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Asset Management, Inc.

The Song Remains the Same: Round and Round She Goes

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Reflections & Perceptions

After some early volatility in February and April, the stock market responded with a powerful rally that has taken the S&P 500 Index to new all-time highs. From the bottom established at an index level of 677 on March 9, 2009, to the end of this year's second quarter, the S&P 500 Index has appreciated on a total return basis by 224%! The current bull market is seemingly losing little steam as it enters its sixth year. The second quarter of the year has been especially strong with the S&P 500 Index appreciating by 5.23%, marking its sixth consecutive quarterly gain. Returns were broad based as six of the ten major market sectors delivered returns in excess of the market during the quarter.

The incredibly strong run in the stock market has driven investor concern and discussion over valuation levels. After last year's gains that far outpaced earnings growth and the additional gains made thus far in the current year, there is a growing chorus that price earnings multiples are too high and that the market has gone too far too quickly. We would note that from a Price to Earnings ratio (P/E) perspective, the market as represented by the S&P 500 Index is neither cheap nor is it expensive. For instance, the 10-year and 25-year historical averages of P/E ratios currently stand at 13.8x and 15.5x, respectively. Consensus estimates at this time sit at $120 for 2014 and $133 for 2015. Using the second quarter ending level for the S&P 500 Index of 1960, we find the market trading at P/E of 16.3x 2014 and 14.7x 2015 earnings estimates.

Comparing these levels to the historical averages does not necessarily imply a market that is overvalued. Providing additional support to this market has been the recovery and continued growth of corporate profits. Since establishing a bottom in 2008 at a level of $49.54 for the S&P 500, the Index's constituents have been able to not only recover all the ground lost during the housing-induced bear market by 2010, but also climb to new record high profit levels in the ensuing years. Consensus estimates forecast a continuation of this positive trend into 2014 and 2015, which we believe lends an important support to this upward trending market.

A recurring theme throughout this bull market has been the amount of cash that resides on corporate balance sheets. Various sources put the figure at $1.6 trillion. To put this number into context, corporate cash as a percent of current assets is at an all-time high of 30%. As well, operating earnings as a percent of sales, currently at 9.80%, are at record highs. Companies have substantially improved their margins through scale, productivity improvements, lower cost of capital and globalization. Some have argued that all of this cash will drive substantially increased capital expenditure activity and, in turn, pressure margins and cash available to shareholders. We do not see things this way. Corporations are not necessarily on the cusp of a large capital spending spree due to the fact that utilization levels are just not that high. Overall capital expenditure levels are currently at 7.0% for U.S. companies versus the long-term average of 7.9%. This environment supports our view of an economy that continues on its slow-growth trajectory and that corporations will use their large cash balances to continue to reward shareholders with share buybacks and increasing dividends.

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Today, 84% or 422 of the companies in the S&P 500 Index pay a dividend, the most since 1998. In addition, all members of the Dow Jones Industrial Average pay a dividend. According to the S&P Dow Jones Indices, 696 dividend increases were reported during the second quarter of this year compared to 591 increases announced in last year's period. For the first half of the year, 1,774 issues increased their payments, up 15.6% from the 1,535 issues that increased their payments during the first half of 2013. On a net dollar basis, corporations increased dividends by $12.6 billion in the second quarter. Based on the current pace of payments thus far in the year, we expect another new high to be attained this year. We expect that the key drivers of this trend including rising profits, expanding operating margins and building cash levels should be supportive of an environment that continues to drive dividends higher.

Looking forward into the second half of the year, we do not expect the economy to change much from its current slow-growth pace. While the first quarter GDP report of this year produced a negative 2.9% annualized rate of growth, much of this was explained away by the severe weather impact during this time period. This was the worst GDP report in five years. That said the market looked through this number as expectations built for a strong rebound in the second quarter. Much has been made of this muddle-through economic environment due to the fact that this recovery's profile lags that of other economic recoveries. Since the negative GDP report of 2009, the economy has grown at a slow and volatile pace. In contrast, earnings growth over this period of time has been anything but muddle through. So while we continue to expect a slow pace of economic expansion, that rate of growth should be able to continue to drive growth in earnings and dividends. Add in a supportive interest rate policy by the Federal Reserve, and the resultant backdrop appears to remain positive for common stock investing.

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