MARKET COMMENTARY

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A Normal Market Correction

One of the most confusing and telling occurrences when investing in stocks is "multiple compression". That may be a new term for you but if you're an investor you are currently experiencing this phenomenon. It is characterized by companies reporting very good earnings and yet their share prices decline. As your advisor I've always professed that past earnings support share prices and expectation of future earnings drives prices higher.

Except, when the PE multiple (price of a share divided by earnings per share) compresses. If we look at the S&P 500 index, those 500 companies were trading at 21.8 times earnings (P/E 21.8) at the end of 2017. It is projected to finish 2018 at 17.3 times earnings. Earnings are projected to grow at 26.4% this year. Further earnings are projected to grow another 11.39% in 2019 and if the S&P 500 doesn't move from the current valuation the P/E ratio will move down to 15.5%.

The equity markets are leading indicators so this multiple contraction is foreshadowing slower earnings growth in the future. Note that it appears that growth is slowing not declining and therefore the market will stabilize at a PE multiple it can justify and then resume its upward trend as the earnings uptrend continues.

PE multiples are just one influencing factor on share prices and in order to determine relative returns on the market you can divide the forward PE ratio of 15.5 into 100 to come up with a forward market "earnings yield" of 6.5% which compares favourably to a 10-year bond yield of 3.18%. The premium we would theoretically achieve is 6.50 – 3.18 = 3.32% annually on returns for incurring the risk of owning stocks.

Fundamentally the current economy is providing a good environment for earnings growth through strong global GDP, low cost of capital (low interest rates), a strong consumer and for the time being, a low cost of materials and commodities. It appears that we may be in the last half of the business cycle with a few more years to go. Eventually consumer confidence leads to robust consumption leading to higher inflation and restrictive interest rate tightening. This stage of the cycle is initially characterized by buoyant markets, high levels of confidence and leverage, only to be followed by declining earnings leading to a decline in GDP growth, increases in unemployment and most often a recession.

The global geopolitical uncertainties coupled with trade tariffs being used to apply pressure in negotiations to equalize global trade has created sufficient uncertainty for investors to recalibrate future earnings expectations and as a result the price they will pay for those earnings.

The S&P 500 index rose above 2100 in February of 2015, only to fall back below that level. It consolidated sideways until November of 2016 (21 months), before it convincingly began an uptrend to peak at 2940 in September 2018 for a gain of 40% over 23 months.

Advances of that magnitude supported as they are by fundamentals and earnings growth will invite volatility and corrections as investors reconsider the price they are paying for forward earnings.

Moving forward in this business cycle we have more people working than we've had in decades, interest rates are not restrictive but moderating, trade differences will reach negotiated resolutions, capital investment and infrastructure spending will continue and consumer spending will be strong. These are all stimulants to earnings across the broad markets.

Realizing that the end of the cycle is not predictable, it will be prudent to reduce equity market exposure deferring to higher ratios of fixed rate income assets, <u>but</u> not yet.

"Market forecasting is not rocket science. The key is to understand cause and effect relationships and the key to that is understanding the central bank's mandate, and the impact of monetary policy on the economy and the stock market."
Leon Tuey, July 2017

The markets have been adjusting to slower earnings growth since February 2018. Fortunately we're in a year of 26% annual earnings growth on the S&P 500 while shares have declined in value. That combination has accelerated our move through this correction. 15 times forward PE with upward growth in earnings is not an expensive market. We now need the anxiety of trade uncertainty to be resolved for stock valuations to lead earning growth upward.

Looking Back

- In my December 2017 newsletter I talked about "the times they are a changing" and recommended being overweight in common shares providing value and dividends.

- In May 2018 I talked about the rate of change in earnings growth creating a market correction. The velocity of earnings growth appeared to be slowing but in fact has sustained a high growth rate through the third quarter. I recommended JP Morgan, Walmart, Union Pacific, and Home Depot, all of which are above their May closing prices.

- In July 2018 I talked about market consolidation as we were experiencing the low in the market from the high in January. I projected a break out of consolidation in the third quarter. In actuality we broke out much sooner peaking again in early October, only to decline again by 8% +/- and now here we are experiencing a second consolidation.

"Uncertainty is an uncomfortable position but certainty is an absurd one." *Voltaire*

With earnings rising for the foreseeable future and share prices declining this correction will come to an end as bargain hunters begin to accumulate positions again.

Enjoy the fall weather with all its great colours, don't spend too much time watching the financial news, and if you're getting impatient with the markets feel free to give me a call.

All the best,
Graham