HALLMARK CAPITAL MANAGEMENT, INC.
Integrity
Professionalism
Responsiveness

Economic and Market Newsletter Spring 2017

Hallmark Capital Management, Inc.
1195 Hamburg Turnpike
Wayne, New Jersey 07470
973-808-4144
www.hallcapmgt.com

ARE STOCK PRICES TOO HIGH?

Over the course of the long bull market since the end of the financial crisis, price/earnings ratios for the broad market averages have risen to levels at the higher end of some historical benchmarks. With the last bear market still a painful memory, investors understandably have some hesitancy to wholeheartedly embrace stocks at these prices. Certainly we are not immune from these concerns ourselves. It is worth spelling out some of the reasons why one might retain a reasonably favorable view on stocks.

First, while price/earnings ratios have a good track record of predicting long-term stock returns, they have been a poor timing tool for year-to-year changes in the stock market. Second, in past bull markets, some of the best returns have been generated in the later stages of the cycle. Third, there may be fundamental reasons why price/earnings ratios today might not be comparable to those in the past. Last, for various reasons, not all stocks have fully participated in the general rise in the market and their price/earnings ratios seem reasonable.

THE COMPLEX RELATIONSHIP BETWEEN VALUATION AND RETURNS

Common sense would lead one to believe that paying a high valuation for a security lowers its expected future return. In investing, however, common sense sometimes can be misleading. Surprisingly, some of the best annual returns from common stocks have occurred when price/earnings ratios were well above normal. As a group, investors tend to care more about the future than they do the past. When higher earnings are expected down the road, price/earnings ratios are often bid up in anticipation … even if the acceleration in profits is likely to occur with a significant time lag. Stocks sometimes bottom a full eighteen months before the economy, based on the idea that better times are coming.

Currently, investors appear to be waiting more for new governmental policies rather than an improvement in the economy. In our last letter, we discussed the potential impact on corporate profits from the proposed changes in Federal tax rates and regulations, which could be large. At this point, the details have yet to be hammered out, but stocks have risen in anticipation that change is coming. To the degree these policies significantly raise after-tax profits, above average valuations may prove to have been warranted, even if the laws do not immediately take effect.

Investors can probably deal with a delay as long as they know that an improvement in profits is on its way, especially since the improvement would happen almost regardless of the state of the economy. However, a robust economy would make the case for stocks even stronger. The critical issue is whether investors will be proven right or wrong about what the Administration will be able to achieve.

Unfortunately, valuation levels do not provide much insight on whether or not a particular consensus forecast will turn out to be accurate. Investors can be just as right or just as wrong, regardless of where price/earnings ratios lie. Periods of overvaluation can last a long time, since investors may stubbornly cling to their hopes for a positive outcome, even in the face of strong contrary evidence. They finally react only when the truth becomes too obvious to ignore. History shows that it pays to be cautious when investor sentiment reach extremes, but moving too early carries its own risks.

BULL MARKETS ARE OFTEN STRONGEST NEAR THEIR END

It is an old saying among investment professionals that being right too early is just as bad as being wrong. Given how well stocks have done in the final stages of a bull market, the fear of leaving too early is actually justified. Over the past eighty years, the total returns from the Standard and Poors' 500 Index have averaged a stunning 25% in the twelve months before a bull market peaked. Not only is that an impressive number, but the final-year gains represented, on average, 19% of the entire bull market advance. Therefore, investing in the latter stages of a bull market is particularly challenging, since reducing equity exposure too early may deprive a portfolio of significant gains. On the other hand, waiting too long is not desirable either. It is no wonder that bull markets are said to "climb a wall of worry."

HOW SIMILAR ARE PRICE/EARNINGS RATIOS?

There is no single, accepted measure of valuation for common stocks. Even the widely-cited price/earnings ratios come in enough versions to make one's head spin … forward and trailing price/earnings ratios, Schiller or CAPE price-to-earnings, price-to-normalized earnings and inflation-adjusted price/earnings are just a few examples. Not all of them necessarily point in the same direction; stocks can be expensive on one of these measures, but reasonably priced on another. It matters greatly which measure of valuation is being compared. Historic comparisons can be suspect as well.

HOW COMPARABLE ARE EARNINGS?

Financial data are less consistent over time than most people realize. While accurate stock prices are available going back to 1881, earnings numbers cannot be so easily compared. With all the changes in accounting rules, it is almost impossible to judge whether a $1 worth of earnings today is even remotely equivalent to a $1 of profit that was reported over a century ago. Even statements from the 1970s and 1980s aren't fully comparable to today. While financial statements today may not be perfect, there is no question that the level of required disclosure makes them far more reliable than they were back in the 1890s or the Roaring 20s. It makes sense to us that investors would be willing to pay more for stocks when the quality of earnings is better. This may be one reason, out of many, why price/earnings ratios have been trending higher since the Securities and Exchange Commission was formed in the Depression.

COMPANIES ARE MORE EFFICIENT

Price/earnings ratios may also be higher due to the fact that large corporations are far more productive than in the past. For example, back in 1901, the largest American corporation was U.S. Steel. After J. P. Morgan bought out Andrew Carnegie, U.S. Steel had revenues of half a billion dollars and it employed 168,000 people. The mills took well over 12 man-hours of labor to make each ton of steel. This year, U.S. Steel's 37,000 employees will generate over $12 billion in sales and it only takes 1.9 man-hours of labor per ton of steel produced. While that is an incredible improvement in efficiency for that particular company, it is dwarfed by the changes in productivity that have happened elsewhere in the economy. The most valuable company in the world right now is Apple Computer. Apple employs 115,000 people and it generated $215 billion in sales last year. Over the past 115 years then, the sales/employee for America's most valuable company has jumped from U.S. Steel's $3,300 in 1901 to Apple's $1.8 million in 2016.

As the U.S. economy has changed, the role of the big, cyclical smokestack industries in the major indexes has shrunk as new industries have emerged to take their place. The composite earnings stream for the major indexes is far less sensitive to changes in the overall economy. Investors have always paid more for companies offering a steady stream of earnings than highly cyclical ones, so it makes sense that price/earnings ratios have risen over time as the mix within the indexes has shifted toward more stable companies.

While all of these trends may have helped raise price/earnings ratios over time, we are not making the case that valuations will stay at current levels indefinitely. We recognize that stocks always fall into a valuation range, which leaves plenty of room for price/earnings ratios to move lower under certain conditions. Our argument is that many of these secular trends have helped increase price/earnings ratios over time, so that the threshold of an acceptable price/earnings is probably higher than it was in the past.

NOT ALL STOCKS ARE EXPENSIVE

Even in an environment where price/earnings ratios are generally rising, there are still many stocks with valuations that are well within the historic norms. Within the S&P 500 Index, 135 stocks, or 27% of the total, are priced at less than 15 times this year's earnings estimate. A low multiple does not automatically make them bargains, but it does provide the possibility of finding a reasonably priced investment today. Our methodology seeks to balance the quality of the company against the prospective earnings growth and its valuation. Within those parameters, we believe we can still build a portfolio with the potential to provide an acceptable rate of return. This is especially true in the current low interest rate environment.

NO RESPITE FROM LOW INTEREST RATES

Although the Federal Reserve chose to raise their targeted Federal funds rate in March, overall interest rates held fairly steady during the first quarter. While corporate credit markets have been helped by generally improving business conditions and steady cash flows, lower bond yields also reflected some mixed economic data that was reported. Most forecasts for first quarter real GDP growth have been reduced from 2.5% to something closer to 1%. For the past few years, first quarter GDP numbers have been particularly weak, and some economists are beginning to wonder if the seasonal adjustment factors the Department of Commerce uses need to be adjusted.

According to the futures market, investors expect two additional interest rate increases from the Federal Reserve this year, pushing the Federal funds rate above 1% for the first time since the financial crisis. In its press release, the Fed stressed that it believes only gradual increases in the Fed funds rate will be required, but they did give themselves enough leeway to shift to a more hawkish policy if the economy were to accelerate. They have never waited as long during an expansion to begin raising rates and they have rarely hiked interest rates when real GDP was increasing at such a slow pace.

The most recent minutes of the Fed's Open Market Committee also point to a desire to start reducing the Fed's balance sheet by the end of this year. After years of quantitative easing, the Central Bank's holding of Treasuries and mortgage-backed securities is equal to 24% of GDP, nearly six times the historical average. The problem is unwinding this position without causing a spike in mortgage rates, which could hurt both the housing industry and the overall economy. While there is every indication that the Fed will move cautiously, it will be extremely difficult for them to shrink the balance sheet without putting some upward pressure on interest rates.