Lebed
Asset Management LLC

Six Beacon Street
Suite 925
Boston, MA 02108
Ph: 617.722.8322
Fx: 617.249.2020

Investment Commentary—January 2018

As 2017 came to a close, stock market investors here and around the world had much to celebrate. As if superb investment returns--in excess of twenty percent on many indices--weren't enough, Republican leaders in Congress finally delivered a tax bill that will slash U.S. corporate taxes and boost earnings. Although signs of euphoria have begun to appear (mortgages taken out to fund Bitcoin speculation qualify nicely), soaring share prices are not completely unjustified. The global economy, having begun to reaccelerate late in 2016 is now firing on all cylinders, with the Eurozone leading the way. The U.S. economy is doing its part as well, with capital expenditures beginning to perk up. While there is a great deal to criticize in the tax bill as a policy matter, its near term economic impact will be positive. And even if it's unclear how much of the reduction in corporate taxes will flow into the economy, shareholders win either way.

Party pooper that we are, we offer a couple of caveats. First, for the global economy, this may be as good as it gets. 2018 should be another good year but increasingly central banks are looking to withdraw monetary stimulus. Leading the way, the U.S. Federal Reserve is planning three fed fund rate hikes in 2018. Further, the Fed has begun to sell some of the $3.6 trillion of bonds purchased during various rounds of "quantitative easing" (QE). These bond sales could put further upward pressure on interest rates. The European Central Bank is still engaged in QE but has taken baby steps toward winding that down and may accelerate the process in the months ahead. Central bank policy actions operate on a lag. Over the last year or so we have finally seen the full benefit of years of aggressive central bank stimulus. By the end of 2018 we may begin to see the impact of stimulus withdrawal.

The other point we'd make (not for the first time) is that share prices have gotten rather lofty. Three months ago we noted that "some valuation metrics make it appear that stock prices are at extreme levels." As the S&P 500 has climbed an additional four percent since, the question of valuation is, if anything, more pressing. So, *are* valuations extreme? And more importantly, what if anything should you do about it?

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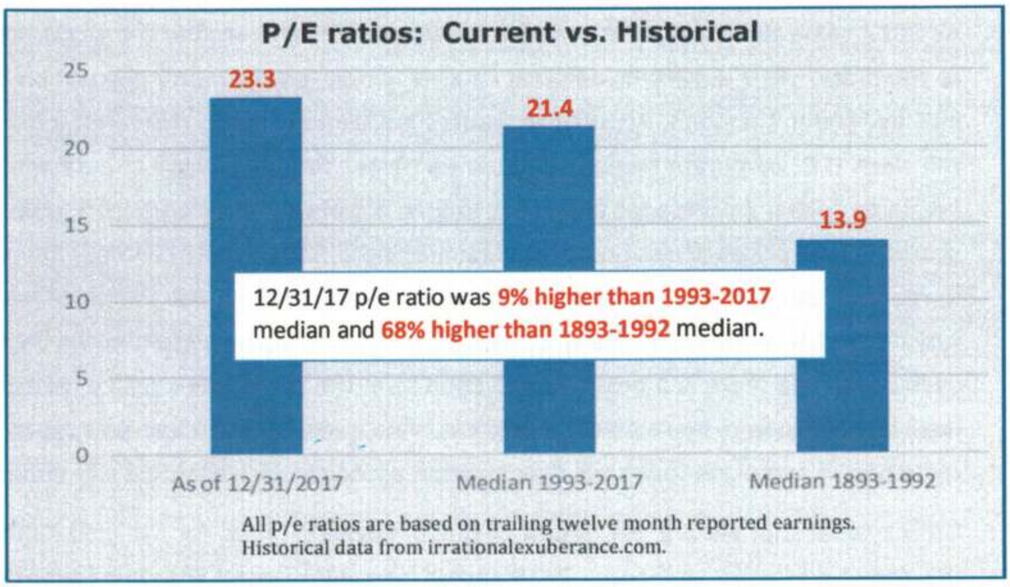
Let's frame the valuation discussion using the most common measure of valuation, the price-earnings (p/e) ratio. Based on reported earnings for the previous twelve months, the p/e ratio of the S&P 500 as of December 31, 2017 was 23.3. Is that high? Yes. How high? It depends on your frame of reference. Over the last 25 years (1993-2017) the median p/e has been 21.4. In the 100 years prior to that (1893-1992), however, the median p/e was dramatically lower, 13.9. Big difference! Using 21.4 as our point of reference, the S&P 500 is nine percent overvalued. Using 13.9 as our point of reference, the S&P 500 is 68% overvalued. Which is it?



There are plausible arguments to be made on each side. The optimistic case--that old p/e benchmarks are obsolete—rests in large part on the idea that stocks were <u>undervalued</u> for most of the twentieth century. As Jeremy Siegel famously documented in his 1994 book, <u>Stocks for the Long Run</u>, returns on stocks over 20-year periods have almost always exceeded returns on bonds. After more than a century, the argument goes, investors finally caught on. The result has been a gradual but permanent (and arguably very rational) increase in the price investors are willing to pay for a dollar of earnings.

Optimists would also point to improved quality of earnings. The U.S. manufacturing economy of the twentieth century required that a significant portion of company's profits be reinvested in the form of new equipment. In the intellectual property economy of the twenty-first century, a higher percentage of earnings is available for shareholders. Finally, there is the issue of interest rates. The reciprocal of the p/e ratio (earnings divided by price instead of the other way around) is known as the earnings yield. A p/e ratio of 20 corresponds to an earnings yield of 5%. When interest rates are high, an earnings yield of 5% might not sound too enticing, but with today's super low interest rates it doesn't sound bad at all.

The pessimistic case--that 68% is a much better estimate of the overvaluation of the stock market—has two pillars. First, although stocks may have been too cheap for most of the twentieth century, the pendulum has swung too far. Think about the median p/e of 21.4 over the last 25 years and the corresponding earnings yield of 4.7%. Even in an intellectual property economy some portion of earnings has to be devoted to capital expenditures. Let's say that gets us down to

4.0%. Organic earnings growth (as opposed to growth driven by using earnings to repurchase stock or fund acquisitions) might add another percentage point, which gets you to something like a 5.0% real (after inflation) return. As central banks gradually allow interest rates to normalize, and after investors are reminded that bear markets are still a thing, will investors really be satisfied with a 5.0% real return? Siegel is probably right that a baseline p/e ratio of 14 is too low, but (and here we'll put our cards on the table), we're inclined to think that the p/e ratios of the last twenty-five years have been artificially high, goosed by the irrational exuberance of the late 90s and nearly ten years of massive post-financial crisis central bank stimulus.

Furthermore, it's important to remember that corporate profits are cyclical. In 2017, trailing twelve-month earnings for the S&P 500 reached an all-time high, even after adjusting for inflation. There will be a one-time boost next year from reductions in the corporate tax rate but after that there is a lot more downside than upside. Paying a high p/e ratio when earnings are at an all-time high is a little like signing a veteran slugger to a rich long-term contract after a career year. While it may feel good in the moment, it won't feel so good as you watch the aging hitter's production decline.

When we put it all together, we're inclined to think an appropriate p/e multiple of the U.S. stock market would be closer to 13.9 than to 23.4. If we settled on 16, the S&P 500 would be 50% overvalued at this writing. It's impossible to make a precise determination but that seems about right. The obvious and difficult question, however, is what to do about it. The idea of the stock market being overvalued (or undervalued) is a tricky thing. At any given time, one can find a range of opinions—doubtless there are market pundits arguing at this very moment that the U.S. stock market is significantly undervalued[1]. Assuming that we're right about the market's overvaluation, it may not mean all that much in the short term. In fact, Jeremy Grantham, who has a pretty good track record on these things, suggested recently that, although overvalued, the U.S. stock market may be on the verge of a "melt-up." In other words, we could be on the verge of a speculative bubble where "fear of missing out" (or as millennials say, FOMO) takes over, leading to panic buying and accelerated share price gains. Based on historical comparisons Grantham suggests the possibility of another 30% plus rise in the S&P 500 over the next nine to eighteen months. We hasten to add that Grantham's scenario doesn't have a happy ending—sadly, all bubbles eventually burst.

FOMO is a powerful thing. Along with the fear of losing everything it drives a lot of terrible investment decisions. These bad decisions often come in pairs. For example, some of the investors who suffered the worst in the tech bubble were initially very cautious but later regretted

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[1] We can't resist pointing out that on October 1, 1999, mere months before the tech bubble burst, James Glassman and Kevin Hassett published a book entitled <u>Dow 36,000</u>. Lest there be any confusion, the title of the book was <u>not</u> intended as a twenty-year forecast. By the way, if Hassett's name rings a bell it's because he is Chair of the Council of Economic Advisers under President Trump. Interesting.

that caution and, prompted by FOMO, piled in near the end and suffered grievously. In the wake of the financial crisis some investors pulled out of the stock market near the lows and then compounded the mistake by waiting several years to go back in.

There is only one way we know to avoid making bad investment decisions based on the fear of missing out and/or the fear of losing everything. First, have an investment policy that governs how much of your portfolio should be allocated to any given asset class. Revisit that investment policy from time to time and make sure it reflects your near term and long term cash flow needs. Always operate within the ranges dictated by the investment policy. Don't make investment allocation changes frequently and when you do make them acknowledge up front that the timing won't be perfect and may even feel terrible for a time.

Let's go back now to our assessment that the market is significantly overvalued. What can it tell us about the future? The historical record from other periods of overvaluation strongly suggest the following: over the medium term (five to ten years), the downside risks are greater than the upside risks, and returns are likely to be lower than historical averages. We encourage all clients who aren't there already to move toward the lower end of their target allocation to stocks, especially U.S. stocks, if you're not there already. But do so in full recognition that Grantham's melt-up scenario may play out. If it does, have the discipline to rebalance again. Over time disciplined investment in accordance with sensible allocation targets is the best way—really the only way--to ensure satisfactory portfolio returns.

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