CAMPBELL CN NEWMAN
Asset Management, Inc.

A New Arrangement But the Same Song

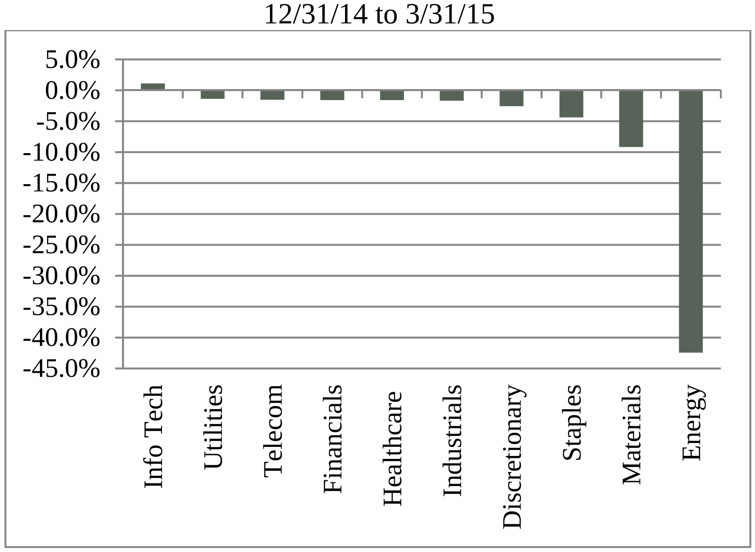
March 31, 2015

Reflections & Perceptions

Since the lows in 2009, stock prices have rallied along with the earnings of their underlying companies. Trailing 4-quarter operating earnings for the S&P 500 bottomed at approximately $40 in mid-2009, while the operating earnings results for 2014 (preliminary) are for just over $113. (Source: Standard & Poor's) Ultra-loose monetary policies have further supported the rally, as have reasonable valuations relative to historical ranges and the level of interest rates.

Going into 2015, the S&P 500 consensus earnings estimate for the current year was $131, implying 15% growth compared to 2014. Over the last three months, however, estimates have come down, and now reflect the expectation that earnings in 2015 will be flat to modestly up at $117 to $118 versus 2014's $113. Weather and the strong dollar are two of the things frequently cited as negatively impacting economic activity in the first quarter, but do not account for the full degree of the estimate reductions. As well, large downward estimate revisions have not occurred across the board (see Chart 1), but are concentrated in the Energy sector (-42.4%), as analysts are still playing catch up in reflecting the reality of oil's price decline in their models. Excluding Energy, the market weighted average earnings revision for the 2015 estimate between December and March was just -1.7%, with the Information Technology sector actually showing a small upward revision of 1.1%.

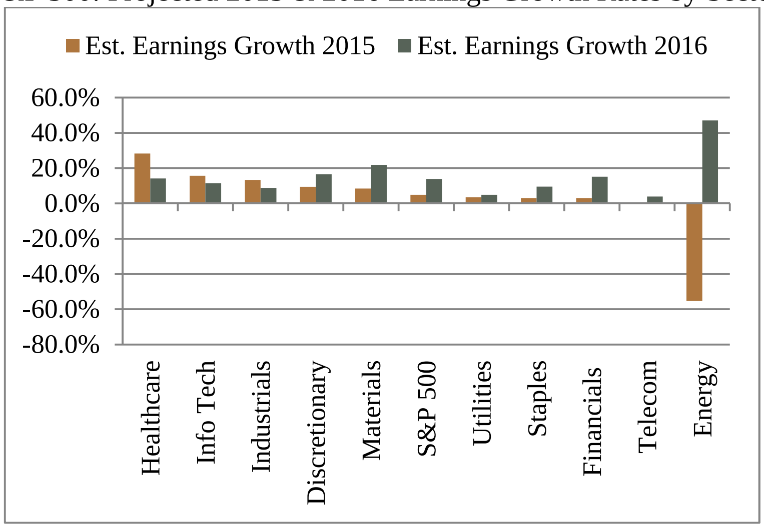
Chart 1
S&P 500 Economic Sectors: % Change in 2015 Earnings Estimates
12/31/14 to 3/31/15



Source: Zacks Investment Research, Inc.

Probably more important is that all S&P economic sectors save Energy are still expected to exhibit year-over-year earnings growth in 2015 (Chart 2) despite the fact earnings estimates have come down. Healthcare has the highest projected growth rate at 28%, followed by Information Technology at 16%. Further gains are expected across the board in 2016, with current S&P 500 earnings forecasted at $135. The greatest growth next year is expected from the Energy sector at 47%, which should likely be taken with a grain of salt since the models imply the year's average price for crude will be about 40% higher than it is today.

Chart 2
S&P 500: Projected 2015 & 2016 Earnings Growth Rates by Sector



Source: Standard & Poor's

Since earnings recovered from the financial crisis, valuations began expanding noticeably in 2013 as prices moved higher faster than earnings did. The S&P 500 is now selling for 17.6x the current year's earnings estimate versus roughly 13x-14x in the 2010-2012 time frame. The current valuation is slightly above this measure's 20-year average of 16.7x but well below the high for the period of 29.2x set in early 2000. Given the ongoing extraordinarily easy monetary policies of the world's central banks (which we expect to continue into the foreseeable future due to the slow growth, low inflation trajectories of the major economies) and the fact that the yields for 10-year Treasury and the S&P 500 are both at about 2%, we don't view valuation a major threat to the rally on balance. We expect prices will trend higher as long as the expectation of earnings growth remains intact.

S&P Sector Multiples vs. 20-Year High	
Utilities	93%
Energy	81%
Staples	63%
S&P 500	60%
Materials	59%
Industrials	58%
Discretionary	54%
Telecom	51%
Healthcare	50%
Financials	46%
Info Tech	27%

Source: Zacks Investment Research. Inc.

Of course, some areas of the market are more or less attractive than others to us. Our analysis continues to show Utility stocks as the most pricey in the market. We think this is especially important because Utilities tend to be thought of a lower volatility, safer bets when times get tough. However, due to the long duration of the low interest rate environment, it appears as if more investors have been looking to Utilities as bond substitutes, pushing prices up—witness its 2014 best S&P 500 sector performance of 28%, which drove its P/E multiple on the 2015 estimate to 17.8x, a 20-year high valuation. Despite having the worst performing sector in 1Q 2015, down -5.2%, the Utilities still have the highest sector valuations relative to their long-term histories. If this relationship persists, we wouldn't necessarily expect Utilities to provide that "anchor to windward shore" protection that they have in the past during more turbulent times. Conversely, the valuations of the Information Technology, Healthcare and Financial sectors look more attractive relative to their historical ranges.