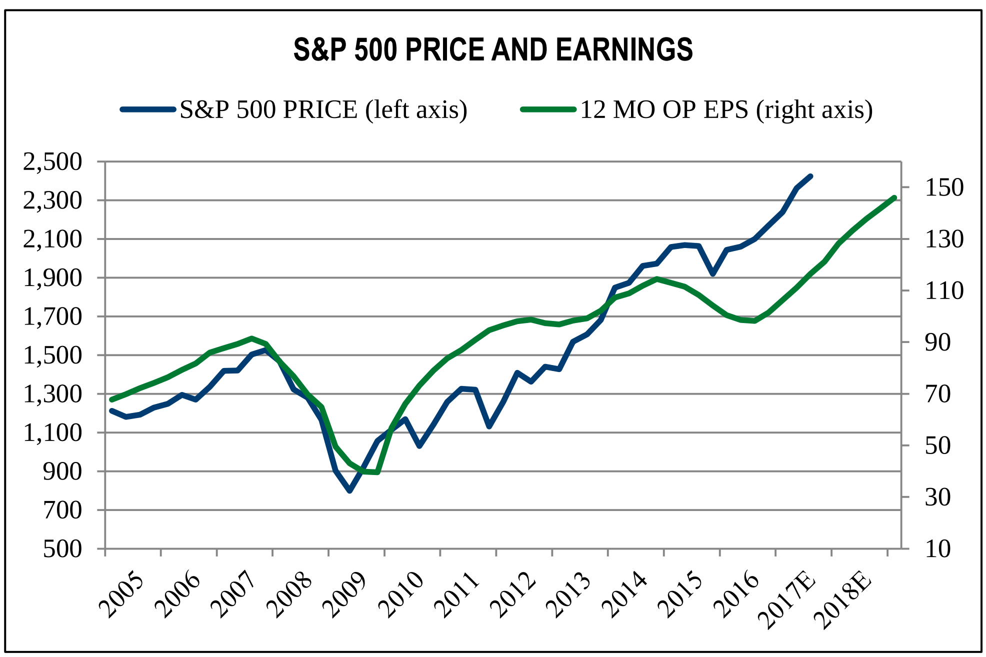
REFLECTIONS & PERCEPTIONS

THE FOREST THROUGH THE TREES

One of the greatest stock pickers of all time, Sir John Templeton, said: "Bull markets are born in pessimism, grown on skepticism, mature in optimism and die on euphoria." As we all know, the current bull market began in spring of 2009 and was born from the extreme pessimism brought about by the financial crisis. Now in its ninth year, there are varying opinions of where this bull rally stands in Sir John's scheme.

Many view the duration of the bull market as an indication of where it is in its cycle. Probably the most commonly used definition of a "market cycle" is three-to-five years. In an unscientific review of recent financial news articles found in a Google search for "bull market length," the vast majority cite the current bull as the second longest on record behind the 1987-2000 run. Although, how a "bull market" is defined and measured makes a difference. One piece from First Trust calculates the average bull market period as 8.9 years, with an average cumulative total return of 468%, by measuring from



the lowest close reached after the market has fallen 20% to the next market high. Also, more along the lines of investor psychology, we perceive that many market observers are anchoring their expectations on their recent experiences in the 2000's--a decade that saw two devastating bear markets in quick succession and no price appreciation for the S&P 500 Index. Stocks are now up approximately 250% from their lows over the last 33 quarters. They seem to be asking, "Isn't it time for a downturn?" while not taking into account what we view as more insightful factors.

As we recently discussed in our pre-election 3rd quarter 2016 *Reflections & Perceptions*, it was the recovery in earnings following the financial crisis, and their subsequent climb to new all-time high levels that was providing the fuel to drive stock prices higher. The observation that bull markets are "grown in skepticism, mature in optimism" reflects the truth that improving fundamentals cause investors to rationally adjust their thinking from pessimism to skepticism and then optimism to reflect the environment.

The relationship between stock prices and earnings growth is shown in the chart on page 1 depicting the S&P 500's price and its 12-month operating earnings from 2005 to date, with earnings estimates for the current quarter through year-end 2018. 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 the collapse in profitability in the Energy sector and the dollar's strengthening. However, recession fears receded and the price of oil recovered to profitable levels for most producers, which has allowed expectations toward future earnings growth to rise and the indexes to rally.

The S&P 500's earnings are projected to grow by about 20% in 2017 and another roughly 10% in 2018. In an unusual turn, the benchmark's earnings estimates were actually revised upward in April in response to 1Q reports—instead of the typical ratcheting down of expectations as the year progresses. It has also been observed that stocks are moving higher on the expectation of improved earnings growth from stronger activity, which is a change from the post-election rally that looked for improvements from deregulation and tax reform. For example, the Atlanta Fed GDP tracker is estimating 2Q GDP growth at 2.7% compared to 1.4% in 1Q.

At the same time, market breadth has displayed few signs of deterioration that communicate the end of most bull runs. According to Lowry's Reports' Market Trend Analysis of June 30, 2017:

> The process of forming a major market top also includes a gradual deterioration in market breadth, and investors find fewer and fewer stocks at valuations that appear to justify new buying. This deterioration in breadth can be a prolonged process, as it first appears among small-cap stocks, then migrates to mid-caps and finally to large-caps. Eventually, this deteriorating breadth affects the Advance-Decline lines, which begin to diverge from the major price indices. Historically, this divergence (and, more often, series of divergences) begins at least four to six months prior to the final bull-market high.

Importantly, the Advance-Decline line for all NYSE issues hit a new all-time high on June 29th at the same time U.S. stock market indices drove to new all-time highs across style and size spectrums.

Rising prices have caused valuations to move higher. The S&P 500's multiple of 16.5x on next year's estimate is approximately 15% above its 20-year average multiple of 14.3x. However, interest rates are still well below their 20-year averages and must be considered when assessing valuations. For example, the 10-year U.S. Treasury's current yield of 2.31% is just 58% of its 20-year average of 3.98%. Lower rates allow for higher-than-average valuations. We also expect that interest rates are likely to remain supportive of valuations in the foreseeable future given recent inflation data with CPI reads well below 2%.

As "bottom-up" stock pickers, we are looking for the best ideas within the parameters we have established to build portfolios designed to outperform their benchmarks over a market cycle at lower levels of volatility or risk. However, as "bottom-up" stock pickers, we must also look at the larger picture in order to do things like confirm whether a given company's growth projections are reasonably supported by the activity in its end markets or to make judgements regarding valuations.

So, where does that leave us? We remain constructive in general terms. After three flat years, the S&P 500's earnings are growing again because of stronger activity. Valuations are higher than their longer-term averages, but do not appear overextended given the level and outlook for interest rates. And, finally, despite its age and success, we perceive that the investor psychology regarding this bull market is still in the skepticism-to-optimism zone.