



CAMPBELL NEWMAN

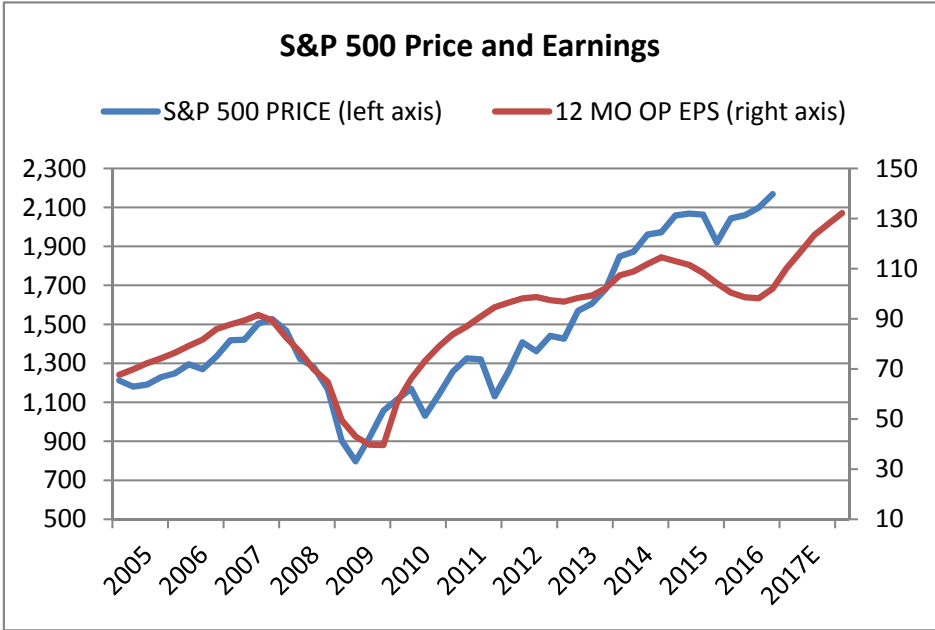


REFLECTIONS & PERCEPTIONS

DO YOU LIKE WHAT YOU OWN TODAY?

The S&P 500 rallied through July and into mid-August to reach a new all-time high close of 2,190 on August 15, before trading flat to down for the remainder of the third quarter. With this new all-time high, the current bull market is roughly seven and a half years old, making it the second longest bull-run in history.

We have frequently discussed how the recovery in earnings following the financial crisis, and their subsequent climb to new all-time high levels, has provided the fuel to drive stock prices higher. This relationship is seen in the chart at right depicting the S&P 500 Index's price and its 12-month operating earnings from 2005 to date, with earnings estimates for the current quarter through yearend 2017. (Source: Standard & Poor's) The U.S. stock market's rise paused in the second half of 2015 and into the first months of 2016 as earnings growth turned negative, largely as the result of a collapse in profitability in the



Energy sector and the dollar's strengthening. However, recession fears receded and the price of oil recovered, which allowed expectations toward future earnings growth to remain positive and the indexes to rally.

The earnings estimate for the S&P 500 in 2017 is currently \$132, or about 13% higher than the approximately \$117 expected for 2016. The forward (currently 2017) consensus estimate for the S&P 500 is frequently overly



optimistic 12-18 months out and needs to be adjusted downward as reality sets in. We note that in each of the last three years (2014, 2015 and 2016E) S&P 500 earnings results have been stagnant after having been initiated in the \$125 to \$135 range.

In aggregate, earnings growth has been hard to come by the last few years despite the extraordinary measures taken by the Fed and other world central bankers. These policies are creating dislocations in global markets by raising asset prices without, arguably, accomplishing their primary goals of improving economic growth and raising inflation. We do not consider the U.S. public equity market to be among the most affected areas because the degree of excess is negligible. For example, the S&P 500's P/E on this year's earnings estimate of \$117 is 18.5x, compared to its 20-year high of 29.2x and 20-year average of 16.8x. Instead, dislocations are more readily identified in the fixed-income market and among rapidly growing but often unprofitable companies with multi-billion-dollar valuations, frequently called "unicorns."

The advent of negative interest rates is one of the most startling upside-down realities of this easy money environment. According to Bloomberg, the total face value of negative-yielding corporate and sovereign debt in the Bloomberg Barclays Global Aggregate Index of investment-grade bonds jumped to \$11.6 trillion as of September 30, up 6.1 percent from a month earlier. How does it make sense to have the lender pay the borrower to borrow?

Since most unicorns are privately held, details regarding their finances are more difficult to find. However, some information regarding Uber and Snap Inc.'s (formerly Snapchat) financial results and valuations were recently reported that show the effects of free money on asset prices.

Uber, the ride-sharing company, was founded in 2009. Since that time, the company has lost at least \$4 billion, according to reports, with \$1.27 billion in losses in the first half of 2016 alone. Yet, Uber has been able to raise more than \$16 billion in cash and debt, with the latest round of capital raised at a \$69 billion valuation, according to Bloomberg Technology. Uber is growing quickly, but so are its competitors. In a business with no competitive "moat," how much is that growth worth? Compare Uber's results with like-sized public market companies: There are 19 companies in the S&P 500 with market capitalizations between \$60 and \$70 billion. These companies reported average 12-month net income of \$3.1 billion ending June 30.

According to an October 6 Wall Street Journal article, four-year old Snap Inc. is preparing for an IPO with a valuation targeted at \$25 billion or more, following on a May 2016 capital raise valuing the company at roughly \$20 billion. The company is growing quickly, with revenues growing from approximately \$60 million in 2015, to an estimated \$250 to \$350 million this year, and as much as \$1 billion in 2017—but without any profit dropping to the bottom line, as far as we can tell. Valuing unprofitable companies on sales and metrics other than cash flow or earnings is reminiscent of the dotcom era, especially at 25x the next year's "reach" revenue estimate.

Finally, easy money allows politicians (and their constituents) to avoid making the hard decisions so that irresponsible fiscal policies persist and grow. Since 1995, publically held debt has more than tripled to \$14.1 trillion (excludes an additional \$5.4 trillion of Intra-governmental Holdings). Yet, the government paid less in 2015 in net interest payments (\$223 billion) than it did in 1995 (\$232 billion).

As the saying goes, bull markets don't die of old age. They die from excesses, events or a combination of the two. The negative impact of the Fed's easy money policy has begun to skew valuations in certain markets as noted above: multi-billion dollar valuations for unprofitable business models and the issuance of bonds with negative yields! Could these be signs of the beginning of the end for the current bull market? Time will tell. The resumption of earnings growth in 2017 will stand as a strong prerequisite for the current bull market to continue its run as the benefit of easy monetary policy wanes. Long-term market survival requires one to acknowledge that bear markets do occur from time-to-time and to prepare accordingly. At this late stage of the economic expansion, it is important that investors ask themselves, "Do you like what you own today?" We ask ourselves this question on a daily basis as we strive to guide our clients' investment portfolios through the market cycle with a focus on companies with proven and durable business models as seen their ability to generate growing profits.