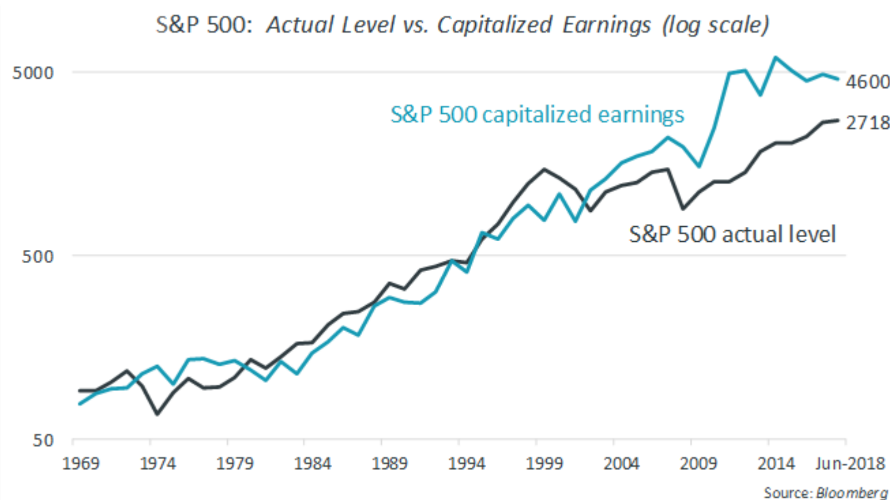
DM Portfolio commentary

2nd QUARTER 2018

Checking the math

One of the most fundamental operations that students learn at business school is how to estimate the value of an asset based on the cash flow it generates. In this calculation, an appropriate current price is derived by "discounting" income streams at a given rate, often the prevailing bond yield of appropriate maturity or the return that the individual requires to commit capital to the investment. All else equal, if the asset can be acquired for less than that figure, the investor should go ahead; if not, he or she may want to look elsewhere.



This method can be used to gauge fair price for income producing real estate, privately held businesses, listed stocks, and just about anything generating (or expected to generate) ongoing earnings. We can also use the technique to get a sense of where an entire equity index is trading relative both to its underlying fundamentals and how investors have valued those characteristics in the past.

In the accompanying chart, we've compared the actual level of the S&P 500 since the beginning of the 1970s with the value that would have been implied by capitalizing its trailing annual earnings at the prevailing 10-year US Treasury Bond rate, a maturity that corresponds with the long term commitment implied by equity investment (we've used log scale in this illustration to keep the lines from running off the page). As you can see, the two figures tracked each other fairly closely for most of the period examined, but began to separate about a decade ago, with index performance falling behind what corporate profit and interest rates would have predicted. In fact, capitalizing the earnings generated by the S&P 500 over the past twelve months by the current 10-year T-bond rate suggests that the index should be sitting at about 4600 points, or 70% higher than where it presently stands; if we run the calculation using consensus earnings expectations for calendar 2018, the figure comes out to more than 5600.

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So what could be causing this discrepancy? It's impossible to say with any certainty, but it is most likely one of the following factors, or some combination thereof. First, it could be that the intersection of earnings and interest rates that has described markets for generations is no longer valid and the contemporary investor is appraising stocks based on entirely different criteria. Though this explanation is possible, it seems unlikely that such a time-tested and intuitive approach to equity valuation would have been abandoned, no matter how different the modern investing environment may appear. Second, maybe the relationship does still hold, but market participants are skeptical of the durability of reported earnings and are instead substituting their own, greatly reduced estimates into valuation models. If this were so, the current level of income generated by the S&P 500 would need to be about 40% lower for the index's capitalized and actual levels to match, a haircut not historically seen in the course of a normal business cycle – in fact, calendar year earnings for the S&P didn't even fall that much during the economic plunge of 2008/09.

A third possible explanation for the divergence is not that investors are circumspect of earnings, but that they regard our very low interest rate environment as unsustainable, even though it's now been with us for nearly a decade. In this case, the 10 year T-bond yield would have to climb from its current 2.9% to about 4.7% to close the valuation gap. Though 4.7% might not seem like an extreme level for a 10 year interest rate, especially to those with memories of the 1980s and 90s, such a plateau would represent a significant relative jump from where we are now. If this occurred, though, it would presumably be driven by unexpectedly strong economic growth and nascent inflation pressure, which would undoubtedly be accompanied by a similar and offsetting rise in company earnings.

While none of this tells us where stocks will go in the near term, and certainly doesn't preclude them from suffering an unexpected drop at any time, it does leave us relatively content that the fundamental structure of the broad market is sound. This comfort allows us to devote more time and energy to doing what we do best: *seeking out individual companies that are doing things better, faster, and more efficiently than the competition and taking positions when their shares can be had at attractive relative valuations.*

Of course, as we write this there's an elephant stampeding through the room in the form of the US government's escalating belligerence toward international trade. In last quarter's commentary, we were sanguine about the darkening skies over global commerce, writing that "the initial hardline stance taken by the US government may turn out to be a bargaining ploy" aimed ultimately at improving China's "treatment of intellectual property and its habit of requiring transfers of proprietary technology from firms wishing to do business there". Now, however, intimidation is hardening to action, with the US activating punitive duties on $34 billion worth of imports from China and rescinding the exemption to steel and other tariffs previously granted to Canada and similar allies.

Not unexpectedly, China and several other nations have responded in kind, directing their counterpunches at US industries for which overseas sales are an important source of revenue. Notably, though perhaps not coincidentally, the effect of these measures will be felt most predominately in Trump country: *bourbon makers in Kentucky aren't happy, a motorcycle manufacturer operating out of Wisconsin and Pennsylvania is reorganizing to dodge costs, and soybean farmers in the Midwest are bracing for tough going as the most important market for the country's largest agricultural export closes its doors to American business.*

This feature is particularly important as November's mid-term elections approach and Republicans perhaps begin to contemplate the odds of losing their majority position in the House of Representatives. James Carville, chief strategist for Bill Clinton during his unexpected 1992 win over George HW Bush, famously set the correct campaign tone for his staff with his oft-repeated refrain, *"It's the economy, stupid."* In other words, voters would care more about their pocket books when they went to the polls that year than they would about President Bush's recent triumph in the first Gulf War or his long and distinguished history of service to the country.

At present, markets seem to be taking the view that similar pragmatism will win the day heading into the fall and that trade restrictions will either be walked back through negotiation, or at least limited to what's been put in place thus far. The TSX, for example, quietly reached a new all-time high in Q2 and posted its best quarter since 2013, while the S&P resumed its upward path following a stretch of softness to start the year. Though the rising trend continued into the early days of July, we'll watch developments closely in the coming weeks and adjust portfolios accordingly should White House direction defy common wisdom and take a further turn for the worse.

Have a great summer!