

Aladdin's Lamp

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Am I crazy? It's a question any sane investor needs to ask every so often, and this is one of those moments. In the past 18 months, our clients' portfolios have gradually grown from a modest 3% equity tilt to a more substantial 8.5% overweight today. In that time, we have neither added to nor reduced our overall equity allocation through trading activity; the change is entirely due to market drift as stocks have performed much better than bonds.¹

So now our clients have a larger allocation to a pricier asset class. Isn't it just common sense to reduce our equity allocations and take some profits? Perhaps, but last week our Investment Committee did the opposite, choosing to stand pat with our 8.5% equity overweight. Hence the question: Are we crazy? As the committee's chair and as Eastern Bank's CIO, am *I* crazy?

The stock market bears have an easy story to tell: The Fed is raising short-term interest rates and probably wants higher long-term rates as well; GDP growth was a lackluster 2.6% in the year's seasonally strongest quarter; and inflation is so subdued that some investors think a recession might be coming. Major legislation to provide fiscal stimulus – health care, tax reform, or the promised infrastructure investment bill – has failed to materialize. Meanwhile, price/earnings ratios and other valuation metrics tell us that stocks are undeniably more expensive than they have been at any time since the last recession. Yet no one seems concerned, as the VIX volatility index is plumbing all-time lows. It's a setup straight out of Steppenwolf:

*Last night I held Aladdin's lamp, and so I wished that I could stay.
Before the thing could answer me, someone took the lamp away.
I looked around, a lousy candle was all I found.*

Are market bulls taking a magic carpet ride to a fantastical mirage? Is the stock market nothing more than a lousy candle that we mistake for Aladdin's lamp? Maybe we *are* crazy after all.

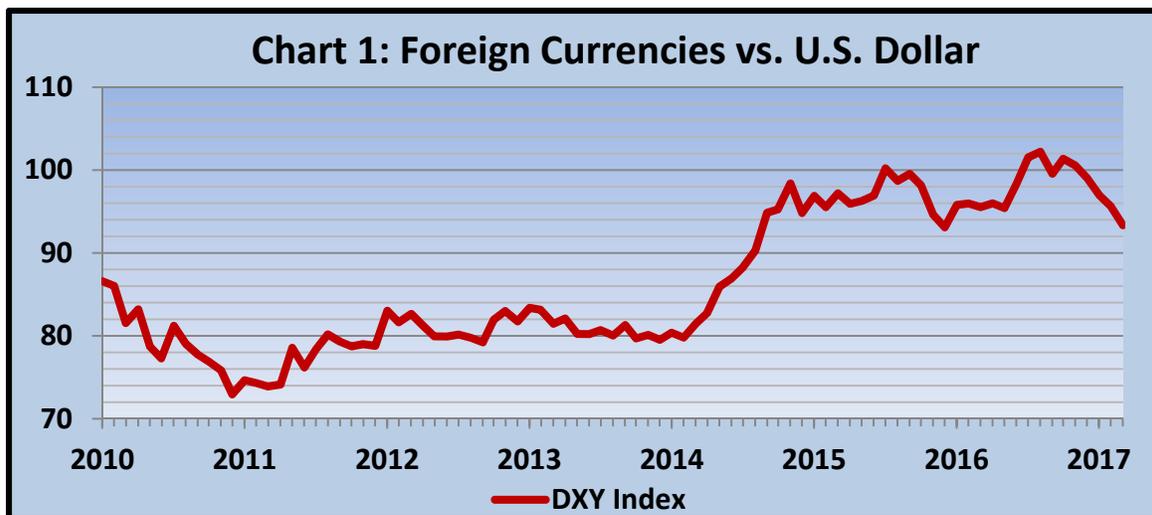
A review of the fundamentals

Then again, maybe we're quite sane. We still expect stocks to grind their way higher through the balance of the year, and potentially beyond. The economy is still chugging along. This is now the third-longest expansion since World War II, although it's also the slowest: GDP growth has averaged just 2.1% since the June 2009 bottom. Slow growth is mainly a function of slower population growth and sluggish productivity gains, and that's why inflation remains so subdued as well. This is not a problem; it's a classic example of the tortoise outlasting the hare.

¹ We measure this as the actual *tactical* allocation to equities in comparison to a client's long-term *strategic* allocation. For example, a client whose long-term target is 60% equity had an actual allocation of 61.8% in January 2016; that same client's actual equity allocation has grown to 65.1% today. From January 2016 through June 2017, stock prices rose 19.8% (including dividends), while bond prices gained only 6.3% (including coupons).

What's more, the individual components of GDP growth are looking healthier than they have in recent years. Housing remains strong, of course, and consumers continue to spend steadily. While it's true that automobiles and retail sales are both declining, in the past few months we've seen a significant uptick in big-ticket business investment. Oil and gas exploration and development have also rebounded, fueled by cheap financing.

All of this bodes well for corporate earnings (which is what stock investors are really buying). Earnings for the S&P 500 have been clocking at a 9% pace through mid-year, driven by better revenue growth than we've seen heretofore in this expansion. On top of this meat, the secret sauce that makes this year's earnings growth especially savory is the U.S. dollar's surprising weakness. Specifically, the dollar has lost about 8% of its value this year when compared against a trade-weighted index of other currencies, as shown in Chart 1. That has made our exports more competitive and boosted the revenue growth rates for corporations; the S&P 500 companies collectively derive about half of their sales from outside the United States.



Source: FactSet

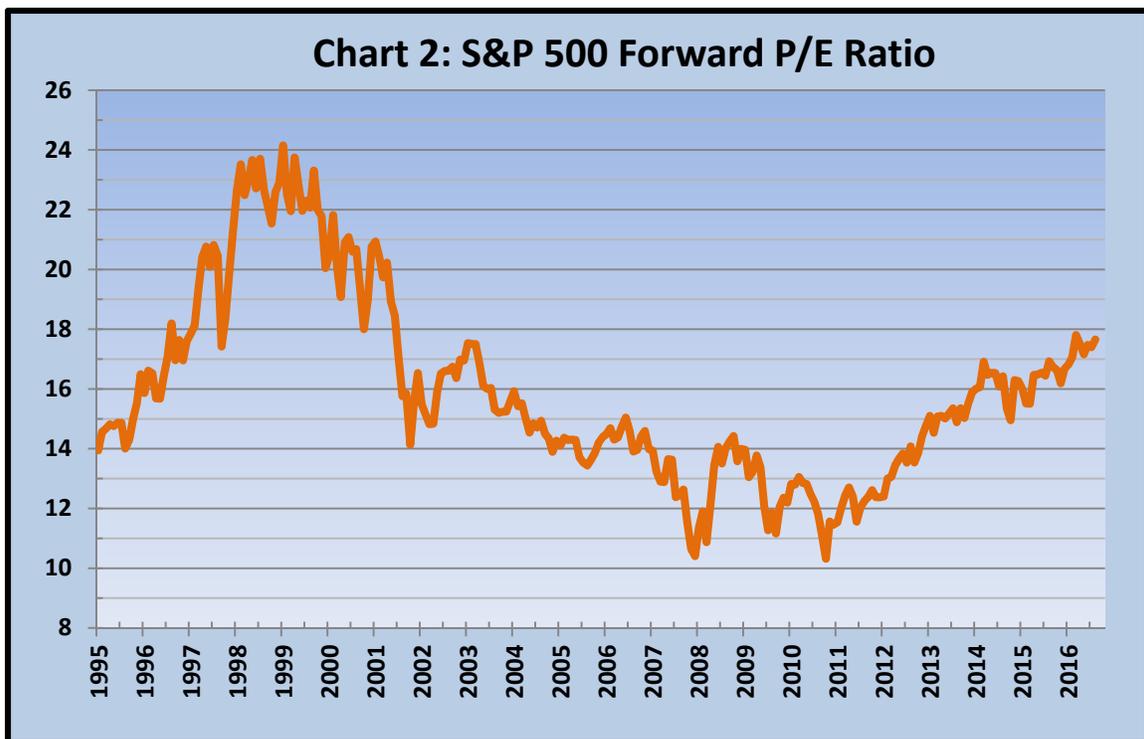
There's an unusual kicker to the dollar's weakness this year, too. A weak dollar translates into higher import prices, which historically have hurt consumers. This year, however, consumer spending remains robust; in part, this is probably because the most obvious indicator of import price inflation is the price of gasoline, which has remained low. We think consumers are able to absorb price increases tied to the weaker dollar, which gives importers a bit more pricing power and can boost overall inflation from its current 1.7% rate back toward the Fed's target of 2.0%.

Oil prices, too, tell a story that supports a bullish investment posture for U.S. stocks. Energy sector profits were crushed last year because prices collapsed, and then recovered this year as West Texas Intermediate prices stabilized in the \$40 to \$55 range. We think the historical boom-and-bust nature of oil markets has moderated as new technology enables U.S. producers to be more nimble in boosting or curtailing production to reflect evolving inventory and demand. While some stock market bears are predicting that oil prices will fall into the \$30 range again, we expect prices to remain in a stable trading range above \$40; this stability can encourage business investment across many energy-intensive sectors of the economy.

Finally, developments abroad have positive implications for U.S. stocks. Europe, in particular, has revived after a decade of stagnation. As European GDP growth gains momentum, consumers and businesses on the Continent are increasing their purchases of American products. (The Brexit process may give American companies an added edge.) Similarly, the weak dollar has sparked a revival in emerging market economies. Stock markets in Europe and emerging markets have outpaced the U.S. this year for the first time in nearly a decade.

A look at valuation

Stock market bears may accept that fundamentals remain strong, and still argue for lower stock prices. Valuations are simply too expensive today, they say, and they can point to Chart 2 for evidence; P/E ratios are higher than they were at the last market top in 2007. Bears can also argue that Congress's likely failure to enact eagerly anticipated fiscal stimulus should begin to hurt stock prices.



Source: FactSet

U.S. stocks are currently priced at about 17.7 times year-ahead earnings, compared with a long-term average of 16 times. This suggests that stocks are *slightly* expensive – perhaps about 10% above their historical valuation midpoint – but there have been many occasions in the past when stocks have traded at higher multiples, at all points of the economic cycle. The P/E ratio has hardly budged since year-end, as the market's 9.4% gain through the first six months was matched by a 9% expansion in S&P 500 profits. With steady earnings growth in our forecasts, we think stocks can continue to increase in value without requiring further multiple expansion or even tax reform from Congress.

Moreover, interest rates are very low, a situation that inflates the current value of future earnings and stock prices.² Although the Fed does want to see rates begin to drift upward, Chair Janet Yellen has emphasized the need to move gradually and only as supported by emerging data; in other words, the Fed will act with considerable restraint in the months ahead. In short, there's nothing in Chart 2 that suggests that P/E ratios need to (or will) come down anytime soon. A similar conclusion can be drawn from an examination of just about any other valuation metric: Stocks aren't cheap, but they're not *too* expensive either.

Too often investors take profits too soon, and fall victim to their own impatience; we could have pared back our market participation six months ago, or a year ago, or at almost any time in the past half-decade, based on the reasonable arguments consistently put forward by the bears. We would have been wrong to do so; our patience has paid off for our clients.

We're not market timers. Although August and September historically have been the weakest calendar months for equities, the final four months of the year have often been the strongest; we're not eager to sell now and realize taxable gains, on the hope that *maybe* we'll buy back stocks cheaper in a couple of months. Better to remain patient today, comfortable with a larger allocation to a higher-priced (but not more expensive) asset class than we had at the beginning of the year.

The stock market is not Aladdin's lamp, ready to grant our gaudiest wishes; contrary to the Steppenwolf reverie, fantasy will not set investors free. But nor is the market just a lousy candle. With solid EPS momentum and a restrained Fed, we are retaining our favorable tilt toward stocks. It won't be a magic carpet ride, but we do think stocks have room to continue aloft through year-end and possibly beyond.

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² Low interest rates also mean that the reported values of future liabilities, such as pension payments, are inflated in comparison to when interest rates are at more normal levels. The sharp increase in reported pension liabilities as interest rates fell over the past three decades is one major reason that some cities today appear insolvent. If interest rates rise meaningfully in the future, the reported values of pension liabilities will fall, and municipalities will look healthier.