Baird Market and Investment Strategy

Macro Update

November 14, 2017

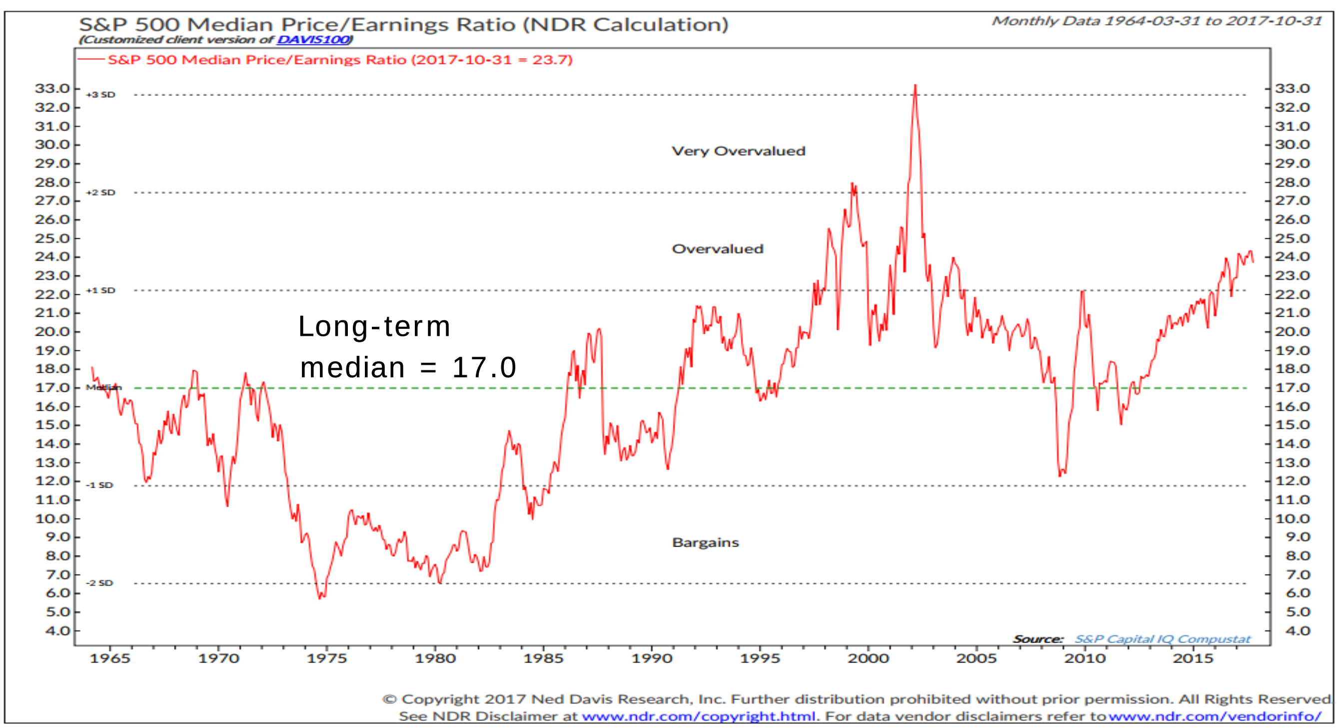
Please refer to Appendix – Important Disclosures.

Stocks Priced for Perfection, but Global Growth Providing a Tailwind

Key Takeaways: Valuations are not as high as they have ever been, but still at levels that could weigh on future returns and leave little margin for error in terms of quarterly earnings growth. Earnings growth is coming from overseas, and estimates globally are going higher.

Since the third quarter of 2014, S&P 500 earnings have risen 3.5% and the index itself is up over 30%. The comparison is somewhat more favorable when accounting for the collapse in energy sector earnings, but even still, earnings growth accounts for only about half of the rise in stock prices over the past three years. The other half is attributable to multiple expansion. This can be seen graphically by looking at charts of stock market valuation, which in many cases have been rising and are now at levels historically associated with overvaluation. Our preferred gauge for actually gets around some of the issues with company and/or sector related earnings distortions by focusing on the Median Price/Earnings ratio for the S&P 500.

While elevated valuations are a risk factor for stock prices, valuations are notoriously unreliable poor indicators of near-term performance. As British economist John Maynard Keynes once quipped, “the market can stay irrational longer than you can stay solvent.” Nevertheless, there is a strong inverse relationship between current valuations and stock market returns over the coming five-to-10 years. Moreover, in the current environment, stocks appear to be priced for perfection and even better-than-expected earnings reports are not being celebrated by the market.



Source: Ned Davis Research

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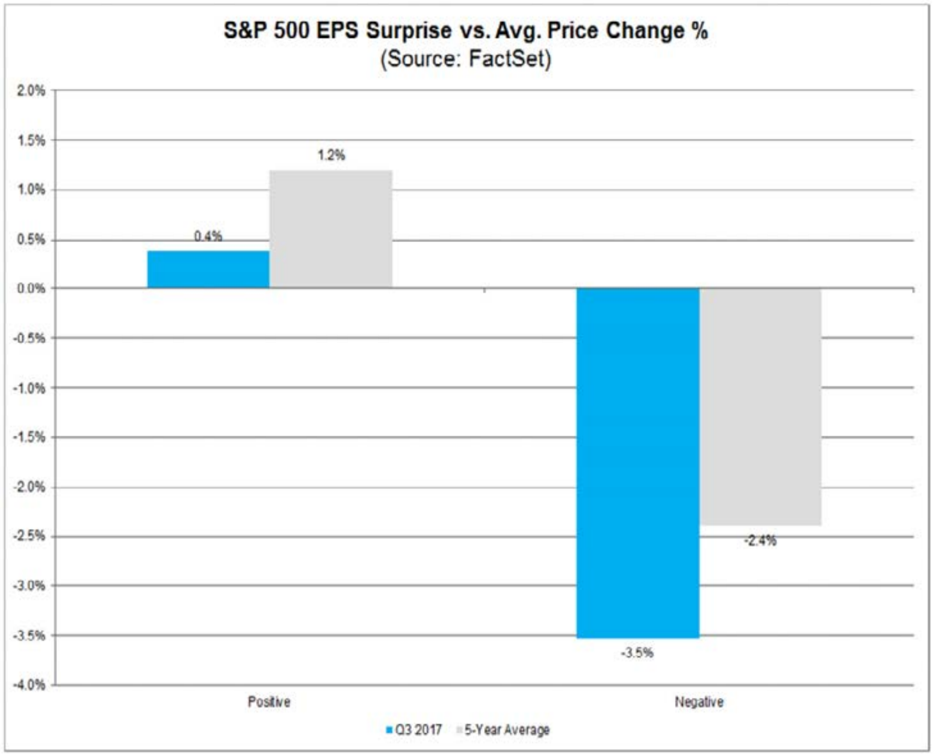
The stock market historically celebrates upside earnings surprises and punishes companies that disappoint on earnings (hence part of the motivation on the part of companies to guide down earnings expectations). Evidence that current valuation levels reflect stocks being priced for perfection comes from the market's response to the most recent round of earnings reports. Companies that provided positive earnings surprises in Q3 got less of a reward (in terms of price appreciation) while those with negative surprises got punished even more harshly than normal. The risk from valuations goes beyond quarterly earnings reports. There is a strong inverse relationship between current valuation level and forward stock market returns.



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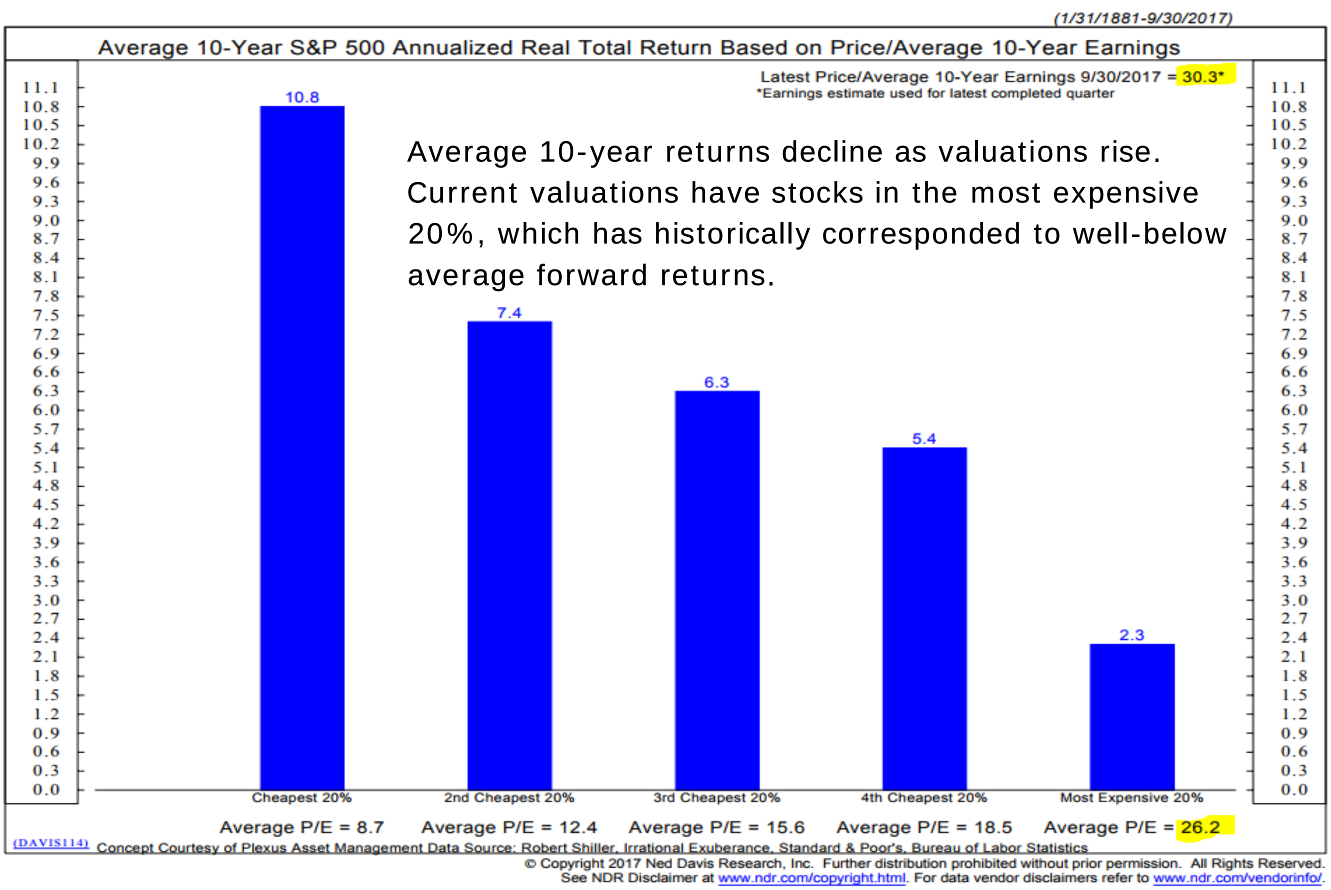
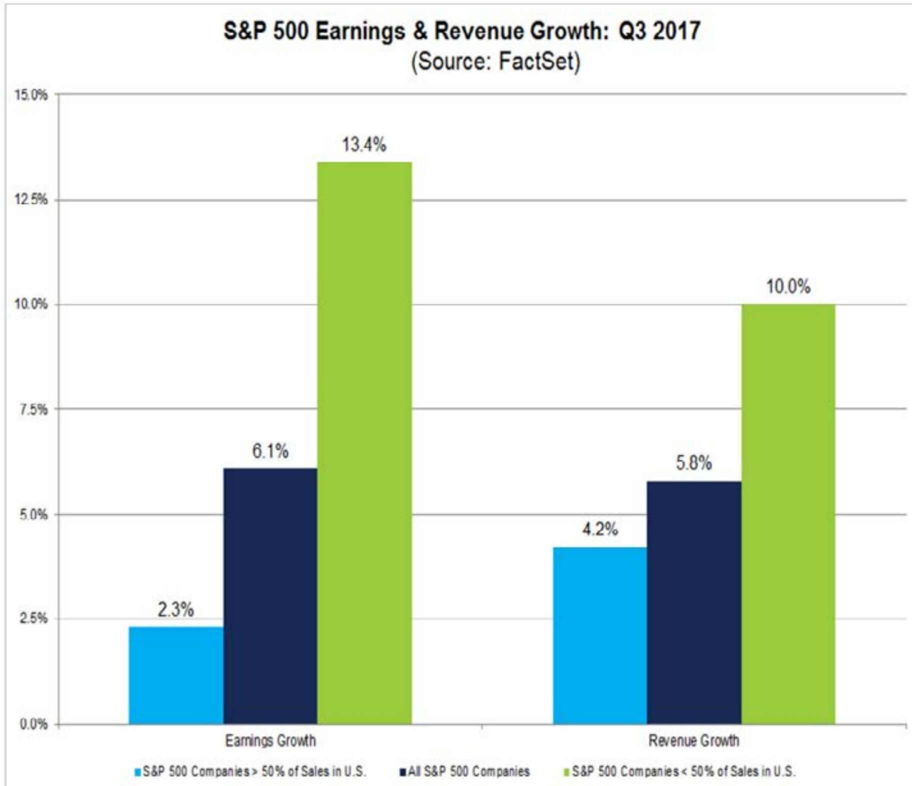


Source: Ned Davis Research

The good news is that valuation relief can come from earnings recovery as well as price corrections. Right now, the rebound in the global economy is a primary driver of earnings growth. Companies in the S&P 500 that derive more than 50% of their sales from the U.S. saw a 4.2% growth in revenues and 2.3% growth in earnings in the quarter. Companies that got more than half of their sales from overseas, however, saw revenue growth of 10% in the quarter and earnings growth of 13.4%. Another sign of global leadership: while earnings estimates for this year and next have stabilized on the S&P 500, they have actually turned higher on a global basis (the MSCI All-Country World Index). Global growth is fueling improvements in our domestic economy and stock market.



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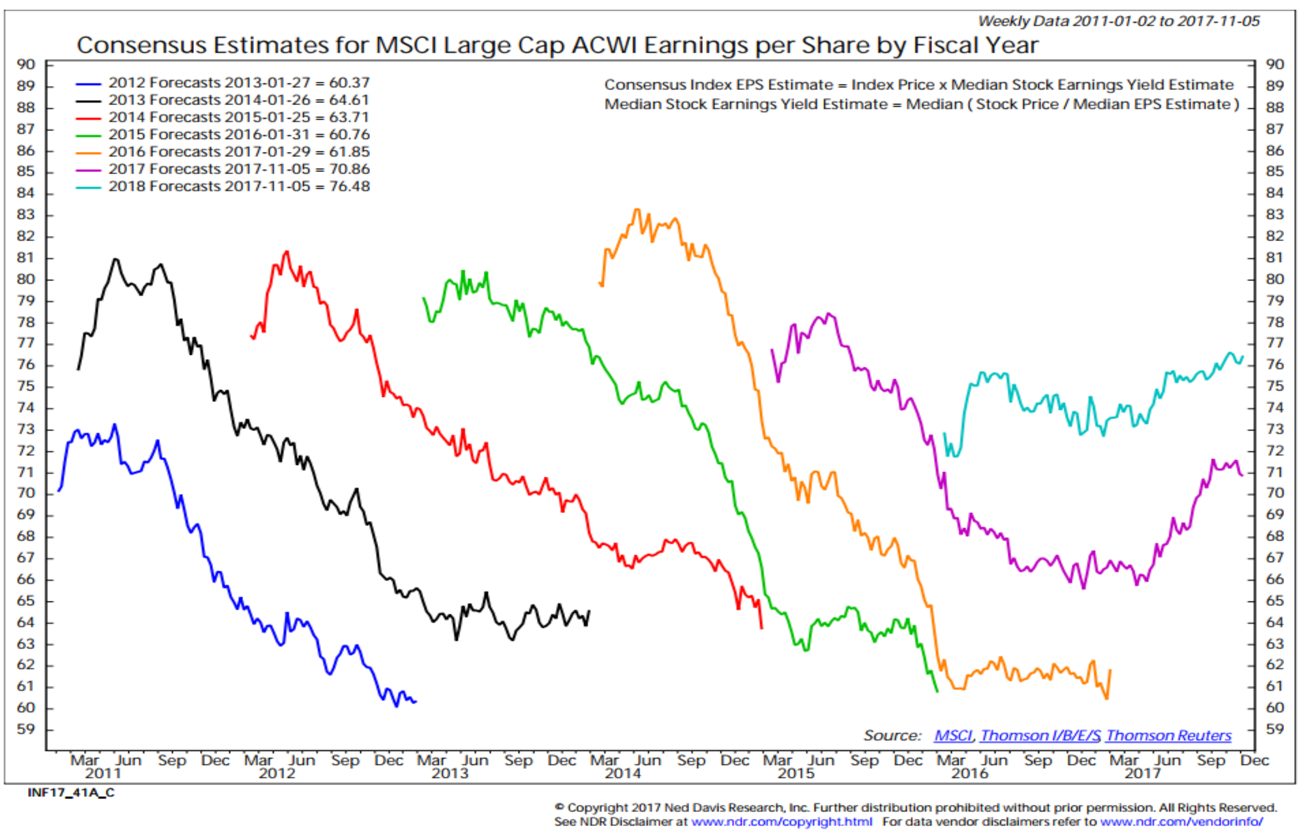

Source: Ned Davis Research

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