# Partner Talk®

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## Current Markets

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As we enter the fourth quarter, speculation relating to the valuations in the equity and fixed income markets is plentiful. There are many concerns -- economic growth has been modest, corporate earnings have been flat, the upcoming U.S. election has increased uncertainty, and the consensus is that the Federal Reserve will increase the federal funds rate in the fourth quarter. Yet, many market valuations have approached all-time highs. Returns in the U.S. market have been solid -- the return of the S&P 500 Index year-to-date is 7.84% and the return of Barclay's US Aggregate Bond Index is 5.79%. It is natural to ask "Are the pundits right that the market is overvalued?" This note will review the current state of some of common valuation factors and argue that any conclusion with respect to the appropriateness of market valuations should be drawn carefully.

One thing we do know is that the future is inherently unpredictable. Any attempt to categorize the market as overvalued or undervalued is little more than a guess.

The growth of the U.S. economy at an annual rate of less than 2% is one issue. At this rate of growth, incentives for capital spending by corporations are muted and accompanying higher growth rates and robust job creation do not appear to be on the horizon. If the U.S. was to enter a recession that would especially be a problem. However, most economists see the likelihood of a recession to be small and expect the economy to continue on at a slow but positive growth trajectory. Thus, at this point, while not a positive, economic growth prospects alone do not appear to be a source of significant downward pressure on stock prices.

Corporate earnings have been relatively flat this year. The expectation for the ending third quarter is that in aggregate, earnings will increase more than 10% from the observed earnings in the third quarter last year and in the second quarter this year.[1] Also, the market's expectation is for solid earnings growth in the fourth quarter and strong growth for 2017. We can calibrate these earnings estimates through the price to earnings ratio.[2] On a backward looking basis for the S&P 500, the P/E is about 20 and on a forward looking basis the P/E is approximately 16.6. These values are above the historical average but well within the normal variation that has been observed over time. One can reasonably conclude that, while stronger earnings are obviously preferred, the current earnings power of the economy is not inconsistent with market valuations.

The impact of the upcoming election on market values is a real unknown. While one can hypothesize that volatility will result from uncertainty related to the outcome and to the accompanying policies of the victor, the impact on market values is not predictable. As my colleague Richard "Jonesy" Lerch concluded in his June 2016 cover letter, "the best strategy to deal with the upcoming election is to stay the course and not make rash or emotional decisions based on unknown political outcomes."

The Federal Reserve last increased the federal funds rate in December 2015 and it is widely speculated that more increases are on the way. But, at the recent September meeting of the board, the rate was not changed. The Federal Reserve Board has emphasized that rate increases are data dependent suggesting that any rate increase will coincide with solid economic activity. This position is somewhat comforting to the market since strong economic activity can reduce the impact of the upward pressure on interest rates induced by a rate increase. Provided a rate increase comes with strong economic performance, the greatest impact of the rate increase is likely to be in the government bond market. The corporate bond market and the stock market will be impacted to a lesser extent. Partially for this reason, PMA has maintained a tilt towards corporate bonds in its fixed income exposure.

Many factors feed into the valuations in the market place. In the investment process, it is important to be aware of these factors. Importantly, the question that needs to be asked is how these factors should alter the investment strategy. At PMA, we do not believe that future returns can be predicted and thus the factors are accommodated in our risk-control process and an important aspect of building risk-controlled portfolios.

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[1] When the press reports earnings declines or gains, they compare the twelve month period ending 9/30/2016 to the twelve month period ending 9/30/2015, for example. Expectations are that this year-over-year comparison will show a modest contraction, despite the strong showing in the third quarter of this year.

[2] See Robert Capanna's August 2016 cover letter for a recent discussion of the price to earnings ratio.