
# TWO STEPS FORWARD, ONE STEP BACK?

The S&P 500 logged a 6.07% return during the 1st quarter 2017, extending its post-election rally while entering into the ninth year of its bull run. The quarter's rally was broad-based with nine of the Index's eleven economic sectors reporting positive returns, supported by solid earnings reports for 2016's 4th quarter and, generally speaking, a greater optimism coming from managements in their forward guidance. Growth tended to outperform value during the period due to market expectations that the new Administration's policies will foster acceleration in economic activity.

Information Technology was the S&P 500's top performing sector with a quarterly return of 12.57%, followed by the Consumer Discretionary and Health Care sectors performance of 8.45% and 8.37%, respectively. Financials underperformed with a 2.53% return for the Index sector as the yield curve unexpectedly flattened during the quarter despite Fed Funds rate increases in December 2016 and March 2017. The Index's weakest sector was Energy (-6.68%). Energy prices fell during the quarter in response to a global glut in reserves, as a recovering U.S. oil industry is challenging OPEC's efforts to push prices higher.

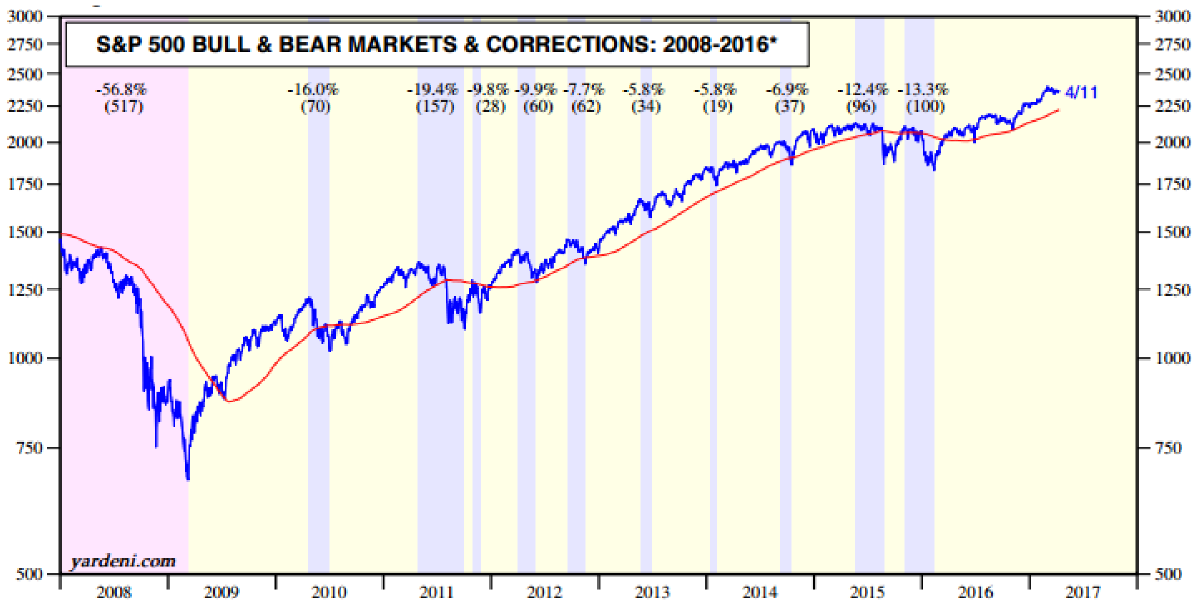
After reaching its all-time high price of 2,400 on an intra-day basis on March 1, the S&P 500's price action became a bit rougher going into the end of the quarter. A loss of confidence in the Administration's ability to deliver on its pro-growth agenda is most frequently cited as the source of the market's choppiness, although some profit-taking after the 15% run off of its pre-election November low of 2,085 is another plausible rationale.

During our meetings with clients, potential clients and consultants, we are frequently asked about our outlook for "the market." We sense that the tone of this question is evolving to: "When is this going to end?" as the age of the current bull cycle, and the levels it has achieved, are causing greater skepticism about the future.

It's important to note that bull markets don't die of old age, but as the result of economic contractions. At this point, we see no meaningful or immediate signs that the economy is headed into a recession. However, as we examine the current situation, we would expect "the market" to correct at some point, as it always does.

Since the bull market began just over eight years ago, there have been ten periods when the S&P 500 declined by 5% or more from its highs. Four of these corrections were greater than 10% in magnitude, and the other six were between 5% and 10% (Figure 1 on page 2). The average length of these declines was 66 days. The most recent "market" correction happened more than a year ago in February 2016, precipitated by the price of oil's drop to below $30/bbl and concerns over a slowing global economic environment. While the S&P 500 Index has consistently moved higher over the last 13 months, six of its eleven economic sectors have experienced price declines greater than 10%, in what could be seen as "rolling correction." Leading into the November election, the Health Care, Consumer Staples, Real Estate, Utilities and Telecom sectors were in correction territory. Since November 5, only the Energy sector has declined.

FIGURE 1




--- 200-day moving average Source: Standard & Poor's
*Ratio Scale. Corrections are declines of 5% or more (in blue shades). Bear markets are declines of 20% or more (in red shades). Number of calendar days in parentheses.

Additional perspective may be gained by examining the market in a historical context. Table 1 compares the current market valuation and interest rate environment to past price peaks in 2000 and 2007. The current P/E ratio for the S&P 500 Index on forward (or 2017) estimated earnings is 17.9x, which does not appear too extended versus its 20-year average of 16.9x and the 25.1x recorded at the market peak in 2000. Also, given the low level of interest rates, the market does not appear expensive on a dividend-yield basis, either. Today's S&P 500 dividend yield of 2.0% is actually slightly higher than its 20-year average of 1.86%, and well above the 20-year lows set in the late 1990s and early 2000 of roughly one percent. Additionally, the yields on stocks continue to compare rather favorably to bond yields across the curve.

TABLE 1: S&P 500: PREVIOUS PEAKS VS. TODAY

| Metric | 3/24/2000 | 10/9/2007 | 3/31/2017 |
|---|---|---|---|
| S&P 500 Level | 1,527 | 1,565 | 2,362 |
| Trailing EPS 12 Mos. | 51.02 | 88.18 | 106.26 |
| Trailing P/E Ratio | 29.9 | 17.7 | 22.0 |
| Forward P/E Ratio | 25.1 | 15.0 | 17.9 |
| Net Debt/EBITDA | 3.4 | 3.4 | 1.9 |
| Price/Book Value | 5.4 | 3.0 | 3.0 |
| Dividend Yield | 1.10% | 1.80% | 2.00% |
| 10-Year Treasury Yield | 6.20% | 4.70% | 2.40% |
| 3-Month T-Bill | 5.90% | 4.02% | 0.76% |

Source: BofA Merrill Lynch, I/B/E/S, Bureau of Labor Statistics

In addition, the length of this bull market is not out of whack with past long-term rallies. Since 1926, there have been eight major secular bull markets, with an average length of 8.9 years and an average total return of 490%. The four longest bull markets lasted an average of 13.6 years. This current bull market has just crossed into its 9$^{th}$ year while logging a total return of 240%.

For stocks to sustain their forward momentum, we need to see an extension of last quarter's more positive reports regarding earnings and management outlooks. The current consensus calls for S&P 500 earnings to increase roughly 12% in 2017 over 2016, after three years of no growth. Over the course of the next six weeks, companies will be formally reporting their first quarter results and framing their full year guidance. The outcome of this reporting period will serve as an important milestone in reinforcing the expected turn in earnings growth during the year. We continue to believe that stock prices can move higher alongside earnings growth with an occasional correction along the way.