2019 Market Outlook

Data points to significant valuation discount and growth premiums available today vs. long term mean.

Where the world (excluding the U.S.) is flat and the "Natives" are hostile.

The Bear case would be if U.S. GDP declines or turns negative in 2019. The causal factors are likely to be an imported slowdown from the "rest of the world" (ROW). Exogenous factors such as domestic political strife may also have an outsized negative impact. We believe the most likely case would be a ROW recession that would

negatively impact the U.S. economy, thus decreasing EPS growth. Political party resistance may also increase risk premiums because of increased political uncertainty. The actual possibility of policy reversal negatively impacting U.S. GDP is minimal before 2020, but important initiatives such as a massive infrastructure bill and further administrative cuts may not see any progress or approval. The lack of an infrastructure bill and/or administrative cuts would have a neutral impact on U.S. GDP growth.

Consequently, we believe a **worst-case outcome for 2019 would be flat EPS growth for the S&P 500 along with a reduced earnings multiplier**. In our 2019 forecast, we apply a 10% discount to the current P/E ratio and assume a 16 times multiplier for increased risk from exogenous factors. Thus, a 2019 EPS estimate of $160 multiplied by 16 **leads to an S&P 500 of 2,560**. As of this writing on December 28, 2018, the S&P 500 is 2,475; hence, this scenario calls **for a total return of 5.5%**.

However, our 2019 assessment is for GDP growth of 1.75%, resulting in EPS growth of 3.0% (taken from a historic GDP / EPS multiplier of 1.7). We then grow 2018 EPS of $160 by 3.0% and multiply this result by a blended P/E multiplier of 18 (50% from our normal case of 20x + 50% from our exogenous risk adjusted case of 16x). Therefore, **we forecast an upside target of 2,960 for the S&P 500, resulting in a 21% total return potential**. Embedded in this assumption is a flat interest rate outlook (our model does not call for any rate increases in 2019) and a partial agreement on trade matters with China, resulting in no further tariff increases in 2019.

Below are important data series of the S&P 500 and U.S. GDP and our interpretation of their meaning for comparative analysis.

Figure 1: S&P 500 Sales & Earnings Growth Correlation to GDP Growth

S&P 500 Nominal Sales Growth		S&P 500 Nominal Earnings Growth		GDP Growth Nominal YOY	
30-Jun-18	9.03%	30-Jun-18	17.75%	30-Sep-18	5.47%
31-Dec-17	7.03%	31-Dec-17	16.21%	31-Dec-17	4.49%
31-Dec-16	2.09%	31-Dec-16	9.27%	31-Dec-16	3.40%
31-Dec-15	-3.11%	31-Dec-15	-15.42%	31-Dec-15	2.89%
31-Dec-14	4.16%	31-Dec-14	2.11%	31-Dec-14	4.42%
31-Dec-13	2.24%	31-Dec-13	15.82%	31-Dec-13	4.43%
31-Dec-12	3.76%	31-Dec-12	-0.51%	31-Dec-12	3.56%
31-Dec-11	9.36%	31-Dec-11	12.41%	31-Dec-11	3.65%
31-Dec-10	5.98%	31-Dec-10	51.76%	31-Dec-10	4.19%
31-Dec-09	-12.86%	31-Dec-09	242.54%	31-Dec-09	0.47%
31-Dec-08	1.70%	31-Dec-08	-77.52%	31-Dec-08	-0.83%
31-Dec-07	7.62%	31-Dec-07	-18.81%	31-Dec-07	4.59%
31-Dec-06	8.94%	31-Dec-06	16.73%	31-Dec-06	5.29%
31-Dec-05	10.93%	31-Dec-05	19.27%	31-Dec-05	6.47%
31-Dec-04	10.88%	31-Dec-04	20.13%	31-Dec-04	6.40%
31-Dec-03	5.37%	31-Dec-03	76.66%	31-Dec-03	6.30%
31-Dec-02	-8.45%	31-Dec-02	11.75%	31-Dec-02	3.86%
31-Dec-01	-1.18%	31-Dec-01	-50.62%	31-Dec-01	2.12%
http://www.multpl.com/s-p-500-earnings/table		31-Dec-00	3.80%	31-Dec-00	5.45%
		31-Dec-99	27.74%	31-Dec-99	6.51%
Average	3.53%	31-Dec-98	-5.06%	31-Dec-98	6.02%
		31-Dec-97	2.56%	31-Dec-97	6.13%
		31-Dec-96	14.05%	31-Dec-96	6.27%
		31-Dec-95	10.98%	31-Dec-95	4.26%
		31-Dec-94	39.79%	31-Dec-94	6.30%
		31-Dec-93	14.67%	31-Dec-93	4.98%
		31-Dec-92	19.54%	31-Dec-92	6.65%
		31-Dec-91	-25.16%	31-Dec-91	4.33%
		31-Dec-90	-6.69%	31-Dec-90	4.48%
		31-Dec-89	-3.71%	31-Dec-89	6.44%
		Average	14.73%	Average	4.63%

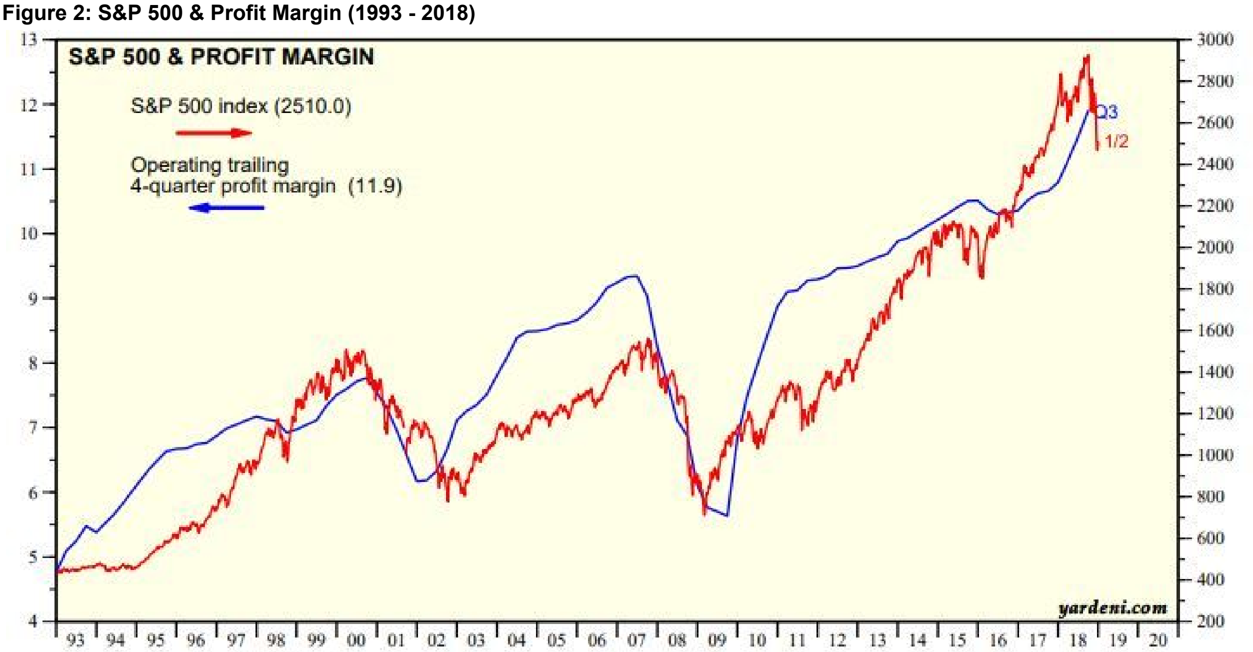
S&P Earnings Growth Correlation to GDP Growth
-0.03

S&P Revenue Growth Correlation to GDP Growth
0.67

Degree of Operating Leverage (DOL)
1.37

DOL with taxes
1.72

Figure 2: S&P 500 & Profit Margin (1993 - 2018)



Source: Standard & Poor's Corporation and I/B/E/S data by Refinitiv.

Key Points:

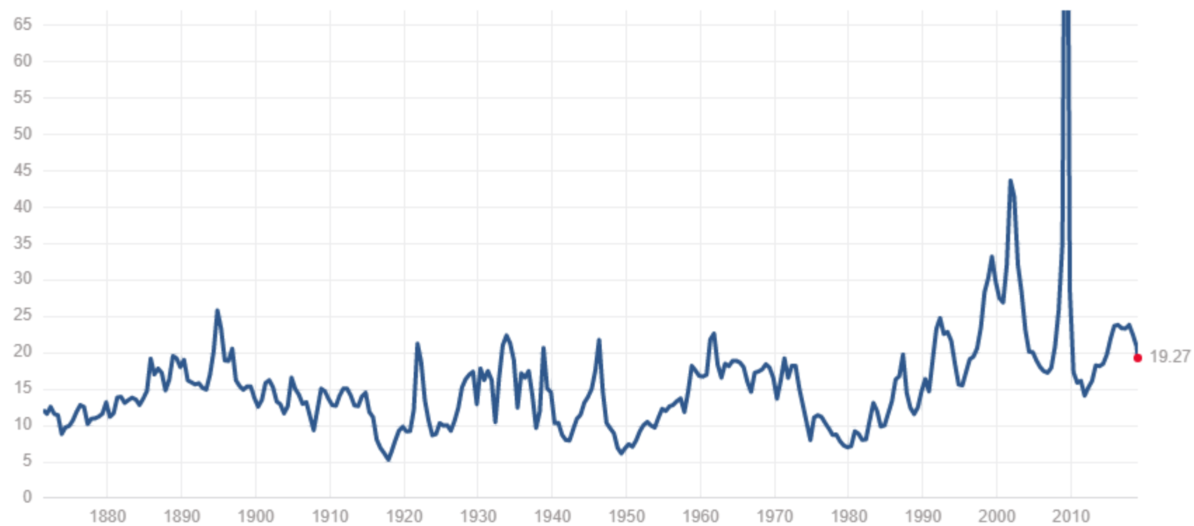
- We use data from the last thirty years to illustrate the positive correlation between S&P 500 earnings growth and GDP growth.

● Over the last 18 years, S&P 500 profit margins have risen from 6% to 12%, further emphasizing the point that companies are becoming more efficient in turning a profit.

S&P 500 P/S ratio now = 1.87
Mean = 1.51

P/E ratio now 19.27 TTM
Mean = 15.7

Figure 3: S&P 500 P/E Ratio (1870 – 2018)



Shiller P/E now 26.7
Mean = 16.6

EPS yield now = 5.4%
Mean = 6.8%

Price / Book Value now is 3.00
Mean = 2.79

Figure 4: S&P 500 P/B Ratio (2000 – 2018)

1-year Treasury now = 2.62
Mean = 3.07

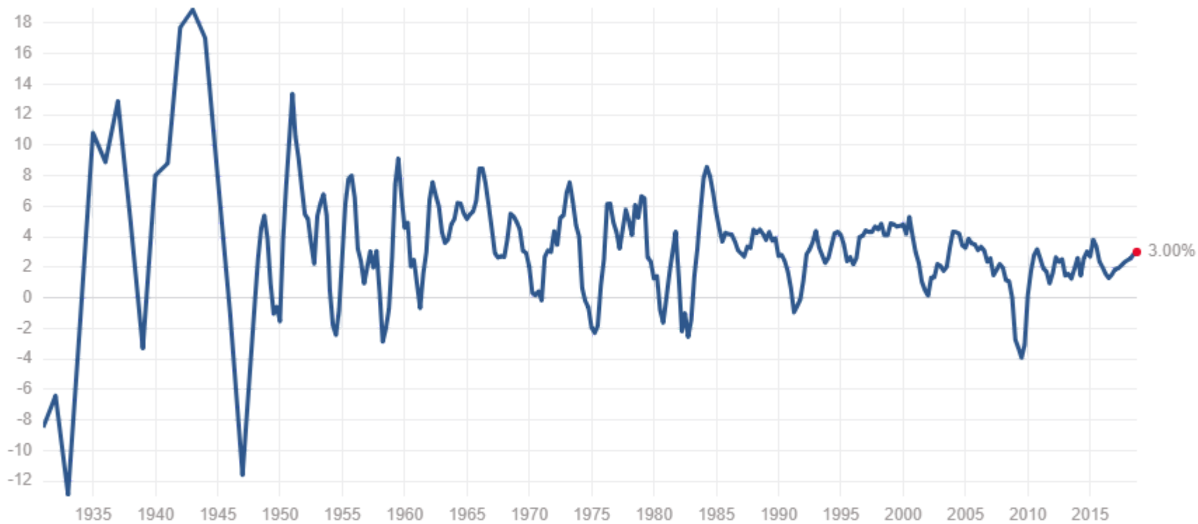
10-year Treasury yield now = 2.69
Mean = 4.56

Figure 5: 10-Year Treasury Yield (1870 – 2018)

Sales growth now = 9.03 Significantly above mean
Mean = 3.3

Real GDP growth rate now = 3.00
Mean = 3.24

Figure 6: Real GDP Growth Rate (1930 – 2018)



Debt / equity now = .86x
2008 = 1.2x

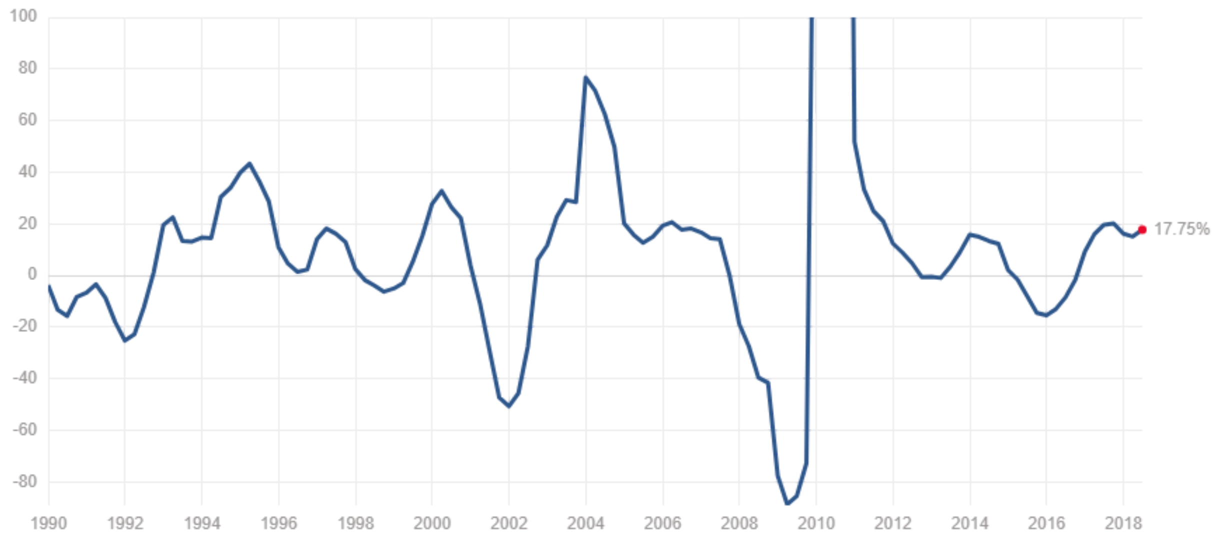
Interest coverage now = 10.47x
2008 = 4.0x

FACT: Corporate balance sheet much stronger now than in 2008.

Return on equity now = 15.6%
2000 = 18%

Real GDP growth rate now = 3.00
Mean = 3.24

EPS growth now = 17.75% EPS growth significantly above long term median
Median* = 12.28%
Figure 7: S&P 500 EPS Growth Rate (1990 – 2018)



S&P 500 Net profit margin now = 12.0% Significant improvement
1994 = 6%
S&P 600 Small Cap now = 5.4%

FAANG now = 10.25% of S&P 500 market cap
With 15% of total cash
Total cash in S&P 500 = $2.7 trillion
FAANG cash = $421 billion

Myth busted: S&P 500 balance sheet weak excluding FAANG cash.

What if scenarios:

Rest of world flat GDP in 2019 = 30% of S&P 500 at 0%
U.S. GDP growth in 2019 = 70% of S&P 500 at 2.5%
70% x 2.5 + 30% x 0% = 1.75% U.S. GDP growth in 2019
Average EPS to GDP ratio = +1.7 / 1
2019 estimated EPS growth is 3% (1.75% x 1.7)
2019 EPS = $164.80 ($160 x 1.03)

Bear markets & recessions:
33% of all bear markets are not accompanied by a recession.

Recessions and inverted yield curve:
Spread between 3 month & 10 year Treasury must invert to -83bps = 50% chance of recession.
Currently, the spread is 2.31 vs 2.79 = +48 bps.

Significant further curve inversion needed to get to 50/50 recession probability.

P/E ratios and market valuations do not exist in a vacuum and must be weighed in consideration with other contemporary data measures such as revenue growth rates, EPS growth rates, profit margins, inflation and interest rates. The long term impact of the corporate tax cuts enacted in 2018 is a positive lever to higher long term EPS growth rates as more capital is available for reinvestment, increased dividend payouts, and/or share buybacks (all positive drivers for higher valuations on equities).

If we examine PEG ratios by comparing the long term mean to the trailing twelve months (TTM), we find current valuations at a discount to the long-term average. If we compare net yields on the S&P 500 (TTM basis vs. the mean), we find a reinforcement that today's market is attractively valued relative to the mean.

Currently, the S&P 500 PEG ratio shows valuations superior to the mean, 1.12 (as of December, 2018) vs. a mean of 1.33. This ratio represents the price per unit of growth where a lower ratio is better. The current EPS yield shows that today's rate spread (EPS Yield / Treasury Yield) is above the mean, 2.0% as of December, 2018 vs. a mean of 1.47% (see footnotes at end for calculation). The excess growth above treasury yields are considered return premiums. Both measures point to contemporary market valuations and risk premiums superior to the mean.

Only the Shiller P/E, Cyclically Adjusted P/E ratio (CAPE), shows a negative comparison of today vs its historic mean because the CAPE ratio is based on a 10-year moving average of P/E ratios. Therefore, the measure is significantly skewed by the lower earnings generated from the "great recession" in 2008 and 2009. Baring a significant slowdown in the near future, the low EPS numbers of 2008 and 2009 will soon be replaced by higher EPS numbers and the Shiller P/E ratio will revert down to its mean.

Clearly, the impact of rising profit margins has been the sole driver of above average EPS growth. This statement is highlighted based upon the average revenue and earnings growth rates over the last 18 years. Over this 18-year period, revenue and earnings have average growth rates of 3.5% and 19.4%, respectively. EPS growth has been achieved with lower capital intensity and lower debt ratios, underscoring the positive impact of technology on rising profit margins. This great earnings growth is all within the backdrop of a low interest rate environment. It is therefore hard to argue that today's market is overvalued in the context of all relevant data inputs.

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Footnotes:

Historical measurement period for correlation analysis is from 1988-2018.

*Median estimate because outlier year of 2009 skews mean.

Our EPS estimates are based on earnings from operations rather than as reported.

EPS yield / Treasury yield now= 5.4 / 2.7 vs mean 6.8 / 4.6 = 2.0% vs 1.47%.