CAPITAL
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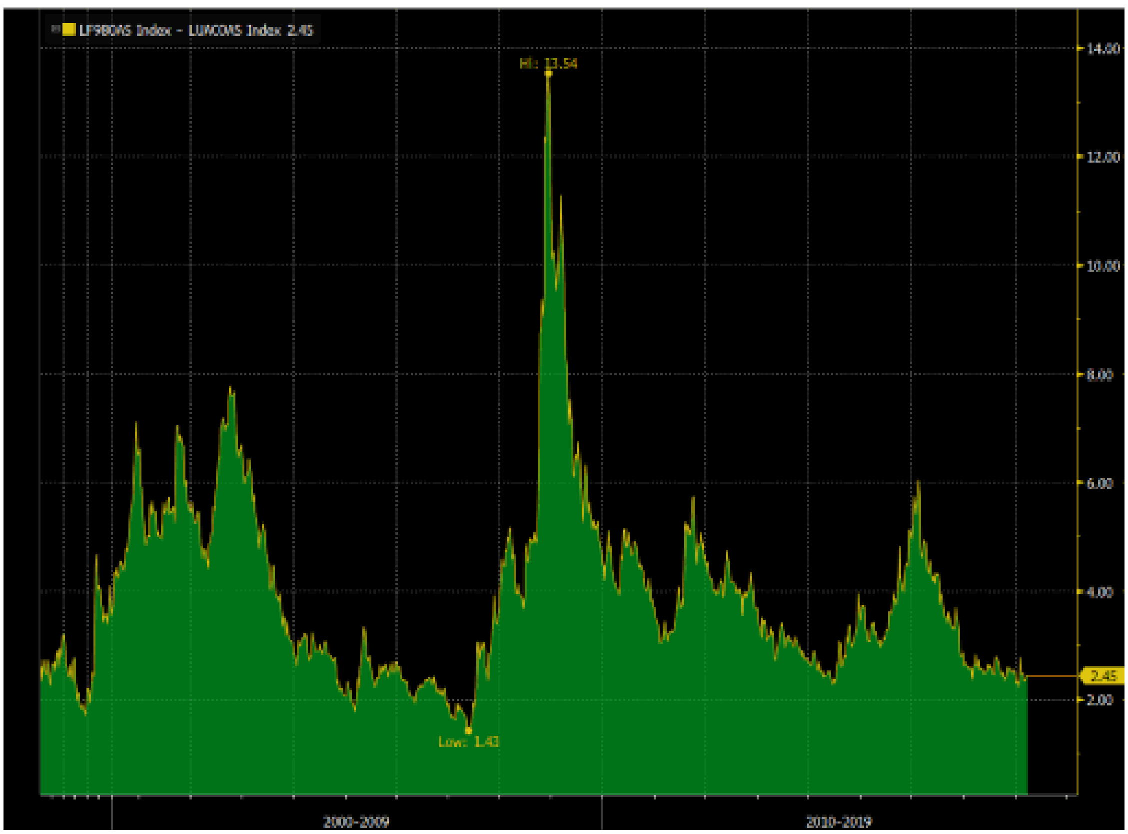
RESEARCH UPDATE
April 3, 2018

Stock Market Comment

The research team at Capital Advisors believes the recent volatility in the stock market is probably more noise than signal for several reasons. First is the recent behavior of the bond market. Specifically, relative calm in the global credit markets has been comforting in the face of heightened volatility in the stock market. Here we are referring to the behavior of "credit spreads," or the difference in yield between bonds of higher versus lower credit quality.

We consider credit spreads to be one of the most helpful indicators of stress in the corporate sector. When the spread between sub-investment grade bonds and investment grade bonds widens out considerably it can be a signal of genuine stress in the economy. When the spread remains low and stable, as it has since early 2016, it usually reflects a healthy environment for the economy. As the chart below shows, credit spreads have remained tame throughout the recent spike in stock market volatility.

Credit Spreads Remain Calm…
Yield Spread Between
Barclays High Yield Corporate Bond Index and Barclays Investment Grade Credit Index
02-04-1994 to 03-29-2018



Source: Bloomberg **It is not possible to invest directly in the index**

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A second reason we recommend patience is valuation. Stocks look cheap enough in the short-term to withstand some bad news, in our opinion. We view the current condition in the stock market to be much more resilient to potential bad news compared to the sky-high valuation environment of the technology bubble in 1999, or the massive leverage and misallocation of capital that presaged the financial crisis in 2008-09.

Earnings estimates for the *S&P 500 Index* have risen substantially since year-end, in part due to corporate tax reform.[1] Meanwhile, the index is down approximately 3.4% year-to-date through April 2nd. The combined effect of these two trends has been a dramatic improvement in the valuation multiple of the stock market, as measured by the estimated price-to-earnings ratio (P/E) for the index. Based on the closing price for the *S&P 500* on April 2nd of 2,582, and the consensus earnings estimate for 2018 of $155.90, the index currently trades at a forward P/E ratio of approximately 16.6.[2]

Looking forward, we can use the same consensus earnings estimate to construct a range of possible price targets for the *S&P 500* as of year-end. To hazard a guess as to where the P/E ratio might be next January we calculated four historical averages for the index to serve as a guide based on the past 3, 5, 10 and 64 years (dating back to the inception of the database in 1954).[3] For example, the average P/E over the past 10-years has been 17.5 (line 2 in the table). Here are the results based upon the April 2nd closing price for the *S&P 500* of 2,582:

S&P 500 Index
2018 Year-End Estimated Price Target
Assuming Consensus EPS for 2018
And a Range of Possible P/E Ratios[4]

Avg. P/E Since Mar. 31…		Est. P/E in Jan. 2019		2018 Est. EPS		Est. Year-End Index Price	Implied Return Incl. Dividends
…1954	implies…	16.5	x	$155.90	=	2,572	1.1%
…2008	implies…	17.5	x	$155.90	=	2,728	7.2%
…2013	implies…	19.1	x	$155.90	=	2,978	16.8%
…2015	implies…	20.1	x	$155.90	=	3,134	22.9%

It is not possible to invest directly in the index

The most important observation is that valuation has improved a lot for the U.S. stock market in recent months. As we suggested in the recent *Overview*, we believe stocks could have a nice run in 2018 **if** current concerns around global trade and rising interest rates can evolve without inflicting their worst-case potential.

Perhaps equally importantly, we suspect stocks can wind up at a reasonable resting place *in time*, even if the path is rocky between here and there. We base this on the observation that the stock market already trades in line with its long-term historical average P/E ratio of about 16.5, assuming consensus earnings estimates for 2018 turn out to be about right. Credit spreads in the bond market suggest they should be.

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[1] Source: Bloomberg
[2] Source: Bloomberg; Standard & Poor's
[3] Source: Bloomberg; The P/E method used for this study was trailing 12-month P/E for all time periods. Measurement periods were quarterly from 3/31/54 to 3/31/18; 3/31/08 to 3/31/18; 3/31/13 to 3/31/18; 3/31/15 to 3/31/18
[4] The source for all data in this table was Bloomberg and Standard & Poor's

This may not be a demanding valuation multiple, even if interest rates disappoint on the upside, or earnings come up short on the downside, because we wouldn't expect to see both outcomes simultaneously. If interest rates disappoint it would probably be driven by a strong economy that should support healthy corporate profits. Conversely, if corporate earnings fall short of expectations in 2018, it would probably imply weaker than expected economic growth, which should prevent the Fed from getting too aggressive with monetary tightening.

To be sure, stocks could go lower in the short-term for any number of reasons. Moreover, we remain conservative in our expectations for long-term returns from stocks over the next 5-10 years for reasons we have discussed before. Specifically, the favorable combination of record-high profit margins and historically low interest may not persist over longer investment horizons of five years or more, creating a potential headwind for equity market returns.

Yet when we focus on the next 12-18 months, things looks pretty promising, in our opinion. If earnings estimates for the next year turn out to be approximately right, and the valuation norms of the past 5-10 years can hold for another 12-months, stocks might look just fine by this time next year.

Our point here is *not* to encourage investors to rush into the stock market. Rather, we encourage investors to stay committed to the equity market exposure they have. As we described in the latest *Overview*, we have deliberate risk management processes in place in all of our investment strategies to help navigate the volatility we expect in the asset markets. Conditions can always get worse, but they can also get better. It's important to stick with a well-designed investment plan.

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The **Barclays Investment Grade Credit Index** is a market capitalization-weighted index representing U.S. traded investment grade corporate bonds. The index seeks to track the price and yield performance of domestic investment grade corporate credit securities.

The **Barclays High-Yield Corporate Bond Index** is a market capitalization-weighted index representing U.S. traded corporate bonds rated below investment grade. The index seeks to track the price and yield performance of domestic sub-investment grade corporate credit securities.

The **S&P 500 Index** is a market capitalization-weighted index representing the leading companies in the U.S. stock market. The index seeks to track the price and dividend yield performance of the domestic stock market.

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