LPL RESEARCH
WEEKLY MARKET COMMENTARY

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VALUATION CHECK-IN

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KEY TAKEAWAYS

We make the case that stock valuations are reasonable when considering interest rates and inflation.

The combination of rising earnings estimates and falling stock prices has reduced valuations quite a bit over the past several months based on forward earnings estimates.

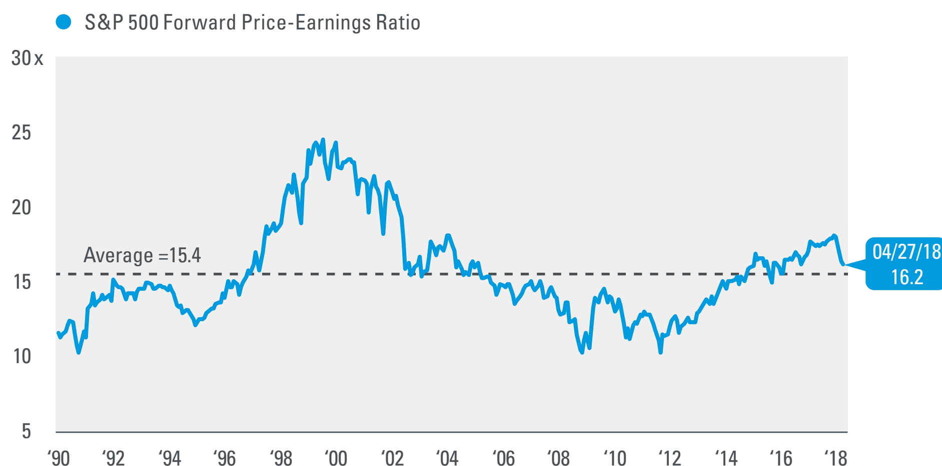
When we combine reasonable valuations with solid fundamentals and a positive technical and sentiment backdrop, stocks look like a potential opportunity to us.

Time to check in on stock valuations. After providing our assessment of stock market fundamentals, sentiment, and technical conditions over the past few weeks, this week we turn to the last piece of our investment process: valuations. Here we will make the case that stock valuations are reasonable, despite above-average price-to-earnings (PE) ratios.

VALUATIONS HAVE COME DOWN

Before making the case that stocks are fairly valued, we want to first point out how far valuations have fallen in recent months. Our favorite valuation tool for stocks, the PE ratio, has seen a falling "P" and a rising "E." The S&P 500 Index is about 7% off its closing high for the year, set on January 26, while estimates for 2018 earnings for the index have risen by about 3% during that time (they are up 8% year to date). The increase in earnings estimates for the next four quarters is even more dramatic, having jumped 6% since the January stock market peak, boosted by very strong

1 STOCK VALUATIONS ARE ONLY SLIGHTLY ABOVE POST-1990 AVERAGE



Source: LPL Research, FactSet 04/27/18

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Forward price-to-earnings is a measure of the price-to-earnings ratio (PE) using forecasted earnings for the PE calculation. The earnings used are just an estimate and are not as reliable as current earnings data.

The S&P 500 Index is unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results. Estimates may not develop as predicted.

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first quarter earnings growth of 24% year over year, a big upside surprise compared with estimates as of quarter-end, and mostly positive guidance from company management teams.

Higher analysts' earnings estimates coupled with lower stock prices have clipped about 12% off stock valuations in just the past three months, taking the S&P 500's forward PE from 18.5 to 16.2, according to FactSet data [Figure 1].

A CASE FOR STOCKS BEING FAIRLY VALUED

We believe the S&P 500 is fairly valued at a forward PE ratio of slightly over 16, even though that level is a touch above the post-1990 average of 15.4. On a trailing PE basis, using earnings over the past four quarters, the PE is higher at 20 (the long-term average is near 17). But in a scenario of sharply rising earnings, trailing PEs tend to be inflated and fall quicker as earnings ramp up—the trailing PEs may fall by a point or two by year-end assuming stock returns and earnings reach our targets (both up double digits).

Simply put, we think above-average valuations are justified given our positive outlook for earnings, still-low interest rates by historical standards, and low inflation. We look at each of these factors below.

Forward PE disclaimer

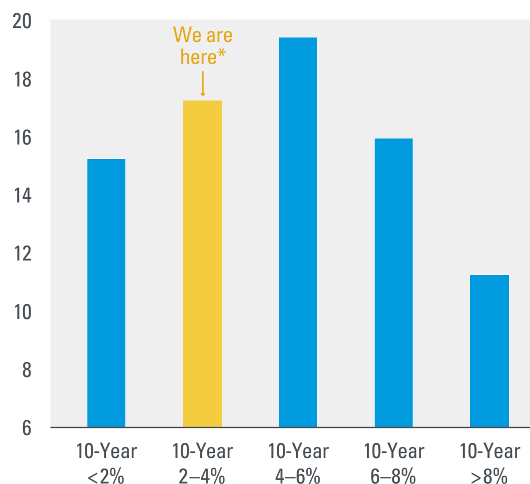
Valuations relative to overly optimistic estimates can be misleading so before evaluating forward PEs, we ask ourselves how likely S&P 500 companies are to produce earnings at or near consensus estimates. While our estimate for 2018 S&P 500 earnings for share, at $152.50, is below the consensus estimates tracked by Thomson Reuters and FactSet of $158–159, implying 20% earnings growth, the strong start to earnings season and the resilience of earnings estimates during earnings season leaves our estimate potentially on the conservative side. Bottom line, we think the earnings outlook is sufficiently strong to justify slightly above-average valuations based on forward earnings estimates.

Still-low interest rates

Interest rate levels, which are another important consideration when evaluating stock valuations, are currently supportive of above-average stock valuations. Interest rates dictate how attractive bonds are relative to stocks, so lower rates make stocks relatively more attractive. Interest rates also determine the discount rate at which future cash flows are discounted back to arrive at a present value (in theory, that's fair value for the stock market). Interest rates are also indicative of financial conditions. Easier financial conditions are generally supportive of higher valuations.

To illustrate the relationship, we can break historical valuations down into interest rate buckets, as we have done in Figure 2. This exercise illustrates that,

2 CURRENT INTEREST RATE LEVELS ARE SUPPORTIVE OF STOCK VALUATIONS



Source: LPL Research, FactSet 04/27/18

*Current 10-Year Yield = 2.96%

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Chart utilizes Trailing PE – The sum of a company's price-to-earnings, calculated by taking the current stock price and dividing it by the trailing earnings per share for the past 12 months.

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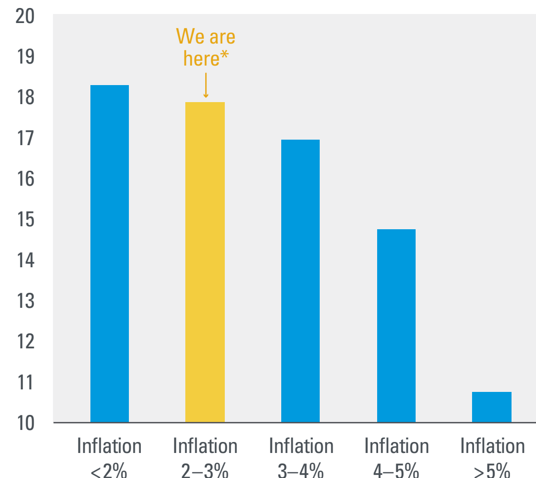
based on historical data (back more than 50 years), when interest rates are in the current range (2–4% in the figure), stock valuations have tended to be higher. In fact, current stock valuations are only a little above average for the current level of interest rates. Adjusted for interest rates, valuations are not high. This doesn't mean stocks can't fall as interest rates rise, especially if rates rise quickly. However, it should provide some assurance to anyone nervous about valuations. Note that we used trailing PEs for this analysis because of the longer available history.

Low inflation is also supportive of higher stock valuations

The valuation picture is similar relative to inflation. Based on the annual change in the Consumer Price Index (CPI), stock valuations tend to be higher when inflation is low [Figure 3]. This makes logical sense because higher inflation, like higher interest rates, erodes the value of future cash flows in today's dollars (even though companies can more easily raise prices to offset higher costs in inflationary environments). Also, higher inflation tends to be accompanied by higher interest rates.

On average, stock valuations have historically been highest when annual consumer inflation is below 2%, but the 2–3% segment has been good too. Historically, when inflation has exceeded 4%, valuations start to become meaningfully impaired. As with interest rates, valuations are fairly close to average when factoring in the level of inflation. At year-end, assuming stocks, earnings, interest rates, and inflation come in at or near our targets, stock valuations may even be below average when factoring in interest rates and inflation.

3 STOCK VALUATIONS TEND TO BE HIGHER WHEN INFLATION IS LOW



Source: LPL Research, FactSet 04/27/18

*Latest change in annual CPI = 2.4%

Inflation represented by consumer price index (CPI); data series back to 1962.

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CONCLUSION

Stock valuations have fallen quite a bit recently due to rising earnings and weaker stock prices and are only slightly above average. We believe slightly above-average valuations are justified based on the strong earnings outlook, still-low interest rates, and low inflation. When adjusted for interest rates and inflation, stock valuations are near average—and may get cheaper as earnings ramp up throughout 2018.

When we combine reasonable valuations with solid fundamentals and a positive technical and sentiment backdrop, stocks look like a potential opportunity to us. We maintain our S&P 500 year-end 2018 fair value target of 2950–3000, implying double-digit stock market returns.* ■

*We believe 2018 earnings will be supported by stronger global economic growth, a pickup in business spending, strong manufacturing activity in the United States, and the new tax law. Our year-end S&P 500 fair value target range is 2950–3000 based on a price-to-earnings ratio (PE) of 19.5.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

All investing involves risk including loss of principal.

DEFINITIONS

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Forward price-to-earnings is a measure of the price-to-earnings ratio (PE) using forecasted earnings for the PE calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there is still benefit in estimated PE analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

Trailing PE is the sum of a company's price-to-earnings, calculated by taking the current stock price and dividing it by the trailing earnings per share for the past 12 months. This measure differs from forward PE, which uses earnings estimates for the next four quarters.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

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