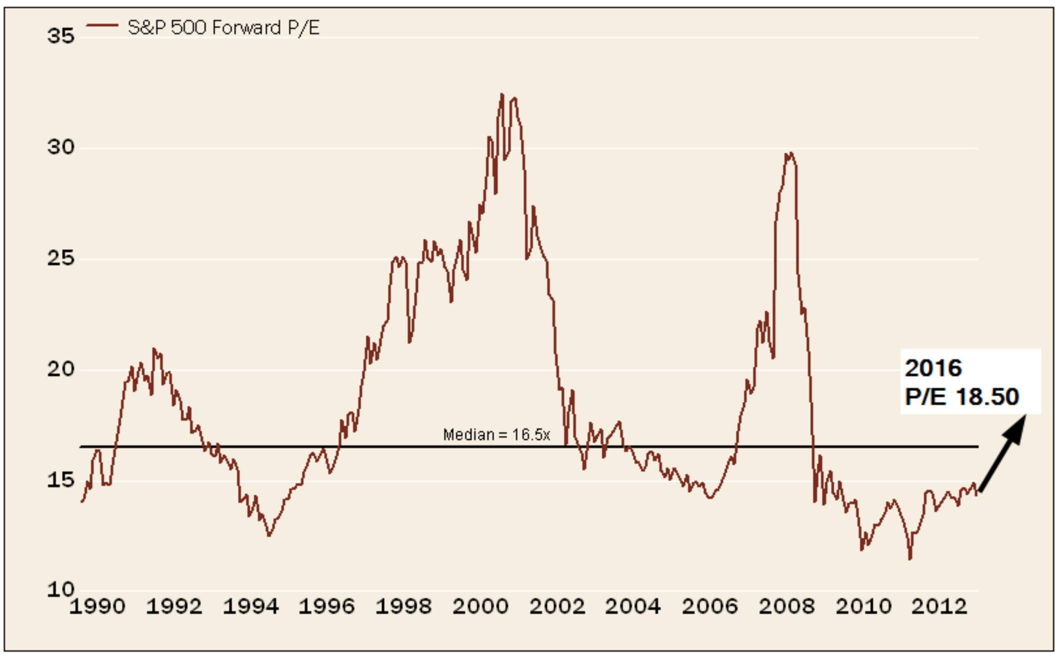
September Market Outlook

Even though the U.S. economy is doing better than most of our major trading partners, the growth in U.S. corporate earnings and the economy are a concern.

The main concern I've had much of this year is valuations. This Outlook will look at a few valuation metrics that evince the overvaluation of this market.

Price/Earnings (P/E)

Below is a chart that shows the historical range of the P/E:



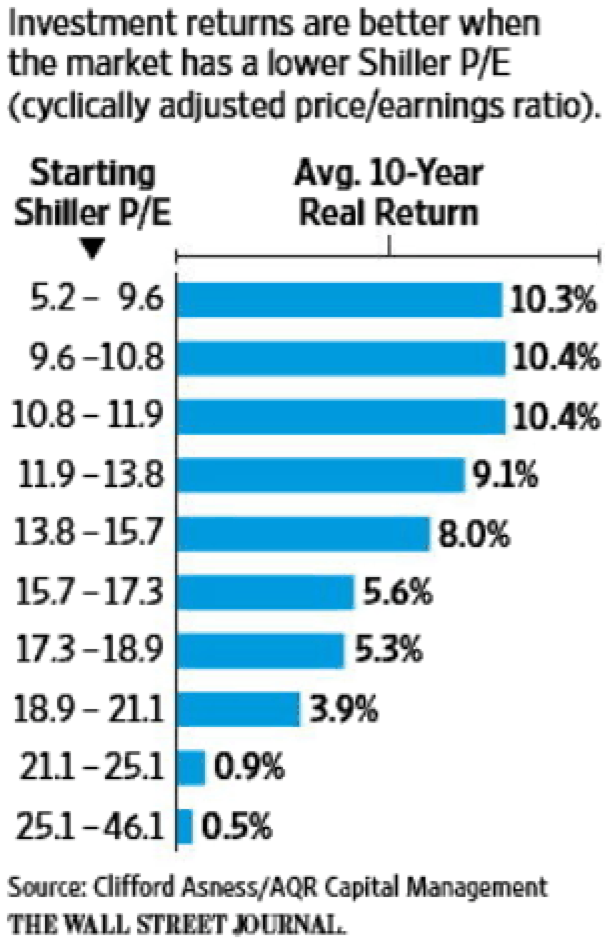
Source: FactSet, Standard & Poor's, as of June 28, 2013.

Let's review this important chart:

According to this historical P/E chart, 16.50 is the median P/E using forward/forecasted earnings.

The current forward P/E for the S & P is around 18.50. The S & P, and most major markets are overvalued.

Why is this important? There are many studies that point out that low P/E stocks outperform high P/E stocks. Below is a table that shows that the market has better prospects when the P/E is lower.



The above table reflects the Shiller P/E (takes a 10 year average of the P/E using smoothed real earnings). According to the Shiller P/E, the current P/E is around 26. According to this table the market has little upside.

I believe the Shiller P/E overstates the P/E as its simplistic and backward looking, but many investors consider it when evaluating the valuations of the market.

I was strongly recommending stocks early in this cycle because of low valuations, as there is normally less risk, and much more upside earlier in a market and economic cycle.

Earnings Yield

The earnings yield was made popular by former Federal Reserve Chairman, Alan Greenspan. Mr. Greenspan used the earnings yield to determine the valuation of the market. He compared the 10-year Treasury note to the Earnings/Price of the SPX based on estimated earnings.

The earnings yield is the inverse of the P/E: Earnings divided by Price.
Today’s earning yield would be 5.6% ($120 2017 est. earnings divided by 2140). The 10-year is now at 1.70%. According to the earnings yield stock market valuation model, the market is undervalued. Any new money in the market should gravitate to the higher yielding stock market.

The Fed has kept interest rates very low. Historically, the 10-year Treasury is at least inflation plus a 2% to 4% premium. Inflation averaged about 1.8% for the last five years, and if we use a 3% premium, the 10-Year should be about 4.8%. Using this more appropriate comparison (4.9% 10- year Treasury versus 5.6% for the E/P) the choice is not as obvious. If we add the rising risks, the trend that earnings estimates have been falling, cash would probably be the best decision for investors, not the stock market or the 10-year treasury.

Barron's has written many articles about the earnings yield. If you're a Barron's online subscriber you may go to their March 16, 1998 article written by Andrew Barry to learn more about the earnings yield. The article is one of their earliest articles on the subject.

http://www.barrons.com/articles/SB889846400643709000

Buying Low (Valuations) and Selling High (Valuations)

Below is a trend of the Dow 30 prices, earnings, P/Es and dividends for this market cycle:

Dow Jones Industrial Average						
	Qtr	Closing	12-Mth	P/E	12-Mth	Div
Year	Ended	Avg.	Earns	Ratio	Divs	Yields
2016	30-Jun	17929.99	NA	NA	449.59	2.51
	Mar.31	17685.09	930.65	19	447.44	2.53
2015	Dec.31	17425.03	976.52	17.8	439.66	2.52
	Sep.30	16284.7	1043.79	15.6	429.37	2.64
	30-Jun	17619.51	1040.66	16.9	417.57	2.37
	Mar.31	17776.12	1093.78	16.3	400.61	2.25
2014	Dec.31	17823.07	1079.08	16.5	388.9	2.18
	Sep.30	17042.9	1143.49	14.9	376.85	2.21
	30-Jun	16826.6	1309.69	12.8	366.21	2.18
	Mar.31	16457.66	1286.32	12.8	365.4	2.22
2013	Dec.31	16576.66	1299.71	12.8	360.1	2.17
	Sept.30	15129.67	1172.72	12.9	364.39	2.41
	28-Jun	14909.6	976.45	15.3	365.59	2.45
	Mar.29	14578.54	933.61	15.6	357.86	2.45
2012	Dec.31	13104.14	901.18	14.5	r353.97	r2.70
	Sept.28	13437.13	885.43	15.2	342.16	2.55
	29-Jun	12880.09	903.73	14.3	334.61	2.6
	Mar.30	13212.04	903.5	14.6	326.87	2.47
2011	Dec.30	12217.56	893.44	13.7	318.37	2.61
	Sept.29	10913.38	924.17	11.8	307.89	2.82
	29-Jun	12414.34	896.69	13.8	300.06	2.42
	Mar.30	12319.73	878.69	14	292.19	2.37
2010	Dec.30	11577.51	826.75	14	286.88	2.48
	Sept.29	10788.05	783.63	13.8	281.73	2.61
	29-Jun	9774.02	739.88	13.2	277.16	2.84
	Mar.30	10856.63	687.81	15.8	272.78	2.51
2009	Dec.30	10428.05	558.83	18.7	277.38	2.66
	Sept.29	9712.28	350.97	27.7	286.26	2.95
	29-Jun	8447	357.13	23.7	297.63	3.52
	Mar.30	7608.92	178.18	42.7	311.78	4.1
2008	Dec.31	8776.39	256.55	34.2	316.4	3.61
	Sept.30	10850.66	412.72	26.3	325.27	3
	30-Jun	11350.01	-115.29	Nil	319.12	2.81
	Mar.31	12262.9	123.99	98.9	r308.38	2.51
2007	Dec.31	13264.82	199.87	66.4	298.99	2.25
	Sept.28	13895.63	277.24	50.1	287.57	2.07
	29-Jun	13408.62	824.65	16.3	280.58	2.09

Source: Barron's, Thomas Reuters, Dan Hassey data base

Earnings

Let’s review the fourth column, 12-Mth Earns.

The last cycle, 2003 to 2007, earnings peaked for the Dow 30 at 824.65 in the 2nd quarter of 2007, green shaded area. Prices peaked during the next quarter.

Earnings bottomed at around -115.29 in the second quarter of 2008, pink shaded area.

Earnings were trendless from around September 2008 to September 2009.

Earnings started to accelerate in the 4th quarter of 2009 and peaked around 3rd quarter of 2014, green shaded area.

Earnings have stayed stagnant since the 3rd quarter of 2014 (pink shaded area), and stock prices reflect stagnate earnings growth.

P/E

Let’s review the fifth column, P/E Ratio.

When earnings peaked in 2007, the P/E was 16.3, a reasonable P/E.

P/Es are normally very high during a recession, we certainly see that at the start of the Great Recession, 2007 to 2009. This phenomenon is known as the *Molodovsky effect.* According to *Security Analysis* (a book that must be mastered by professional and serious investors) the effect is “the tendency of a company suffering temporarily depressed earnings to sell at a high price-earnings ratio.”

Once earnings start to recover, the P/E gets back to normal, during this cycle it started in the first quarter of 2010.

We can see earnings recover in the 2nd quarter 2009. This would have been a good time to start investing.

We can see that the market P/E stayed attractive until 2014. Investors should have been invested in the market from around the 2nd quarter of 2009 until 2014.

The market is now overvalued with a P/E of about 18 to 19 using current earnings. It is not prudent to invest at these higher valuations; there is little upside but more downside. Again, review the table of the potential returns in relation to the P/E.

Dividends

When earnings peaked in the previous cycle, the dividend was $280.58 with a yield of 2.09.

The dividend peaked at 325.27 in the 3rd quarter of 2008 in the last cycle, and started to slide for the next two years.

The dividend moved higher to 311.78 with a yield of 4.1% by the first quarter of 2009. Again, the dividend was cut each successive quarter until the 3rd quarter of 2010.

If an investor would have bought the Dow 30 in 2009 at around 9700 when the market earnings were starting to improve, your dividend yield today would be about 4.6% (current dividend 449.59 divided by 9700).

When we go into the next recession, we can expect dividends to be cut, another reason to be cautious.

The trend we see with earnings, valuations using the P/E, dividend and earnings yield follow the same pattern (undervaluation with much upside, and high valuations with higher risk) in most market cycles.

Conclusion

It is best to sell your equity investments when earnings and prices peak after a major bull market. In other words, sell when the markets are overvalued, and before earnings and the economic and corporate news go from good to bad.

It's best to start buying when earnings and prices start to recover. Also, dividend yields are normally attractive once earnings and dividends recover. Once earnings start to recover, it becomes evident that the markets are undervalued. Economic and business news gets better, and starts the animal spirits, and a positive feedback loop.

I've done my own research on which companies tend to cut their dividends, which don't, and there are some that increase their dividends during a recession. I will update this research with a Special Report on which dividend stocks tend to maintain their dividends during a recession (hint: companies with low debt, and lower dividend payout ratios).

Technical, price analysis is a very good discipline to help investors with buy points when stocks, markets are undervalued. This normally occurs during the basing period of a bear market. I will write about the basing period of a bear market when the market starts basing, normally after panic selling and the decline phase.