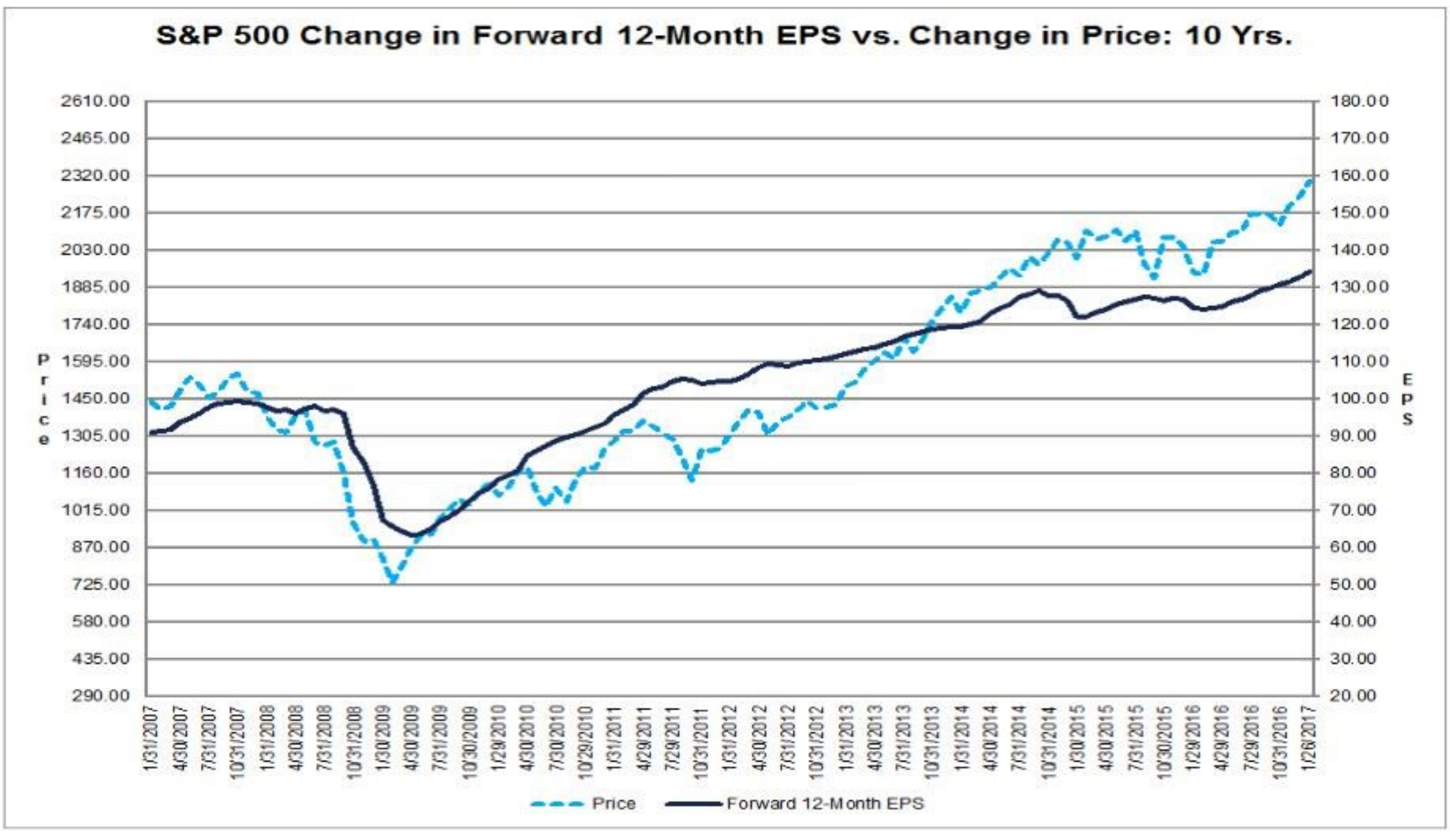
Chart of the Month

February 2017



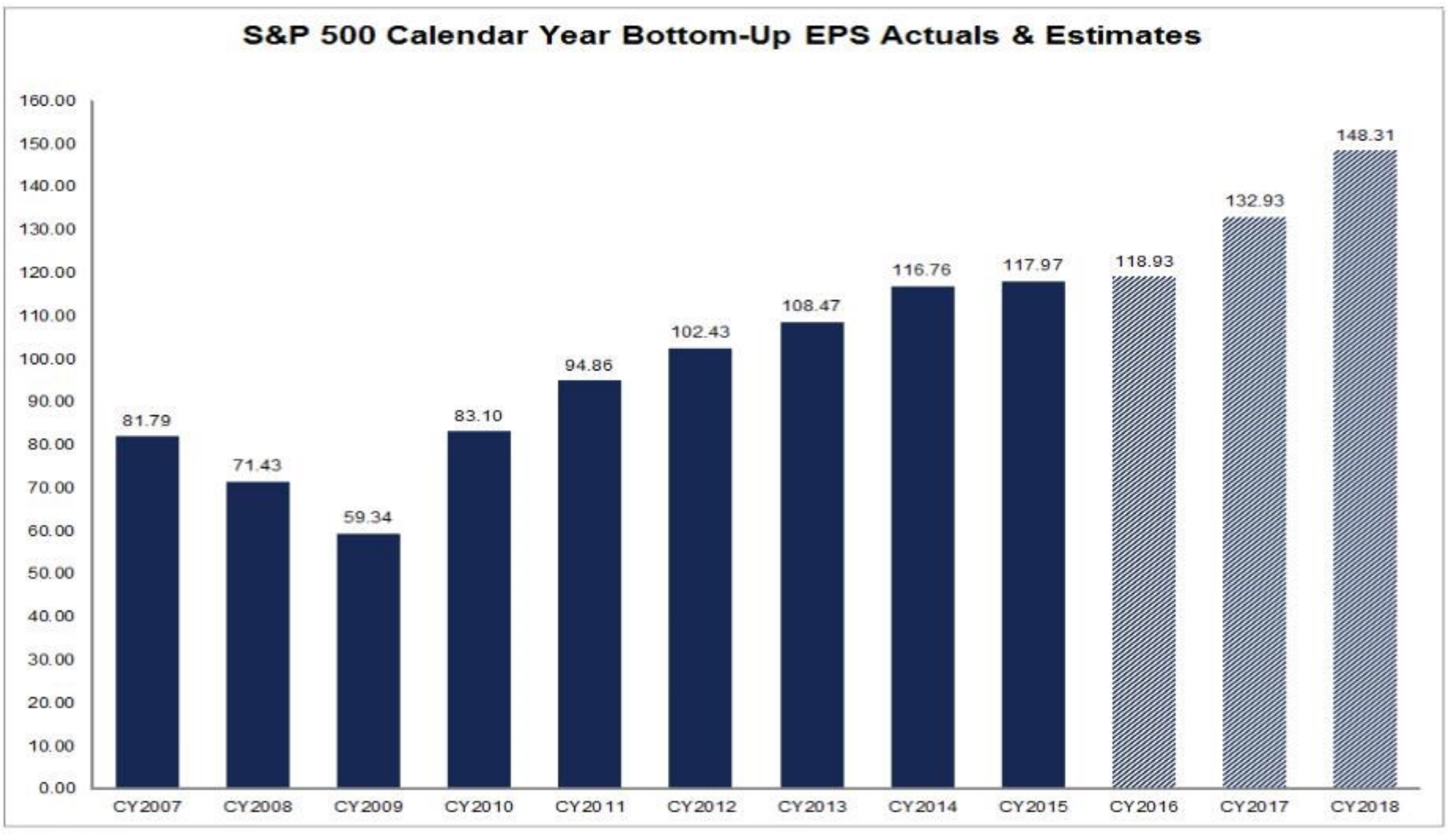
The chart at the top reflects the S&P 500 change in forward 12-month earnings per share (EPS) vs. the change in price over the past ten years. When the price (dotted line and scaled on the left) is *above* the EPS (solid line and scaled on the right), it means that the price-to-earnings (P/E) multiple is *greater* than 14.5x, which equals the 10-year average. Conversely, when the price is *below* the EPS, the P/E is *lower* than 14.5x.

As shown, the S&P 500 has spent about as much time above as it has below the EPS line during the past decade. That said, the current gap between the price and EPS is wider than it has been in ten years, which signifies that stocks are historically expensive relative to earnings. Since 2011, stock prices have advanced at a faster clip than their EPS, causing the present divergence in valuation. Given the disparity between the two, we believe that earnings need to grow at a healthy pace over the next few years in order for stocks to move materially higher. Accordingly, we think it is imperative to focus on the earnings outlook.

The chart at the bottom depicts the actual calendar EPS as well as the estimates for 2016, 2017, and 2018. As of today, three-quarters of the companies in the S&P 500 have reported their earnings for the fourth quarter of 2016. With 25% of the companies scheduled to announce their results over the coming days and weeks, the full-year number of $118.93 is still an estimate at this time, albeit one that should approximate the final tally.

As detailed, EPS declined in 2008 and 2009, rebounded in 2010 with further increases in 2011-2014, then flattened in 2015 and 2016. Going forward, analysts project EPS will rise by double-digit percentages in 2017 and 2018. While the growth in earnings estimates appears to be on the aggressive side, it is important to note that profits for energy companies, which have been depressed over the past couple of years, are poised to bounce back due to oil prices doubling from their lows a year ago as well as from reductions in overhead.

In addition, the passage of new tax and regulatory policies could boost earnings in the future. A reduction in corporate tax rates alone could add meaningfully to the bottom lines of virtually all companies. As such, the consensus EPS projections for 2017 and 2018 may be reasonable. If the S&P 500 meets or beats these expectations, stocks could have another leg to the upside. Meanwhile, we are aware that *some* of the good news – but perhaps not *all* – may be partially priced into the market as demonstrated by the higher-than-normal valuations.



Source: FactSet

Lederer & Associates
Investment Counsel
5305 East 2nd Street, Suite 201, Long Beach, California 90803
Tel: (562) 434-5305 ▲ Fax: (562) 434-5306
www.lederer-associates.com