SIGNATURE RESOURCES CAPITAL MANAGEMENT

Commentary: June 2018

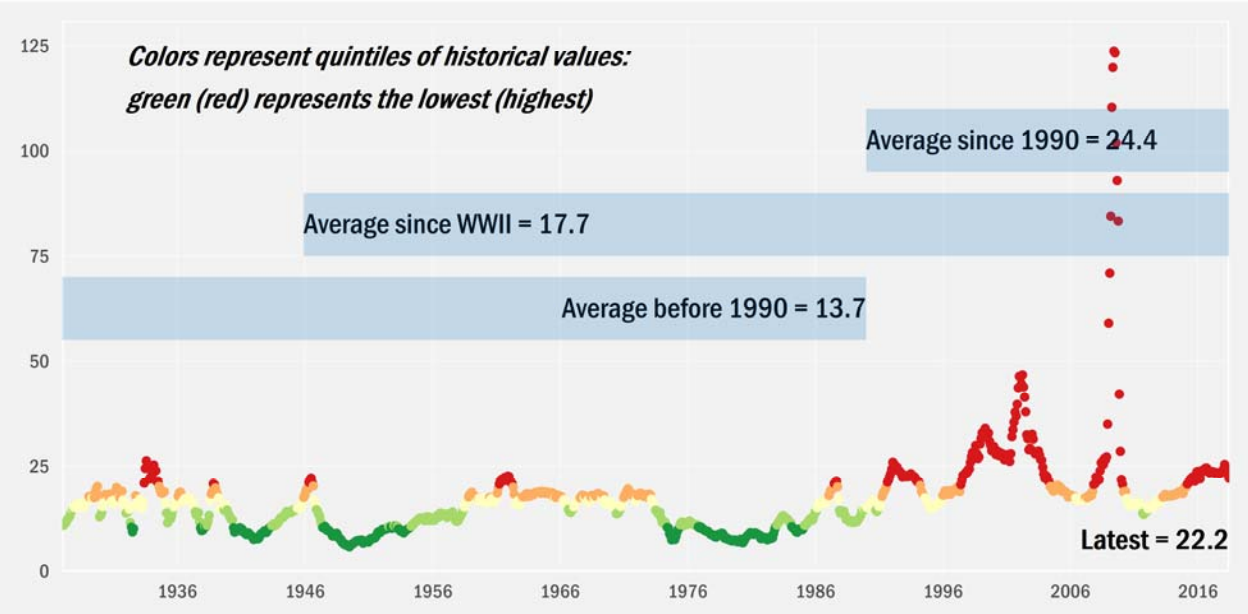
A FUTURE NONE DIVINED

With the large-cap-stock focused S&P 500 Index now up 4.8% year-to-date, after its 21.8% jump in 2017 and its rarely interrupted run since the depths of the Great Recession, admonitions regarding the unsustainability of domestic equity market valuations are growing in number and volume. While we cannot argue statements of fact—that the immense gains have left U.S. markets nearly without precedent in regard to valuation—we can argue the implications. Certainly, there is meaning in stock valuations, and a present reading set against investment theory suggests future equity market returns may fall short of historical norms. Even so, the nature of market history suggests even more strongly that no metric, valuation-based or otherwise, can foretell future market movement. We thus continue to believe the best approach to managing exposure to market risk is one that focuses more on levels of market exposure appropriate for individual investment situations, rather than one that seeks to foretell and act in advance of market shifts.

Stating the Facts

Fancier methods exist to gauge equity market valuation, but we often prefer the dollars-for-distributions view of the price-to-earnings (P/E) metric. A ratio of the price paid for a share of stock to the trailing years-worth of the company's per-share earnings, the P/E offers a gauge of the relative value of that stock versus itself over time and versus other stocks. A higher (lower) level suggests relatively more (less) expensive shares.

Figure 1: Historical Price-to-Earnings Ratio of the S&P 500 Index



Average of monthly values from 12.31.26 to 06.07.18. S&P 500 Index earnings data for 03.31.18 and 06.30.18 are estimates provided by Standard & Poor's. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg, Standard & Poor's and Professor Robert J. Shiller of Yale University

Package a bunch of stocks together, much as does the U.S. large-cap-stock-focused S&P 500, and one can compare the relative valuation of a broader market. In Figure 1, we show historical price-to-earnings data for the S&P 500. The colors distinguish resulting values into five evenly distributed buckets (quintiles), with green representing the lowest-valuation (cheapest) bucket and red representing the highest valuation (most expensive) bucket. The stream of red at the tail end of the index shows just how far we've come.

Valuations may rise for one simple reason: the price of the stock (or stocks, in the case of an index) becomes larger relative to the earnings it (they) represent. This can happen as prices rise (fall) more quickly (slowly) than do earnings. The upshot in rising valuation environments is that investors are paying more for ownership of those stocks. Such is the general character of the U.S. market since 2009. By the P/E metric, the U.S. market of large-cap stocks has been this or more expensive on rare occasions, the two most recent being the Tech Bubble and the Great Recession. Both periods were characterized first by rising prices relative to earnings, which led to rising P/E levels. In turn, prices fell more quickly relative to declines in earnings as both bubbles burst, leading to an easing of market valuations. Interestingly, in neither case did valuations eventually fall to historical lows.

Parsing the Facts

What's to make, then, of the current level of U.S. stock valuations. First, it's helpful to think of a stock price not as a reflection of trailing earnings, but as an expectation of future earnings: the price of the shares represents a claim on the future earnings of the company. In theory, then, higher valuations suggest investor optimism for future growth in earnings. Also in theory, though, higher valuations suggest lower future returns as investors pay up for future earnings in advance of them being realized.

Figure 2: Historical S&P 500 Index P/E, Vs. Forward 10-Year Total Return

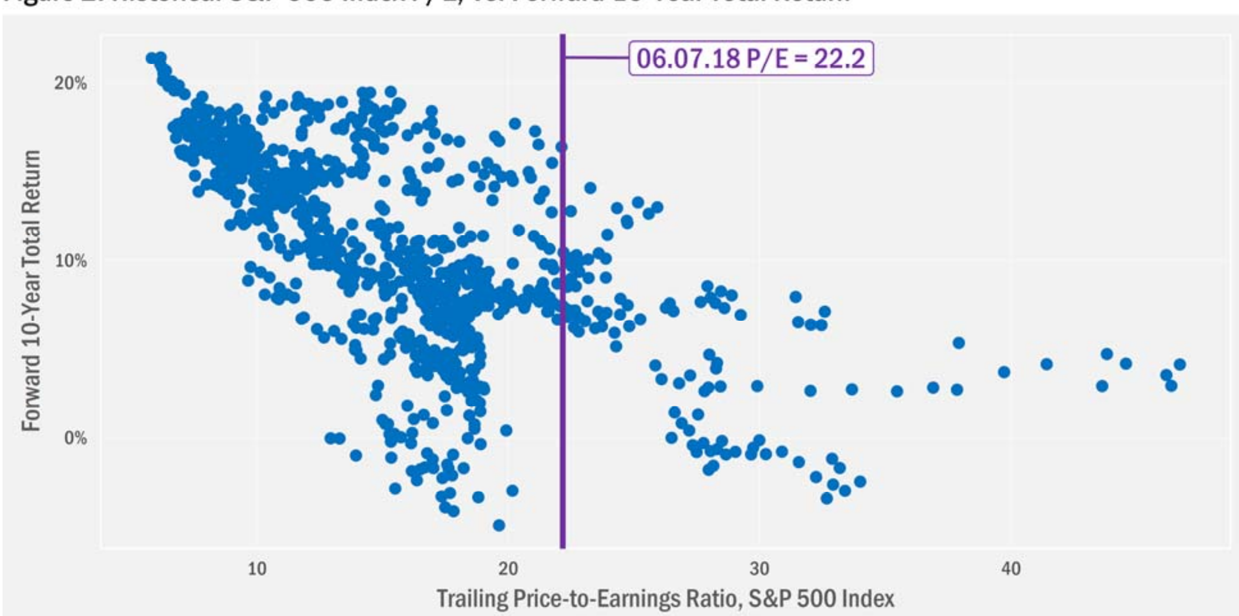


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Figure 2 provides some evidence for this suggestion. The chart very simply plots monthly historical market valuations against the average annualized return of the index from that point over the next 10 years. The attempt is to discern what relative levels of market valuations suggest for future returns. What's apparent is that the higher the beginning valuation, the lower has tended to be the forward decade of returns; as the P/E moves higher (to the right on the bottom scale), the historical future returns have proved lower (down on the left-hand scale).

So, the facts are that present levels of U.S. market valuation have rare precedent in history. That truth, set against the observations that, generally speaking, the higher the historical starting valuation, the lower the historical future return, suggests we might like to temper our expectations for forward equity returns.

Staying Invested

The be honest about what Figure 2 might show, however, the range of potential outcomes at most points along the valuation spectrum has been wide. And most 10-year outcomes still have been positive in history, regardless of the starting valuation. We thus don't necessarily think that present valuation levels should lead us to be fearful of equity markets. After all, present valuation levels aren't grandly different than those seen three years ago, since which time the S&P 500 has experienced a total return of more than 42%. A market timer might have missed out on those gains, fortifying the warning that, to experience anything like the relatively favorable historical returns offer by equity markets, one must remain invested.

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