ARGUS®

WEEKLY ECONOMIC COMMENTARY

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What to Watch in an Aging Bull Market

In the middle week of September 2017, not much happened – but stocks rose 1%-2%. Despite the London subway bombing and another provocative missile test from North Korea, fear was absent from the stock market in mid-September – and September is normally a month in which investors take profits. Complacency is always worrisome, and even more so when caution and perhaps a little fear would be appropriate.

As the market continues to push (modestly) above fair value, investors are registering various degrees of alarm – but that has not stopped them from buying. When an already rich market rises on no real news, investors conclude that greed is fueling unchecked upward momentum. Markets are best when they balance fear and greed in roughly equal proportions, with maybe a slight tip toward greed. Were fear to suddenly return to a more normal weighting in the equation, the market would be at risk of a severe shake-out.

BULL MARKETS SINCE WORLD WAR II

Since the end of World War II, we count 12 bull markets including the current one. On average, those 12 bull markets have lasted just over 58 months. The current bull market is about 105 months old, which makes it the second-longest of the bunch. The longest bull market in this set began in 1991 and died about nine years later in 2000. The 1990s bull market and the current bull market are beneficiaries of lower market rates of interest, which can support higher valuations and partly explains their longevity.

We've talked about years; how about the mileage? The 12 bull markets since WWII including the current ones have averaged a cumulative gain of 149%. The strongest was the 1990s bull market, in which the S&P 500 rose 417%. The current bull-market return is in second place, barely ahead of the 267% gain registered by the 1949-1956 bull market.

Worth remembering about the current bull market is that it began from an unnaturally suppressed level, following the near-collapse of the global banking system. Yes, the S&P at 2,500 is up 271% from lows of 676 reached in March 2009. But the S&P 500 is up "only" 60% from the 1,565 level reached early in October 2007, just before the wheels came off the U.S. housing economy.

Additionally, the current bull's progress has been interrupted by four corrections of at least 10%, including the near-bear (down 18%) in summer 2011. Based on this more moderate cumulative gain, from 1,565 in October 2007 to the 2,506 level in September 2017, the S&P 500 has advanced at just under a 5% annualized gain over the past decade – hardly the hallmark of an hysterical, run-away market.

By contrast, the 1990s bull was interrupted only by the moderate selloff in 1998 triggered by the collapse of Long Term Capital Management. For that reason, when the 1990s bull market toppled over, it fell hard. That was particularly true in the Technology sector, where the Nasdaq at one point traded at more than 50-times trailing earnings. The Nasdaq, which peaked above 5,100 early in 2000, did not hit bottom until reaching the 1,160s in September 2002.

DEATH OF A BULL MARKET

While longer-than-average bull markets create anxiety around risks of their demise, bull markets tend not to die of old age. Most bull markets end because of recession, inflation, or circumstances that severely impair earnings. When we consider two major bull "assassins" of inflation and recession, neither seems to be much of a concern at present.

With the economy at or near full employment, inflation should be a growing problem – buy it's not. For a variety of reasons, wage growth remains subdued. Since the great recession, annual GDP has grown at a sub-2% average rate. Starved by sluggish GDP, job growth has lacked the explosive moment that would engender employee bargaining

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power. The implied risk of outsourcing and reduced power of unions have restrained wage growth in higher-skilled positions. Meanwhile most job openings are toward the bottom of the pay scale. Monetary-driven inflation is no longer a risk as the Fed enacts restrictive monetary policy and the government is shrinking rather than growing its balance sheet.

As for recession, that agonizingly slow GDP growth since the great recession has its virtues. Explosive GDP growth can prompt companies to scale up in excess of the economy's real growth potential. Instead, the slow crawl of GDP growth has kept companies cautious, with strong levels of cash, while low market rates of interest have resulted in moderate debt levels and low cost of debt service. With companies investing only to meet clearly visible demand, an overcapacity-driven crash seems highly unlikely. Investors pining for faster GDP growth should be careful what they wish for.

VALUING THE CURRENT BULL MARKET

While it is straightforward to measure the length and duration of a bull market, valuation is a thornier issue, given that different strategists use different metrics. Some look only at trailing and forward earnings. When assessing valuation of the market, we believe it makes sense to use "normalized" earnings, which reach back approximately three years and look forward approximately two years.

At a current 2,500 on the S&P 500, this bull market is about 3% above our fair value calculation in the 2,425 range. Our fair value calculation is based on normalized earnings of $128, which is the five-year average (2014-18) of S&P 500 earnings from continuing operations. Normalized earnings are then discounted by five-year average PCI inflation of 1.21% and the real Moody's AAA bond yield of 2.43% (the nominal yield of 3.64% less the 1.21% long-term inflation rate).

Looked at another way, the S&P 500 trades at 19.2-times trailing earnings on a long-term basis. At present, the S&P 500 trades at about 19.8-times trailing S&P 500 earnings from continuing operations and at about 19.5-times our normalized earnings calculation. Although any valuation excess bears watching, these multiples are not dangerously out of whack with past levels. Early in 2000, by contrast, the 1990s bull market topped out with trailing P/Es well north of 30-times.

Since 1960, no bull market has peaked before rising 8%-17% above fair value – and that is excluding the extreme value excesses preceding the 2000-2002 bear market. Assuming five-year centered earnings, interest rates and inflation remain roughly at current levels, this bull could begin to top out somewhere around 2,650 to as much as 2,800 on the S&P 500.

EARNINGS PUSH THE VALUATION BOGEY FORWARD

Fortunately, our normalized earnings calculation is finally in a position to begin moving forward. Quarterly S&P 500 earnings from continuing operations on the S&P 500 grew in the first half of 2014 but flattened out in the second half; were flat across all quarters of 2015; and were flat in the first half of 2016 before resuming growth in the second half. The net effect of this pattern is that S&P 500 earnings from continuing operations for 2014, 2015, and 2016 were all in the $118-$120 per-share range.

Our 2017 EPS estimate of $132 is well on its way to being achieved, given EPS growth of 14% in 1Q17 and 11% in 2Q17. Our 2018 EPS forecast calls for high-single-digit growth, which would put earnings in the $143 area. A year from now, and assuming that high-single-digit growth persists for 2019, the normalized EPS basis for our fair value equation will be 5% higher, in the low $130s. As long as the stock market moves up just moderately, the fair value bogey can keep pushing out, keeping stocks out of dangerous overvaluation territory.

CONCLUSION

The S&P 500 has arrived at 2,500, but there is no guarantee it can hold that level. We would expect a pattern of approach, surpass and retreat around this key half-millennial marker, as we have seen repeatedly in the past.

Stocks had a bumpy trajectory at the last millennial marker. The S&P 500 first surpassed 2,000 at the end of October 2014, following a steep climb out of the low of 1,863 just weeks before. Although the market quickly pushed to 2,050, three times over the next four months the S&P 500 dipped under 2,000 as investors were quick to sell into any downward move. And investors had to reclaim 2,000 all over again after the S&P 500 plunged from 2,100 in mid-August 2015 to lows below 1,900 in September 2015 and again in winter 2016.

Speaking of half-millennial markers, the collapse around 1,500 was truly spectacular. After first closing above 1,500 in May 2007, the S&P 500 peaked at 1,565 in October. Two months before, in July 2007, a Bear Sterns hedge fund based on mortgage-backed securities collapsed. By September 2008, the entire global financial infrastructure was hanging on by a thread. In March 2009, the S&P 500 bottomed at 676. In summer 2011, with 1,500 just 100 points away, the debt-ceiling battle sent stocks nearly into bear market territory. The S&P 500 did not get back above 1,500 until 2013!

Based on solid, if unspectacular, earnings prospects and economic fundamentals, we expect the S&P 500 to eventually move on from the current 2,500 level. Argus Investment Strategist Peter Canelo stated recently that he would be alert for a possible S&P 500 peak near 2,680-2,780 over the coming six months and 2,740-2,840 within a year.

Should the bull market begin to unravel, the first stocks to sell off will likely be the current group of market darlings. As the bull market gets further into its maturity, we will discuss where to position for any potential downturn.

Jim Kelleher,
Director of Research

Investors