RISING STOCK PRICES, FALLING EARNINGS

The Growing Disconnect?

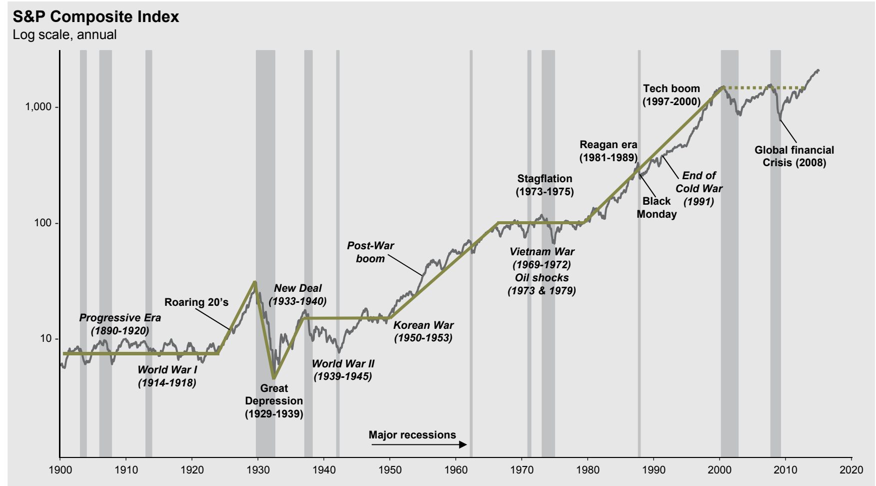
May 2015

Blame it on the weather, Europe and Greece or whatever else you like, the bottom line is that corporate earnings growth has slowed sharply in the early part of 2015. As a result, the Forward Price / Earnings Ratio of the S&P 500 has risen to above 17 for the first time since 2004. At the same time, the Federal Reserve is pondering the timing of its first interest rate hike, further unnerving investors.

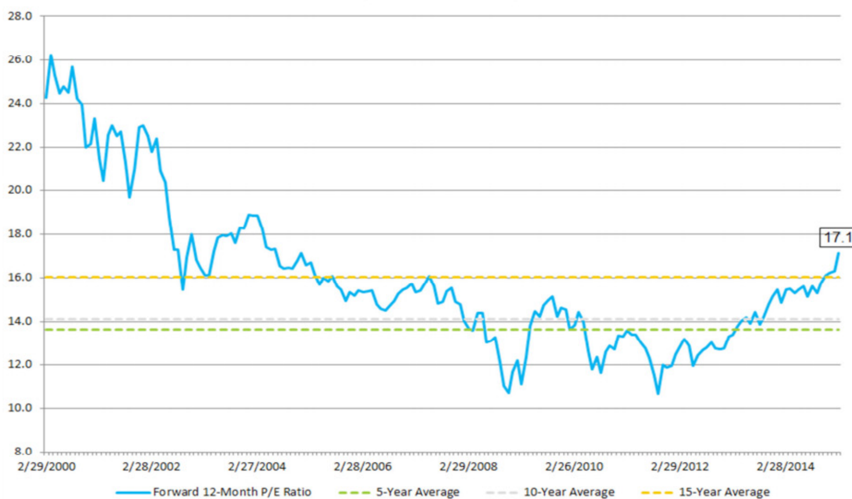
The Question is – Have stock valuations disconnected from fundamentals and is there a major correction ahead?

HAVE INVESTORS SIMPLY GROWN COMPLACENT?

In our view, No! As a matter of fact, there are strong indications that the opposite holds true. That in fact, too many investors have remained on the side lines and been too cautious since the crash in 2008. Over the past 5 decades, since the founding of Gary Goldberg Financial Services in 1972, there have been a number of economic crises, geopolitical events and temporary drops in corporate earnings that have given investors pause. However, had an investor invested $10,000 each year between 1972 and 2014, a forty two year period), at the highest point of the S&P each year, their combined $420,000 investment would be worth more than 5.5 million dollars today, having realized a compounded annual return of over 9%. Even with the worst timing, the returns are solid – as long as you don't try to market time.



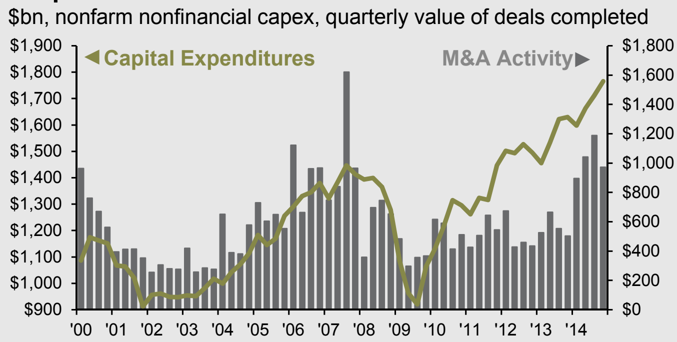
Source: Robert Shiller, FactSet, J.P. Morgan Asset Management. Data shown in log scale to best illustrate long-term index patterns. Past performance is not indicative of future returns. Chart is for illustrative purposes only. Data are as of March 31, 2015.



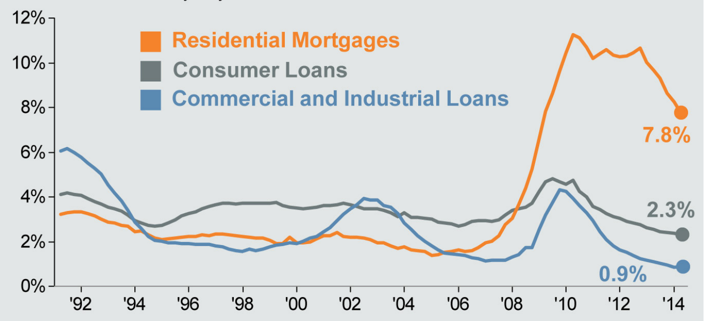
Source: FacSet, February 2015

EUROPE AS WE SEE IT:

Greece has been at the forefront of Eurozone news, overshadowing improving economic data out of the old-world. For instance, Industrial Production, which is viewed as a major indicator of economic health, is nearly twice as strong as forecast for the 12 months ending March 31, 2015. Moreover, in spite of flashy headlines, political progress is being made between Greece and its main lenders, further reducing risks of deceleration and a recession in Europe. In our view, while far from good, the situation in Europe is not nearly as bad as some suggest. Furthermore, as the European Central Bank remains aggressive in their version of QE and continues to purchase sovereign bonds the environment is likely to continue to improve. The domino effect of improvements in Europe will be felt globally, and should translate into stronger second half S&P 500 earnings.



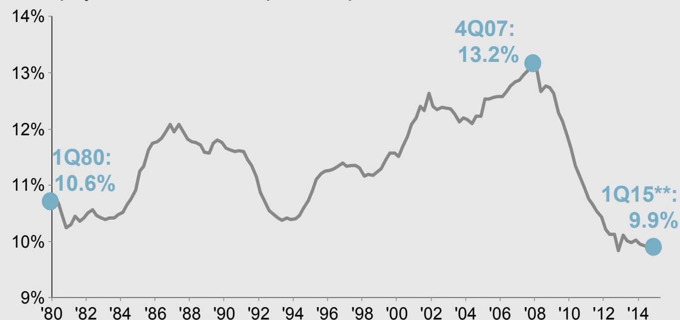
Source: Standard & Poor's, FRB, Bloomberg, Compustat, FactSet, J.P. Morgan Securities, J.P. Morgan Asset Management. M&A activity is the quarterly value of officially agreed transactions and capital expenditures are for nonfarm nonfinancial corporate business.



Source: Federal Reserve, FactSet, J.P. Morgan Asset Management.

THE UNITED STATES AS WE SEE IT:

There is no question that the U.S. economy is strengthening and continues to improve. And while earnings continue to only rise at a very slow place, the employment picture has improved dramatically in the past couple of years. However, there are trouble spots that could prove problematic later in the year. Although counter intuitive, lower oil prices are not particularly beneficial for our economy. So far, the anticipated rise in consumer spending from lower oil and gasoline prices has not taken place – and is unlikely to do so during the summer months. However, the expected layoffs and shuttering of oil wells in the energy sector have occurred. In other words, we're getting the "bad" side of the trade without the "good." The second headwind for our economy is the strong U.S. dollar. While it is politically popular to say that the U.S. has a strong dollar policy and that we welcome the confidence in our currency, the reality is that the strong dollar is negatively impacting our exports and reducing multi-national's corporate earnings. The latter is unlikely to prove much of an issue going forward as most of the currency appreciation is likely behind us. While these headwinds are material, there is good reason to be optimistic about the U.S. economy and U.S. stocks. Most significantly, as the U.S. economy enters its seventh year of recovery, there is an increasing likelihood that more steady progress in manufacturing activity will lead a steady rise in wages, helping consumers who account for 70% of our economy.



*Source: BEA, FRB, FactSet, J.P. Morgan Asset Management. SA – seasonally adjusted. *Revolving includes credit cards. **1Q15 household debt service ratio and 1Q15 household net worth are J.P. Morgan Asset Management estimates. Values may not sum to 100% due to rounding.*

SO, WHERE DO WE STAND?

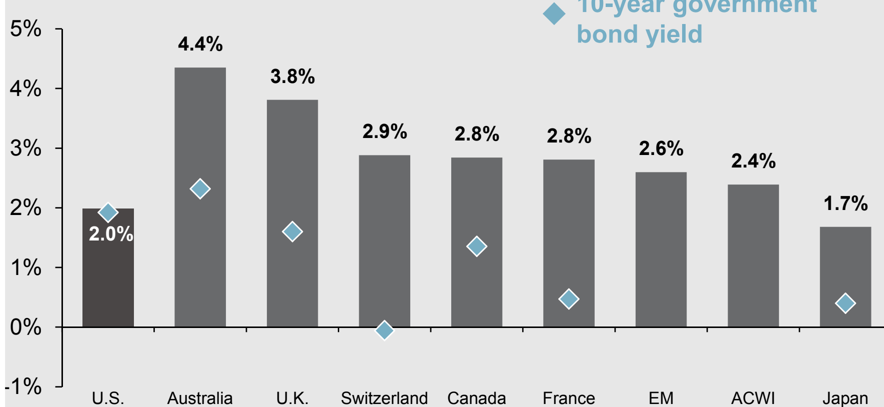
Many investors are asking themselves "Is the six year bull-market running out of steam?" Probably not, in our view we're more likely in the seventh inning of an eleven inning game. Markets and economies rarely slow or accelerate at just the right time or valuation, instead they shoot past their mark – in both directions. Moreover, cycles take a long time to play out – no one understands this better than Fed Chairwoman Yellen and her FOMC colleagues. While the Fed may raise interest rates by a token ¼%, it will wait just a little longer than necessary before doing so, and will then observe the economic reaction to the move. Putting aside short-term volatility and even a market correction, the long-term trend for stocks and other asset prices continues to be positive as Central Banks continue to pursue accommodative policies in an effort to spur inflation.

INFLATION AND INTEREST RATES:

There are three categories of inflation that economists and market participants are focused on. First, there is asset price inflations – homes, stocks, etc. – which has occurred, but is also slowing dramatically. Second, is wage inflation, which has been very slow and is just now starting to occur. Finally, there is commodity price inflation – the rise, or as is the case now, fall of energy and food costs. While these three categories are not weighted equally, if is certainly accurate to say that so far inflation has remained relatively benign. A combination of slower than anticipated growth in China, a general slow-down in demand for goods and services from Europe, and the sharp fall in energy prices have created a disinflationary environment. While this status is likely transitory, it is keeping pressure on Central Banks to maintain their accommodative monetary policies, and in some cases, such as Europe, even increase their stimulus. Within the United States, labor markets are one of the major areas of focus by the Fed. While unemployment has dropped and the overall labor market is improving, wage growth has largely been absent. As a result of this, we expect the Fed to remain patient and err on the side of caution before changing policy course. A token move in interest rates may occur later this year, but don't expect much more.

INVESTMENT IMPLICATIONS:

With a base case scenario of ongoing geopolitical turmoil offset by moderate economic growth worldwide, and a more rapidly improving labor market and overall economic conditions in the United States, U.S. stocks should continue to shine. As we depicted earlier, while some areas of the market are currently overbought, others continue to trade with Price to Earnings ratios below their historical average. Moreover, with the expectations that interest rates will rise at a slow pace, fixed income investments, such as bonds, will come under increasing pressure – likely going through an extended period of underperformance and possible experiencing a decade of negative real-returns.



Source: FactSet, MSCI, J.P. Morgan Asset Management. Yields shown are that of the appropriate MSCI index.

When looking at the international landscape, U.S. interest rates are far from the lowest. German 10-year bonds are yielding less than 1/10th of a percent, compared to the U.S. Treasury, which is yielding just under 2%. This is important to understand, as it helps explain why U.S. Treasuries continue to be attractive as a foreign investment and demand remains strong – even with the advent of tapering by the Fed.

WILL RISING RATES DERAIL THE MARKET?

Here too, conventional wisdom is wrong. Since 1980 the Federal Reserve has raised interest rates 67 times. During these periods of interest rate hikes, the S&P 500 rose 60 of the 67 times in the two years following the first increase – this represents a positive reaction by stocks nearly 90% of the time, pretty good odds if you ask us.

AFTER RISING SO MUCH, AREN'T STOCKS EXPENSIVE NOW?

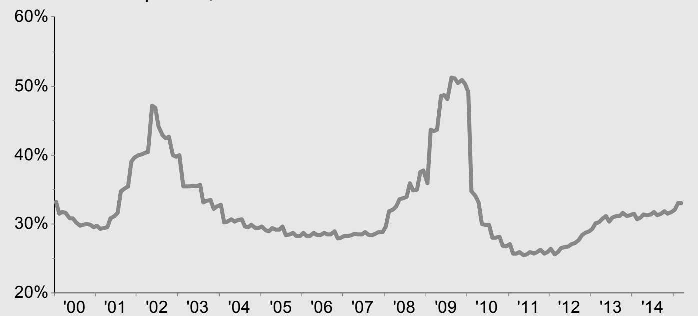
While stocks may not be cheap, they aren't expensive either. As of the end of the first quarter, some sectors of the market appear overbought, while others are still trading below their historical average valuations.

As the charts to the right illustrate, mid and large-cap growth stocks continue to trade at relatively attractive valuations, while small and mid-cap value stocks appear overvalued by historical standards. More significantly, the dividend payout ratio of the S&P 500, is relatively low, indicating that increases in dividends are more than plausible.

Current P/E vs. 20-year avg. P/E

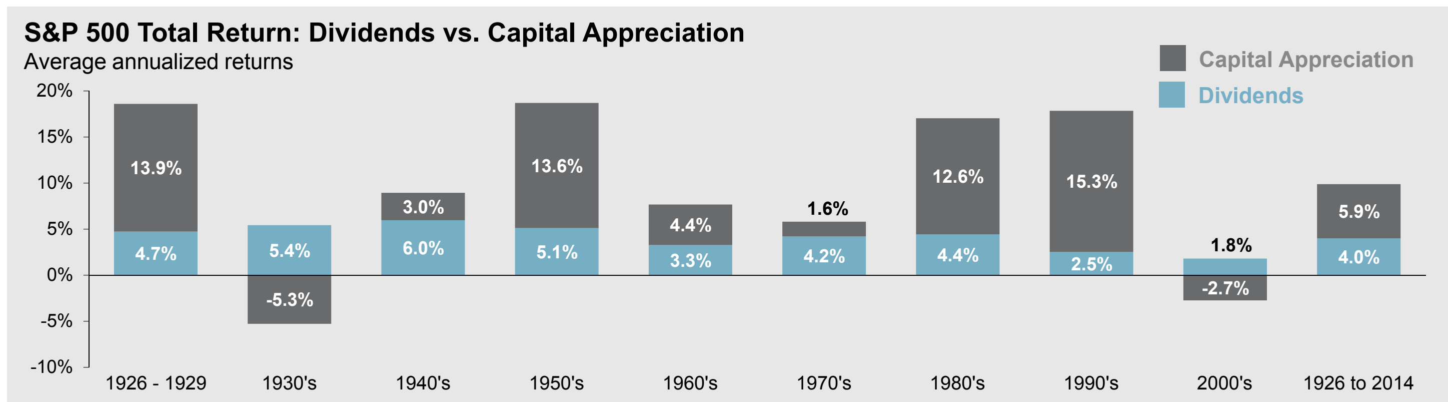
	Value	Blend	Growth
Large	16.4 / 14.1	16.9 / 16.2	19.3 / 21.1
Mid	17.8 / 14.3	19.6 / 16.6	21.7 / 22.0
Small	16.6 / 14.5	18.6 / 17.4	21.0 / 21.6

Source: Russell Investment Group, Standard & Poor's, FactSet, J.P. Morgan Asset Management.



Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management.

DIVIDENDS ALSO PLAY A SIGNIFICANT ROLE IN THE OVERALL RETURN ON INVESTMENTS:



Source: Standard & Poor's, Ibbotson, J.P. Morgan Asset Management.

IN CONCLUSION:

While the world appears to be in turmoil, the reality is that geopolitical events are no different today than they have been throughout most of history. And while the U.S. economy doesn't appear to be doing all that well, improvements continue to be made and the overall state of our nation is in fact in good shape. Moreover, from an investment perspective, there continue to be ample reasons to be optimistic and expect further market gains. We continue to expect high-quality dividend paying stocks to perform well. Specifically, we favor those companies that have:

- **Strong Balance Sheets**
- **Visible and Predictable Earnings**
- **An Above Category Growth Outlook**
- **Consistent and Rising Dividends**

While investment decisions are never easy, at least not without the benefit of hindsight, having a disciplined, consistent investment process is almost certain to continue to be paramount to success and lead to superior results.

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