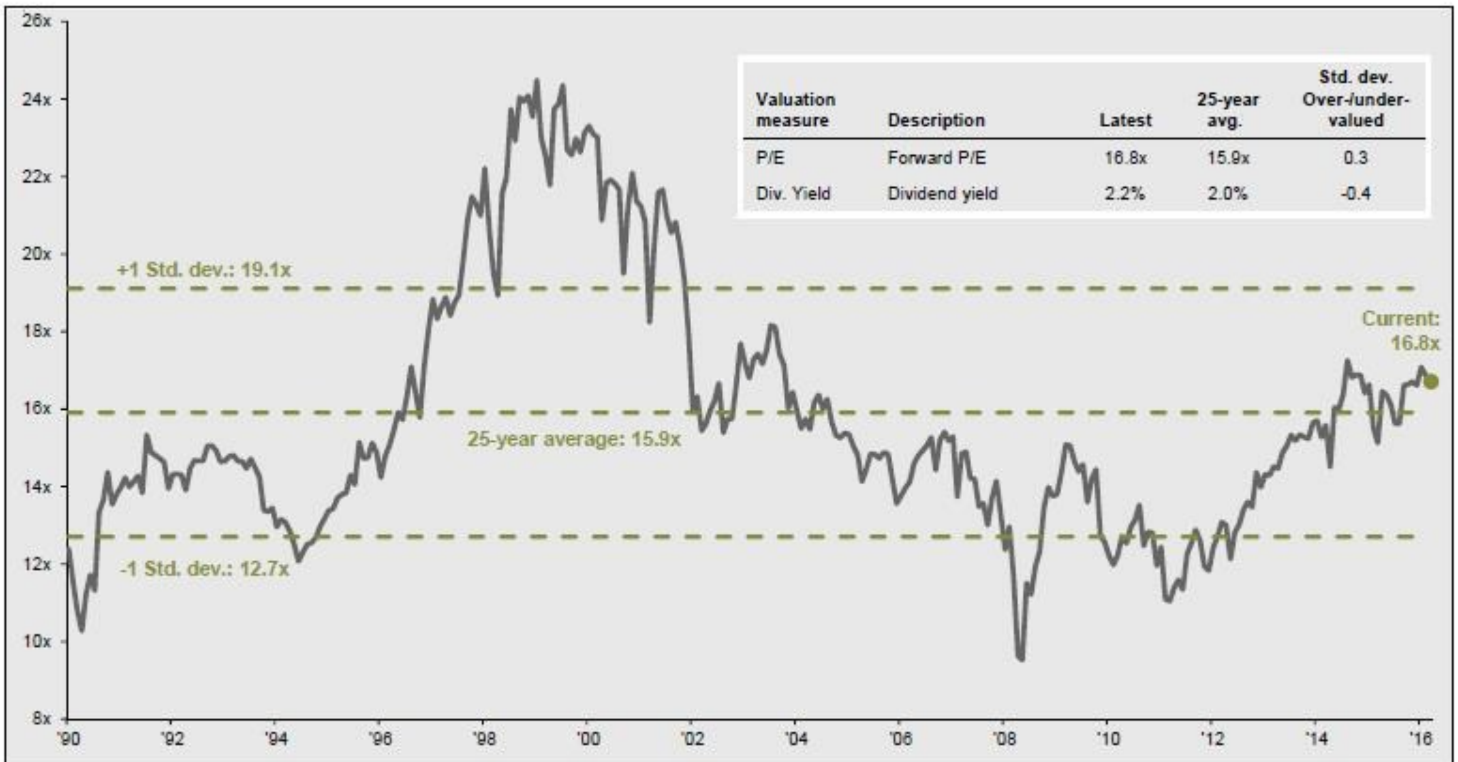
Chart of the Month

October 2016

S&P 500 Valuation



Source: FactSet, FRB, Standard & Poor's

The stock market, in the aggregate, is neither rich nor dear in our opinion.

As shown in the chart above, the S&P 500, at 16.8x the projected earnings for the next 12 months, is trading slightly above its 25-year average of 15.9x. In other words, the index is valued at nearly 6 percent above its norm for the past quarter of a century. On balance, we view this measure as a minor negative for stocks going forward.

At the same time, the S&P 500, with a dividend yield of 2.2%, is offering a higher income return than the 25-year average of 2.0%. This dividend yield is 10 percent above its norm, a minor positive in our outlook for stocks.

We would become concerned if the S&P 500 traded at more than one standard deviation above its long-term average, a level it pierced in the late-1990s during the tech bubble. While bear markets are caused by recessions and not overvaluation, future returns are highly correlated to the P/E multiple at any given time. The higher the valuation, the lower the future returns. Conversely, the lower the valuation, the higher the future returns.

Based on the current valuation of the market, we believe stocks are likely to generate returns that are somewhat below the historical average. Nonetheless, in a low-interest-rate environment, we would be pleased to earn 6% to 8% with approximately 2% coming from dividends and 4% to 6% from capital appreciation. We contend that earnings (which have been held back by sluggish GDP growth, a strong dollar causing foreign-exchange headwinds for international companies, and low oil prices hampering energy-related industries) would need to accelerate in order to achieve the upper end of the range.

Meanwhile, the lack of enthusiasm for stocks — in what has been perhaps the most unloved bull market in history — bodes well from a contrarian standpoint. Put it all together and we remain cautiously optimistic that the market can continue to grind out positive returns for the foreseeable future, albeit with the normal ups and downs along the way.

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