Baird Market and Investment Strategy

Macro Update

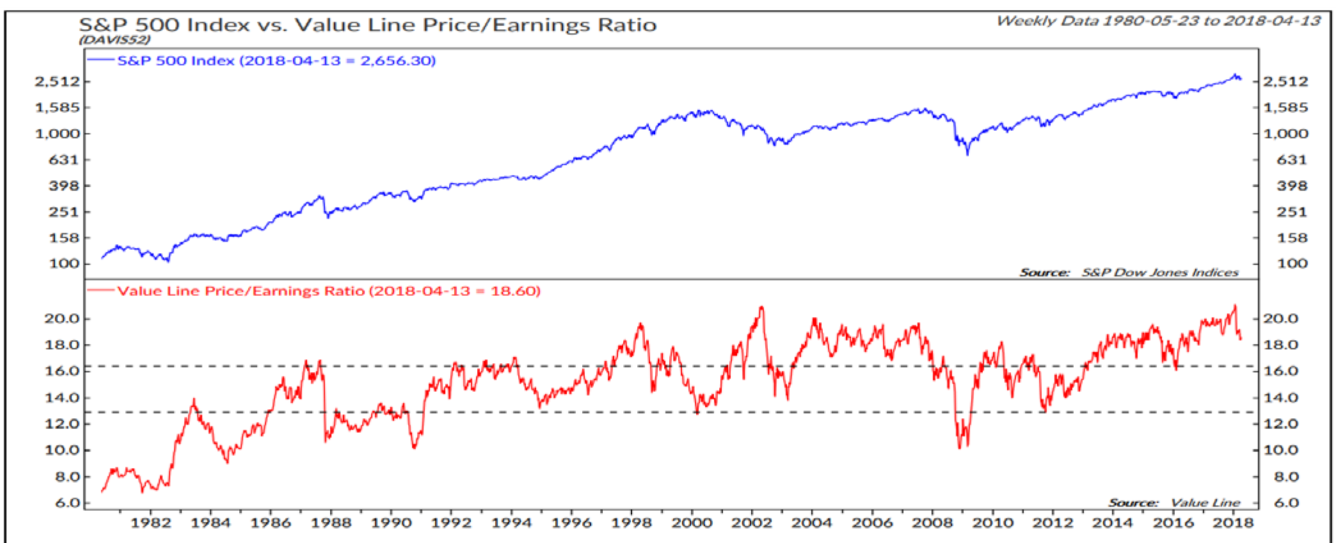
April 17, 2018

Please refer to Appendix – Important Disclosures.

Valuations Suggest Stocks Are Hardly a Bargain

Key Takeaways: **Valuations, especially those that account for earnings expectations, have pulled back from extreme levels. Nonetheless, valuations continue to represent a risk for stocks. Stretched valuations come on the back of strong earnings growth, and with earnings expectations setting a high bar for the current quarter. A slowing in the pace of positive earnings surprises could turn valuation-associated risks into an acute headwind for stocks in coming months.**

Valuations are better employed as gauges of underlying risks in stocks than as indicators of near-term directional opportunities. As such, monthly or quarterly updates are typically sufficient. Given the ongoing volatility in stock prices in 2018 and the expected surge in earnings due to the recent tax cut package, it might make sense to look at a more timely valuation measure that blends both actual and expected earnings. That is provided in the Value Line Price/Earnings ratio, which is the median P/E calculated off of a blend of the most recent six months of actual earnings and six months of projected earnings of the 1700 stocks in the Value Line universe. While this P/E ratio has pulled back from an all-time record high (i.e., higher than the valuation extremes seen in 2000 and 2007), it remains elevated and in a zone consistent with sub-par returns. In other words, even as we begin to account for expected strong earnings growth in 2018, valuations remain historically stretched. There may very well be reasons to take an optimistic view toward stocks, but from where we sit valuations would not be among them.



S&P 500 Index Performance Full History: 1980-05-23 to 2018-04-13		
Value Line P/E Ratio is	% Gain/ Annum	% of Time
Above 16.4	4.35	39.61
12.9 - 16.4	10.71	37.83
Below 12.9	13.47	22.56
Buy/Hold = 8.74% Gain/Annum		

Source: Ned Davis Research

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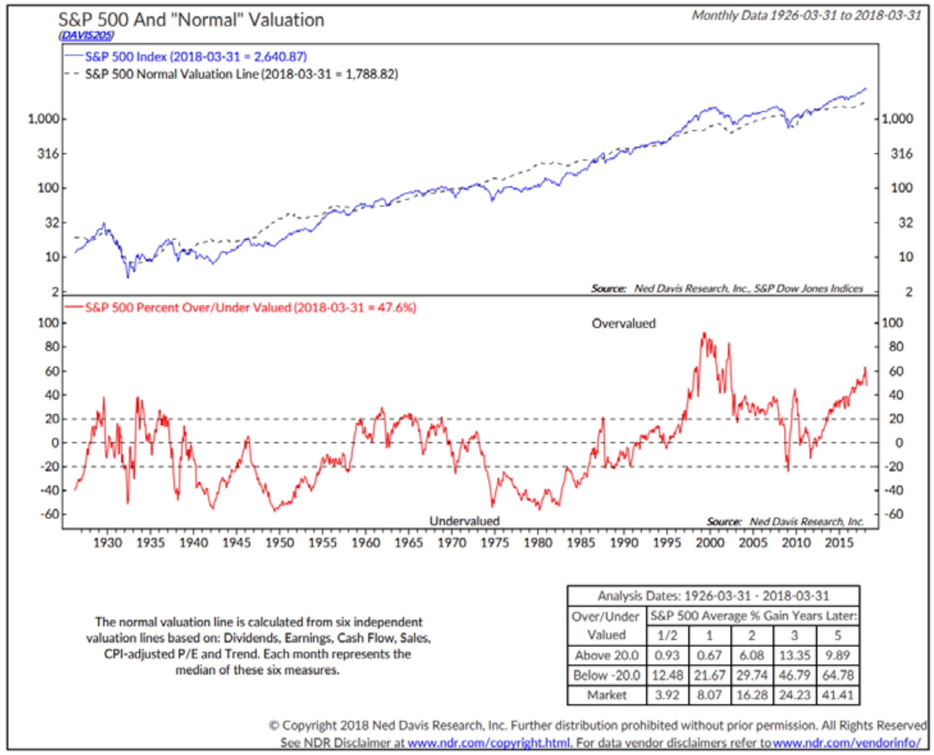
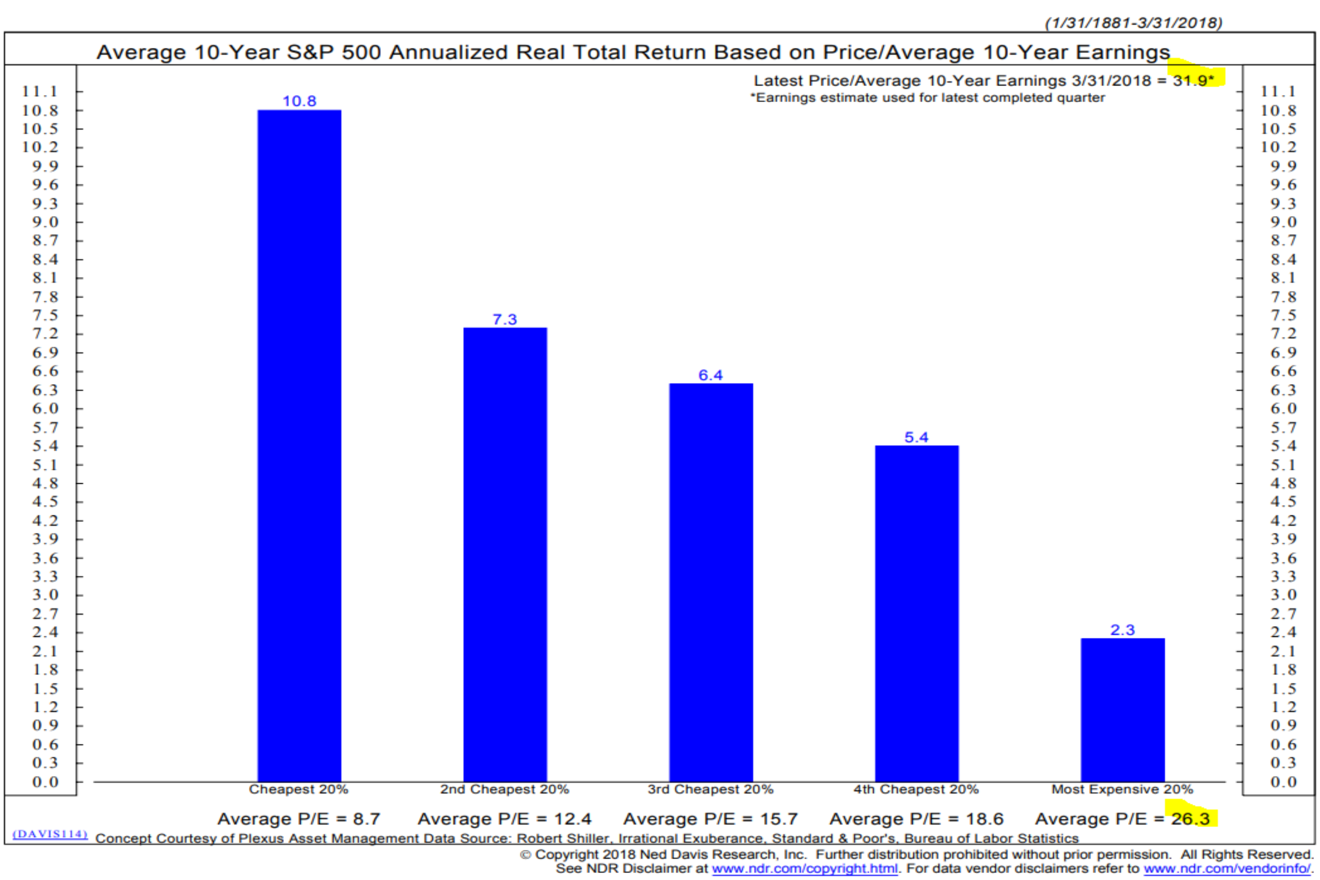
Stocks are not just overvalued relative to earnings. The “Normal Valuation” indicator accounts for six different measures of valuations, but the message is the same as looking at just earnings. Stocks are expensive and current valuations are consistent with sub-par returns going forward.

Returning to valuations based on earnings, there is a strong inverse correlation between current valuations (based on trailing 10-year earnings) and forward real returns for stocks. When stocks have been cheapest, forward returns have been greatest. As stocks get more expensive, forward real returns have diminished. Stocks are currently in the most expensive quintile, consistent with an annualized forward real return of 2.3%.



Analysis Dates: 1926-03-31 - 2018-03-31					
Over/Under Valued	S&P 500 Average % Gain Years Later:				
	1/2	1	2	3	5
Above 20.0	0.93	0.67	6.08	13.35	9.89
Below -20.0	12.48	21.67	29.74	46.79	64.78
Market	3.92	8.07	16.28	24.23	41.41

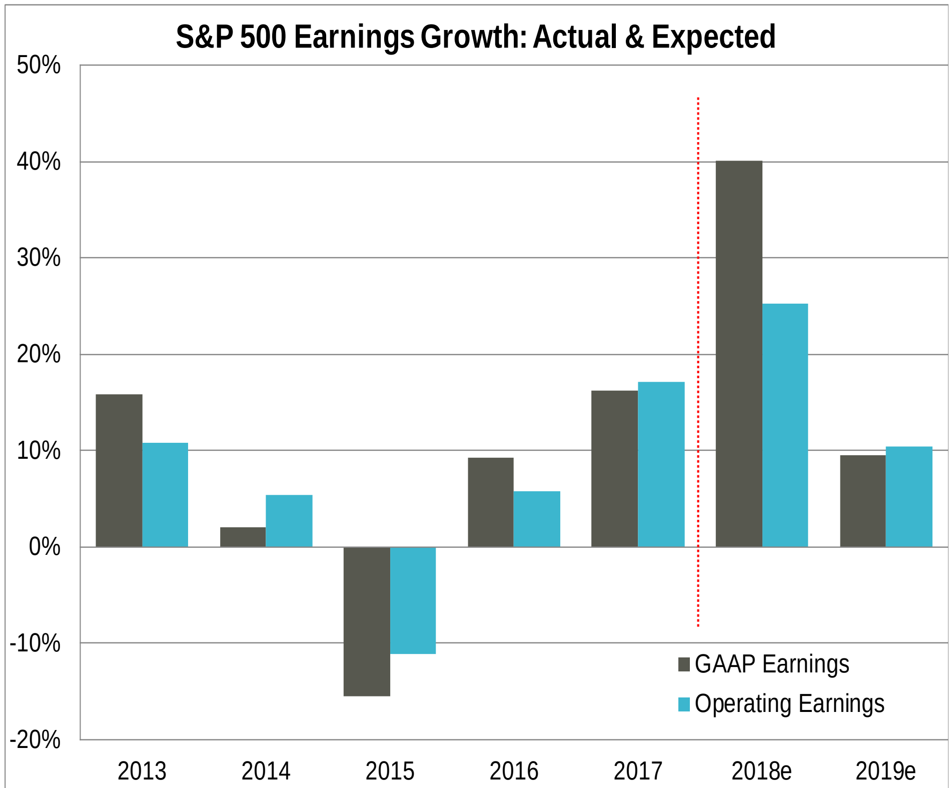
Source: Ned Davis Research



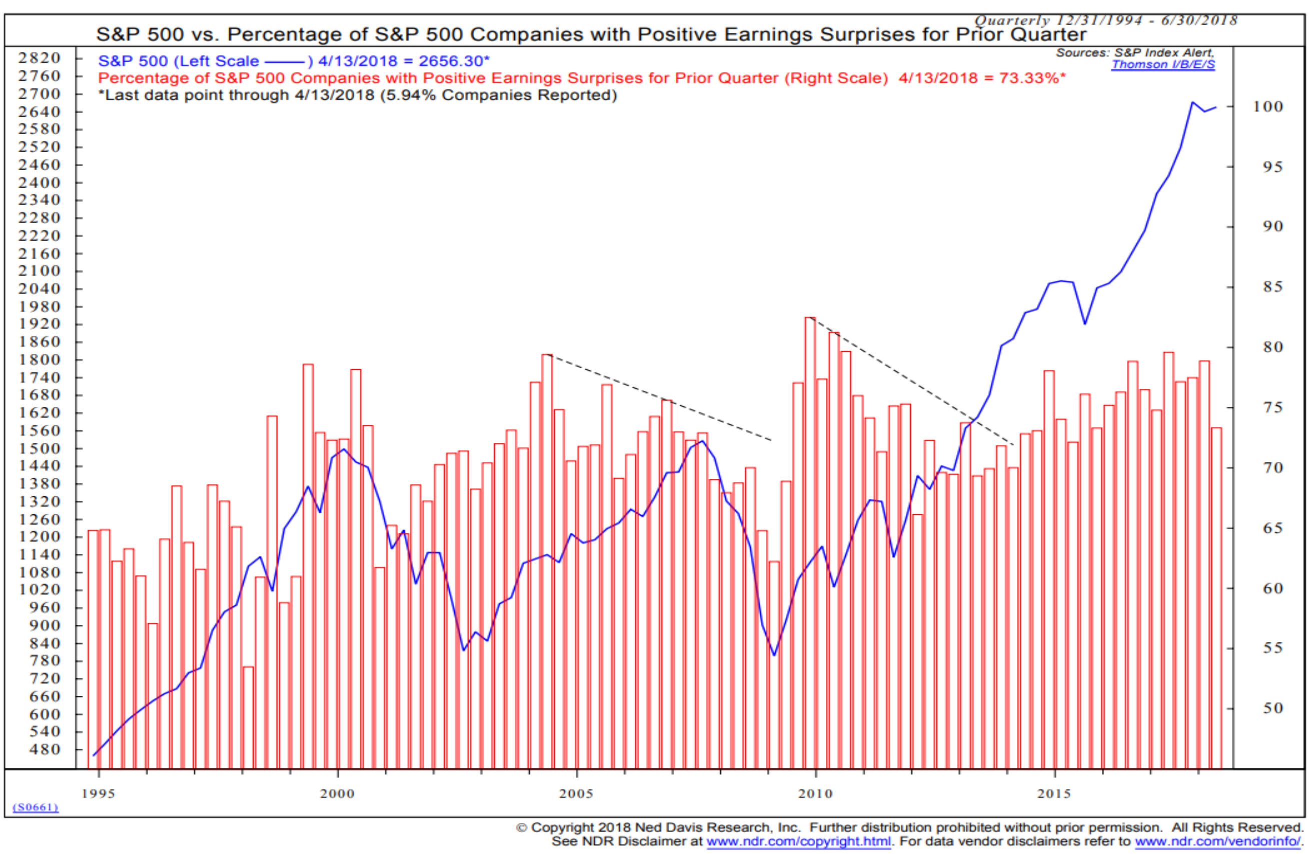
Source: Ned Davis Research

In some ways, excessive valuations could be seen as less problematic if the market was currently working through a trough in earnings. But that is not the case. Earnings are expected to surge in 2018, but this comes after two years of improving earnings growth (S&P 500 earnings were up more than 15% in 2017). Current expectations are that each quarter of 2018 will see operating earnings growth of better than 20%. Reported earnings are now expected to rise 40% this year. This is a high bar to get over at this point in the earnings cycle.

As earnings season heats up, we will keep an eye on the percentage of companies providing positive earnings surprises. A slowdown from the 75%-80% beat rate seen in 2017 could weigh on stocks.



Source: Standard & Poor's



Source: Ned Davis Research

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