Friends,

US ECONOMY

Overall the US economy seems to be doing well. Even though the Fed raised interest rates, they're still low from an historical perspective. GDP is chugging along at around 1.5-2%. The job market is solid; according to JPMorgan, most economists consider an unemployment rate of 4.5% as close to "full employment" as we're likely to see. We're in the middle of 1Q corporate earnings reports, and so far the data has been mixed with some companies reporting better-than-expected numbers, and some disappointing. Residential housing is showing a bit of a mixed picture, with March housing starts declining a disappointing 6.8%, but permits for future starts rose 3.6% (source: Bloomberg). Consumer confidence remains strong, and while the economy is not roaring ahead, it seems to be moving along well enough, with no signs of a recession in sight.

VALUATION

So why am I nervous? A couple of reasons. We're overdue for a stock market correction, which can happen in the most "normal" of markets. We're also overdue for a recession. Going back 17 decades to 1850, there's only been one decade that hasn't experienced at least one recession, and that's the decade that we're in, starting in 2010. And then there's stock market valuations . Attached is a newsletter from John Mauldin, it's one of the most comprehensive and clearly-articulated discussions on valuation generally and PE measures specifically. Depending on how you measure it, the US stock market is anywhere from slightly overvalued, to dramatically overvalued. For example, the PE ratio based on averaged expected future earnings puts the S&P 500 at 17.2x, which is 21% above historical averages (source JPMorgan Asset Management). However, looking at a cyclically-adjusted PE (a fancy way of measuring average earnings over a complete business cycle) puts the S&P 500 at the third-highest level in history; only 1929 (prior to the Great Depression) and 1999 (prior to the Dot.com recession) have been more expensive. But if we don't have a recession should we still worry about the current high PEs? Absolutely. Ned Davis Research grouped historical PEs into quintiles, and then asked the question "what are future stock market returns when starting at various PE ranges?" If you "buy low" like all investors would like, this research showed subsequent returns averaging 16% over a 10 year period. Those are great returns. However, if you "buy high" and start in the most expensive quintile (where we are right now, in fact we're at the upper end of the most expensive quintile according to some metrics), the research showed subsequent returns averaging only 4% over a 10 year period.

FLIPPING COINS

Let's compare the current valuation situation to a wager involving flipping a coin. You choose heads, your friend chooses tails. Assume your friend that would pay you $1 if you win, but you had to pay $1 if you lost; would you do accept? If you flip that coin enough times statistically you're no better or worse off than when you started, with wins and losses evening out. But what if he paid you $2 if you won, but you only had to pay $1 if you lost? This is very attractive; obviously you'll have to pay him occasionally, but the gain outweighs the loss over time. This is how I think about buying stocks when PE's are cheap. You're not guaranteed to make money, but odds are definitely in your favor. And buying stocks when PE's are expensive is like taking the wager that you only collect $1 for wins, but pay $2 for losses; the odds are against you. And in my humble opinion, this is the wager we're being offered today. I'm personally not excited by these odds.

STOCK MARKET CORRECTION

So how does the market correct itself? There are a few possibilities, but basically the trip back to a historical average PE is never fun. We could have a stock market that basically goes sideways for a

number of years, until S&P 500 corporate earnings "catch up" to the current price. On Monday April 24th the S&P 500 closed at 2374. On average, over the next 12 months economists and forecasters are expecting S&P 500 companies to earn $135.17/share, translating to PE based on *future* earnings of 17.56x (consensus expectations according to Bloomberg). According to this metric, the historical average is only 14.4x. Which implies a "fair value" for the S&P 500 of 1946, or -17% from current levels. And that's assuming a return to average valuation, *and* that earnings grow as expected. If earnings we experienced a recession (maybe earnings drops 5% from forecasts), and if the PE dropped to 12x (typical for a mild recession), the S&P 500 would drop to 1540, or -34% from current levels. (As an aside, Wells Fargo Investment Institute's own target price for the S&P 500 is 2230-2330 by the end of the year; the S&P 500 is already above the top end of the range). That being said, just because stocks are expensive, doesn't mean stocks can't keep going up and getting more expensive. And in that case, being cautious could cost you some upside. But when stocks are this expensive, personally I feel some caution is warranted.

I hope this helps, and if you would like to discuss in more detail, please give me a call anytime.

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