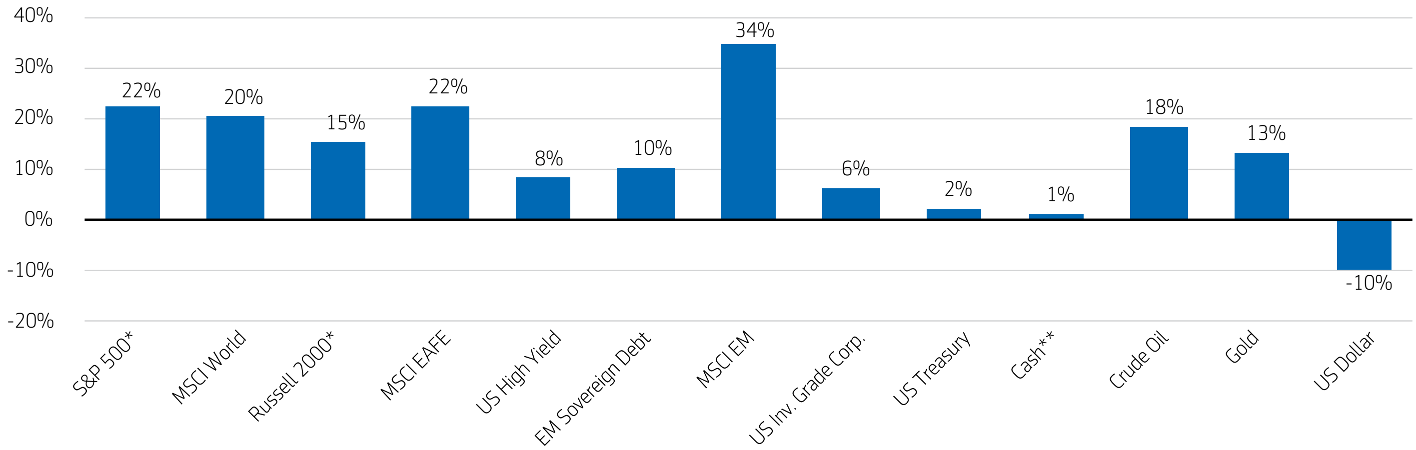
WHAT ARE THE CAPITAL MARKETS TELLING US?

By Gary Black, Chief Executive Officer, US

It was an extraordinary year for the markets with the S&P 500 Index up 22%, many broad international equity asset classes up 20% or more, and most bond asset classes up between 7 and 10% (Exhibit 1). With fundamentals strong, valuations reasonable, tax reform enacted and inflation still very low, many pension managers have increased their investments in equities and are taking on additional risk across other asset classes. This has fueled the recent rally in risk assets even as valuations have become more stretched.

Exhibit 1: 2017 Asset Class Returns



*Includes Dividends
**US Cash LIBOR Total Return
Source: Bloomberg. As of December 31, 2017. Indices represented include: S&P 500 Index, MSCI World Index, Russell 2000 Index, MSCI EAFE Index, Bloomberg Barclays High Yield Index, JPMorgan CEMBI Broad Diversified Index, JPMorgan EMBI Global Diversified Index, JPMorgan GBI-EM Global Diversified (Unhedged), MSCI Emerging Markets Index, Bloomberg Barclays US Corporate Investment Grade Index, Bloomberg Barclays US Treasury Index, LIBOR Total Return 3-month, Brent generic first month contract, gold first month contract, and the US Dollar Index (DXY).

The US economy is in a goldilocks-like "not-too-hot, not-too-cold" environment. With fiscal stimulus now in place, including a sharp reduction in the corporate tax rate, the ability to immediately expense most property plant and equipment, huge incentives to repatriate cash held overseas, reductions in individual tax rates, and tax advantages for those who run small businesses, the current equity market expansion, now in its eighth year, has likely been extended a while longer.

This stimulus, combined with highly accommodative monetary policy from the Federal Reserve's continued efforts to spark growth following the Great Recession of 2008-2009, implies an economic expansion that may continue for several more years. This is especially true given the lack of inflationary forces despite an unemployment rate near levels not seen since the 1960s.

The debate about whether the current deflationary forces are transitory or secular continues, but our view remains that "T-A-G"—Transparency in prices fueled by the Internet; Automation in everything from bank ATMs to scanners to robots to driverless cars going forward; and Global sourcing of every imaginable product and service to the region with the greatest competitive advantage—has fundamentally changed global supply and demand relationships.

Tax reform

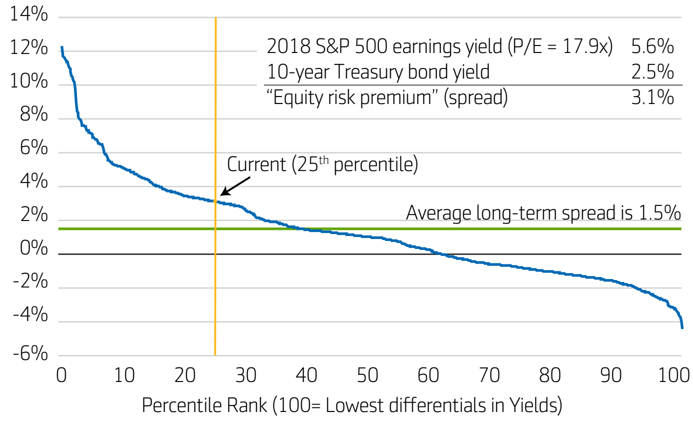
On the tax package just passed, January has brought investors a slew of updated company projections on just what the reduction in tax rates will do for 2018 earnings, and perhaps more importantly, what they will do with all the cash that will come back as a result of the one-time mandatory repatriation tax of 15.5% on cash balances held outside the US. This could bring up to $1.2 trillion in cash to the US for buybacks, dividends, debt retirement or acquisitions. One only needs to consider the buyback economics of this new cash—at an average P/E of even 20x and an average pre-tax cost of borrowing of 3.7% with a tax rate of 21%, buying one's own stock or someone else's stock would be highly accretive versus keeping it in cash or retiring debt.

To put this coming cash wave in perspective, according to Yardeni Research, for the rolling four quarters ending September 30, 2017, the total amount of corporate buybacks for S&P 500 companies was $517 billion; the total amount of dividends for the S&P 500 was $422 billion; combined buybacks and dividends of $939 billion was 4.3% of market cap. On earnings, most strategists' 2018 estimates for the S&P 500 have increased from $130 per share baseline to $150 per share (+15%) based on the new lower tax rates. Analysts' bottom-up estimates will ultimately matter more but could provide significant upside, especially with expected accretion from new share buyback activity.

Rally on

Many investors continue to argue the massive rally in the S&P 500 since March 2009—it has essentially quadrupled off its bottom—has made stocks look expensive. I would respectfully disagree. Despite its rally, the S&P 500 continues to trade at just 18x pro-forma forward earnings assuming the new tax rate according to sell side strategists. This equates to a 5.6% earnings yield compared to 10-year Treasuries at 2.5%. This 310 basis point spread between equities and risk-free bonds remains massive (i.e., equities are cheap), ranking in the bottom quartile of cheapness going back some 60 years (see Exhibit 2). Viewed differently, the equity spread would have to narrow by some 160 basis points to get back to a normal spread—i.e., 10-year Treasury yields would have to rise to over 4%, or P/Es rise to over 25x for the equity spread to match median spreads over the past 60 years.

Exhibit 2: S&P 500 Index[1] Differential of Trailing Earnings Yield and the 10-year Bond Yield (Blue Line) – 1950 through December 15, 2017



Source: Federal Reserve Board, Standard and Poor's, Corporate Reports, Empirical Research Partners Analysis

[1]Capitalzation-weighted data