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May 31, 2018

One of my favorite recent quotes comes from Allan Roth, a financial planner in Colorado Springs, CO. On the subject of forecasting in general, he tells clients that they are paying him $450 an hour for him to tell them that he doesn't know the future. What is more, he considers it to be the most valuable piece of advice he gives them.

In early January, I wrote that the tax reform enacted in December could boost corporate earnings by 5-10%, and that could mean a pretty good year for the stock market. So far, I am batting .500 on my attempt to predict the future, as the first quarter earnings reports for S&P 500 companies shows a gain of 26% over the first quarter of 2017. While we aren't yet able to clearly see how much of this is due to the tax change, there is no doubt that it has boosted earnings.

The "pretty good year" part of my prediction is looking like a pop fly to the shortstop right now. The ball is still in the air, and the shortstop could drop it, but odds are pretty good he will catch it. The stock market, after a nice January has struggled to book gains based on the terrific earnings reports.

Perhaps the most significant outcome this year is the drop in the price / earnings (P/E) ratio for stocks. We saw an increase in the P/E ratio from about 13x earnings in late 2011 to roughly 22x earnings at the end of 2017, and this was largely due to a rise in stock prices. This rise took valuations from a bit below the long-term average of 15x earnings to a level just into "overvalued" territory. Since the start of 2018, a combination of strong earnings gains and the middling stock price results has dropped the P/E ratio to about 20x earnings. Given that economic growth is strong, the current P/E ratio is not high enough to suggest a bear market is on its way, but the drop does suggest that something is going on.

Using a high P/E ratio to predict a bear market is an exercise that can create lots of false signals, especially if it is done in the absence of other evidence of problems. Stocks may be priced at a high P/E ratio in anticipation of future earnings growth, as was the case back in 1923 and again in 1946 and 1992. In all three cases, the P/E ratio dropped rapidly as earnings growth rose faster than stock prices (which still went up nicely) over the ensuing years.

At the beginning of the 1970s, the P/E ratio dropped again, but this time it was the beginning of a lost decade for stocks. As inflation increased, earnings growth stalled and stock prices rose and fell without a clear direction. The P/E ratio dropped below 10 and stayed there for several years. It only began to rise after President Reagan cut taxes and Fed Chairman Paul Volcker broke the fever of inflation. While a low P/E ratio could be a signal to buy stocks, it wasn't a good signal in 1974 as it fell to about 7 and stocks went nowhere for years.

To be fair, a high P/E ratio can be coincident with the beginning of a bear market, such as we saw in 1929 and again in 2000. It is not as common as one might think, and high P/E ratios can occur long after a downturn in stocks begins. In a recession, corporate earnings typically fall, and the drop can be faster than the drop in stocks. In the 2000 – 2002 bear market, the highest P/E ratio (about 30) was measured in 2002, near the end of the bear market.

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Benjamin Graham, the father of value-based investing and Warren Buffett's tutor said that "in the short run, the market is a voting machine, but in the long run, it is a weighing machine." The market acts as a voting machine when investors look at current events and buy or sell accordingly. In 2017, we had a great deal of good news for investors, as the government began an aggressive campaign to reduce the impact of regulation on the economy. The good news culminated in the passage of the tax reform act in December, and the "voting" resulted in a strong stock market in almost all areas. Good economic performance in most of the world certainly helped.

The tune has changed in 2018 as President Trump has begun an effort to implement a new trade agenda oriented at more protection for American workers and jobs. This has created a lot of uncertainty, and I believe this is why the markets are more volatile than they had been for all of 2017. We have seen considerable rhetoric about tariffs, both by the U.S. and our trading partners, and the news on Iran, North Korea and even Italy has not helped matters. Negotiations on a revised North American Free Trade Agreement (NAFTA) have gone nowhere, we might impose tariffs on European cars and we are see-sawing back and forth on restrictions vs. open trade with China.

The market's votes so far this year suggest that the first quarter's earnings growth isn't as important to investors as one might think. It is possible that the market is guessing that earnings growth may not be sustained, especially if Mr. Trump's agenda reduces beneficial trade. Inflation could rise from its currently tame levels, especially if wages begin to rise as a consequence of full employment. The rumblings over North Korea and the Middle East could develop into a hot war with U.S. involvement. Political partisanship could hold up progress in a number of areas, especially on trade and immigration. Investors are voting based on a sense that any or maybe all of these concerns are real problems.

It is also possible that none of these concerns create a long term problem for the economy and for stocks. Mr. Graham's observation about the market serving as a weighing machine is only visible in the long run, and the only thing being weighed is how well the companies performed. We do not know the future, and only when we get there will we know what happened and why the market has been behaving as it has over the past few months. Until then, my best advice is to recognize that the future is unknowable and to plan accordingly.

As most of you know, I have a Magic 8 ball on my desk, and its latest answer is "Concentrate and ask me again". I already tried that and got a headache.

Thomas E. Dexter, CFP®

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