NOW WHAT?

Spring 2018

The stock market turmoil in 2018 stands in stark contrast to the placid market of 2017. Last year there were moves up or down in the S&P 500 of 1% or more only 8 times. So far this year we have had moves of 1% or more 28 times. If this rate holds, we will experience over 100 trading days with swings of 1% or more which, while not unprecedented, obviously tend to occur in years of tumult. David Rosenberg, economist at Gluskin Sheff, points out that 100 days or more of moves greater than 1% occurred in 1974, 2001, 2002, 2008 and 2009. With the exception of 2009, these years all saw significant declines in the S&P 500.

There have been volatile years, like 2009, that produced gains in the S&P 500, and there are a numbers of factors that lead to additional volatility in our current market. Comparisons with the stock market of 1974 for example may not be useful. More recent history might point to years like 2015 and 2016, which while volatile with inter-year declines of 12.4% (2015) and 10.5% (2016), ultimately ended with positive annual returns. Increased volatility may reflect the uncertainly that could lead to a down year in stocks but volatility, in and of itself, does not always lead to down markets.

Many factors seem to have led to the current uncertainty including the length of the advance in the market which began in 2009, the desire of the Federal Reserve and its new Chair to raise interest rates, the tariff and trade policies of the Trump administration and the ever ongoing international turmoil. These are certainly valid concerns and after the sharp run up in the market in January we were due for some sort of correction. The strange thing is, we had at least as much domestic and international turmoil last year and we had one of the least volatile stock markets in history.

In the midst of the market drama there are positive things happening in the economy as the corporate and individual tax cuts are fully realized and employment and job growth are impressive. Some analysts expect economic growth approaching 3%. Argus Research estimates the earnings of the S&P 500 to be $160.00 this year and $179.10 in 2019. At current levels the S&P 500 has a Price/Earnings (P/E) ratio of about 17 times expected earnings for 2018 which is not unreasonable given current interest and inflation rates.

When the noise and distractions of a volatile market are intense it is important to focus on valuations, the underlying fundamentals of the individual companies and an investor's own particular goals and objectives. It is easy to get distracted by the market gyrations and expert predictions and lose focus of long term principals and goals.

In looking at the P/E ratios of individual stocks and the market as a whole represented by the S&P 500 we look at both trailing earnings (usually last 12 months) and forward earnings (next 12 months or remainder of calendar year). In this way we can compare the P/E ratios of individual stocks or industry sectors versus other stocks, sectors or the whole market. We can also break down the S&P 500 into two broad categories, growth and value. Growth stocks are generally characterized by faster earnings and revenue growth than value stocks and generally sell at higher P/E ratios. Investors are in effect paying a higher price per dollar of the earnings of a company that is growing those earnings at an above average rate. The so called FANG stocks Facebook, Amazon, Netflix and Google have been classic examples of this over the past few years.

As has been the case with the FANG stocks, growth stocks, despite their relatively high P/E ratios, can continue to outperform the general market as long as they maintain their above average earnings growth rates. Over very long periods however, it is the value side, the lower P/E, lower expectation stocks that actually outperform. Often, high expectation stocks cannot continue to deliver above average earnings growth for long periods of time and they can be subject to dramatic revaluations. Lower expectation stocks can deliver steady, more reliable earnings and dividend growth over long periods of time.

To illustrate what are considered growth and value stocks now, we look at the Vanguard Growth Stock Exchange Traded Fund (ETF) symbol VUG and the Vanguard Value ETF symbol VTV. The growth ETF has a current P/E ratio of 21.6X and a yield of 1.10%. Its top holdings, which represent 22% of the fund, are Apple, Amazon, Facebook and Google. The value ETF has a P/E ratio of 15X and a yield of 2.47%. Its top holdings, representing 17% of the fund, are Microsoft, Berkshire Hathaway, J.P. Morgan, Johnson & Johnson and ExxonMobil. One could argue that Apple, with a P/E of 16X could switch places with Microsoft with its P/E of 28X but these holdings illustrate the current growth versus value categories pretty well.

While it is hard to argue against any of the stocks listed above, over long periods of time it is difficult for large companies to maintain growth rates that are significantly higher than average. Hence, paying a lot for higher earnings growth can lead to underperformance, particularly in times of market upheaval. Often, expensive stocks tend to be concentrated in one sector such as technology which can result in dramatic revaluations in difficult times.

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We don't think that technology stocks for the most part are significantly overvalued just as we think the general stock market is not outrageously expensive. That doesn't mean we can't have a significant decline and we don't know what will happen to the stock market in the short term. However we do like to focus on the value side of the market for the most part. We feel these companies give our clients the best combination of earnings and dividend growth which can be sustained over good and bad times. While value stocks are not immune to market declines, for many investors these companies provide a steadier, more reliable cash flow from increasing dividends even in times of economic upheaval.

We appreciate your confidence in Knox & Downing Advisors and we will stand with you in what may be a turbulent year.

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