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THE MUSIC IS STILL PLAYING, SHOULD YOU KEEP DANCING?

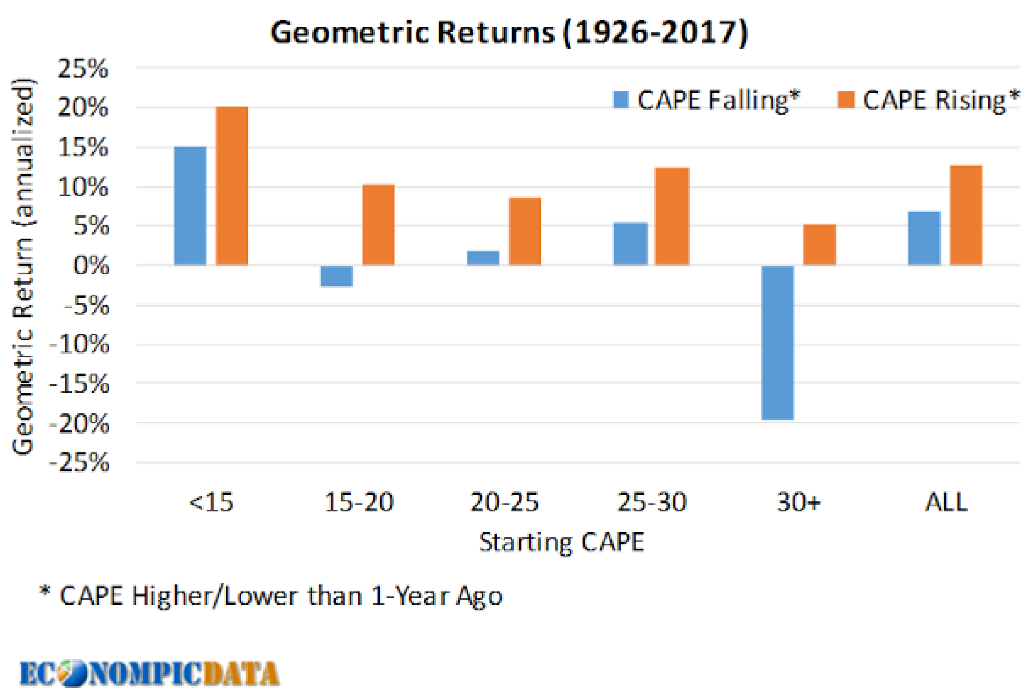
Highlights

There has been much recent hand wringing over excess stock market valuation. On the other hand, the American economy is showing few signs of an impending recession, which is a bull market killer.

We are reminded of former Citigroup CEO Chuck Prince's comment in the period leading up to the subprime crisis: "As long as the music is playing, you've got to get up and dance. We're still dancing."

How worried should investors be about valuation? The music is still playing, should you keep dancing?

Further research shows that high CAPE ratios have not historically been bearish for monthly returns when the CAPE ratio is rising, or price momentum was positive. But get out of the way when valuations are high and momentum turns south.



The response-elevated valuations will depend on each investor’s risk tolerance. The Risk-On party is getting out of hand, and the neighbours have called the police. But the music is still playing. Should you keep dancing? That depends on how quickly you think you can get out the door in the event of a police raid.

The Music Is Still Playing, Should You Keep Dancing?

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An Expensive Market

Analysis from Goldman Sachs indicates that the stock market is at historical nosebleed levels for virtually all metrics, except one, free cash flow yield.

Exhibit 1: U.S. Equities is Expensive on Virtually All Metrics

Exhibit 2: S&P 500 aggregate index and median stock both highly valued on most metrics
as of August 1, 2017

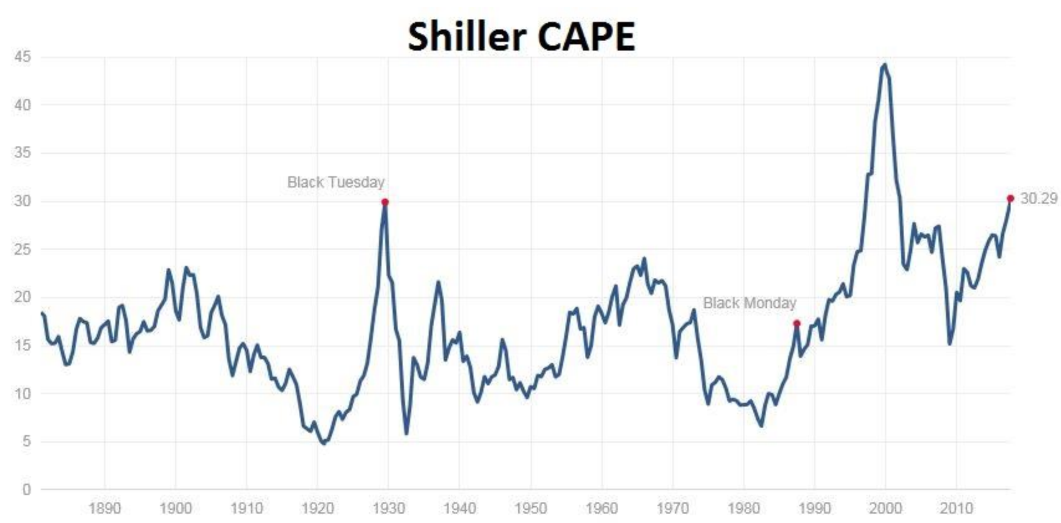
	Aggregate Index			Median Stock		
Metric (Aggregate index)	Current	Long-term average	Historical %ile	Current	Long-term average	Historical %ile
EV / Sales	2.3 x	1.3 x	95 %	2.8 x	1.4 x	99 %
EV / EBITDA	11.6 x	8.2 x	88	12.0 x	8.1 x	99
Forward P/E	18.0 x	12.8 x	89	18.1 x	13.1 x	96
Cyclically adjusted P/E (CAPE)	26.0 x	18.7 x	87	NA	NA	NA
P/E to growth (PEG)	1.4 x	1.1 x	89	1.9 x	1.2 x	100
Cash flow yield (CFO)	7.4 %	9.4 %	87	7.2 %	9.0 %	96
Price / Book	3.2 x	2.5 x	85	3.4 x	2.2 x	99
Free cash flow yield (FCF)	**4.2 %**	**4.0 %**	**52**	**4.3 %**	**4.1 %**	**47**
Median			**88 %**			**99 %**

Note: Data since 1990 for CFO and FCF, 1981 for PEG, and 1976 for all others.
Cash flow from operations yield and free cash flow yield exclude Financials and Real Estate.

Source: Haver, FactSet, Goldman Sachs Investment Research

The Shiller Cyclically Adjusted P/E ratio (CAPE) now stands above 30, which has only been exceeded by readings seen at the height of the NASDAQ bubble and beats levels seen just before the Market Crash of 1929.

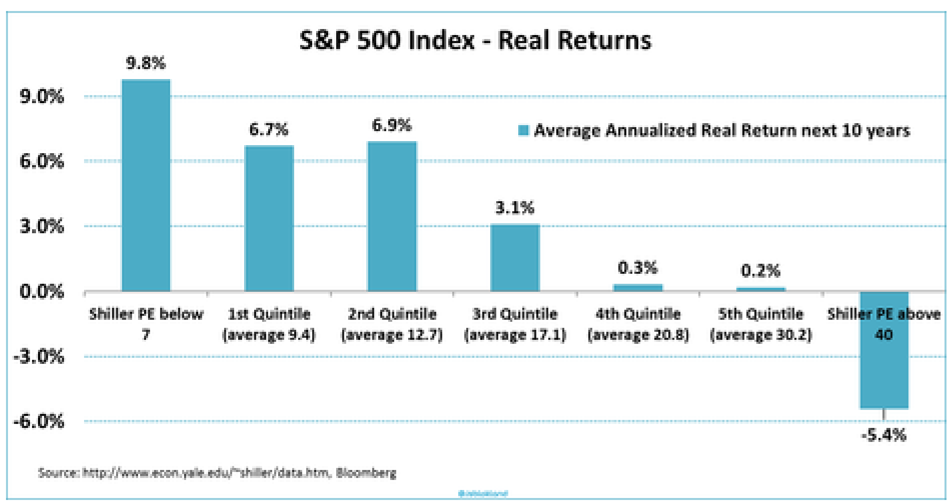
Exhibit 2: Shiller CAPE



Source: Robert Shiller

Elevated levels of CAPE have historically seen poor long-term returns.

Exhibit 3: Returns by CAPE Quintiles



Source: Robert Shiller, Bloomberg

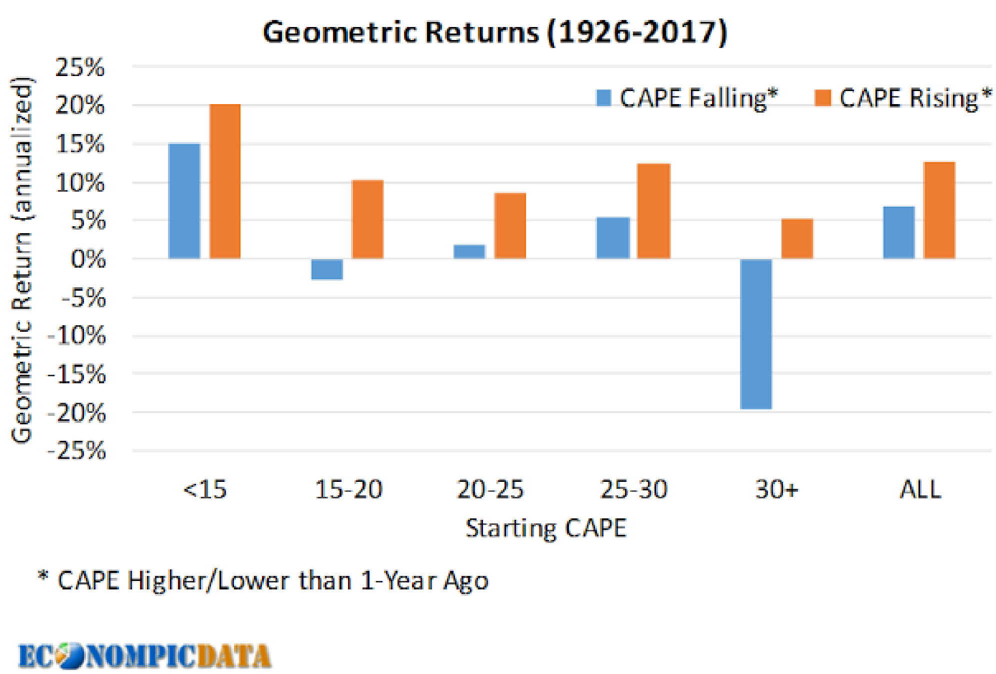
Should investors be worried about current levels of equity valuations? Yes and no. These problems have a way of not mattering until they matter.

The Music Is Still Playing

Analysis from EconoPic found a "music is playing", or momentum, effect in the face of high equity valuation. The author further divided CAPE quintiles by changes in CAPE from 12 months ago, and studied the subsequent monthly returns. The results revealed a definite price momentum effect.

High CAPE ratios have not historically been bearish for monthly returns when the CAPE ratio is rising, or price momentum was positive. But get out of the way when valuations are high and momentum turns south.

Exhibit 4: High CAPE Only Matters When CAPE Is Falling



Source: EconoPic Data

Here is the same data in table form.

Exhibit 5: Price Momentum Effects on CAPE

Geometric Return (1926-2017)

	Starting CAPE VALUE					
	<15	15-20	20-25	25-30	30+	ALL
CAPE Falling*	15.0%	-2.8%	1.9%	5.4%	-19.6%	6.9%
CAPE Rising*	20.1%	10.2%	8.5%	12.4%	5.3%	12.6%
Grand Total	17.1%	5.5%	6.0%	10.5%	-2.8%	10.1%

Standard Deviation (1926-2017)

	Starting CAPE VALUE					
	<15	15-20	20-25	25-30	30+	ALL
CAPE Falling*	25.0%	21.8%	17.8%	12.2%	17.5%	22.5%
CAPE Rising*	16.2%	17.7%	10.8%	12.1%	20.8%	15.5%
Grand Total	21.7%	19.3%	13.8%	12.1%	20.0%	18.8%

** CAPE Higher/Lower than 1-Year Ago*

Source: EconoPic Data

Should You Be Dancing?

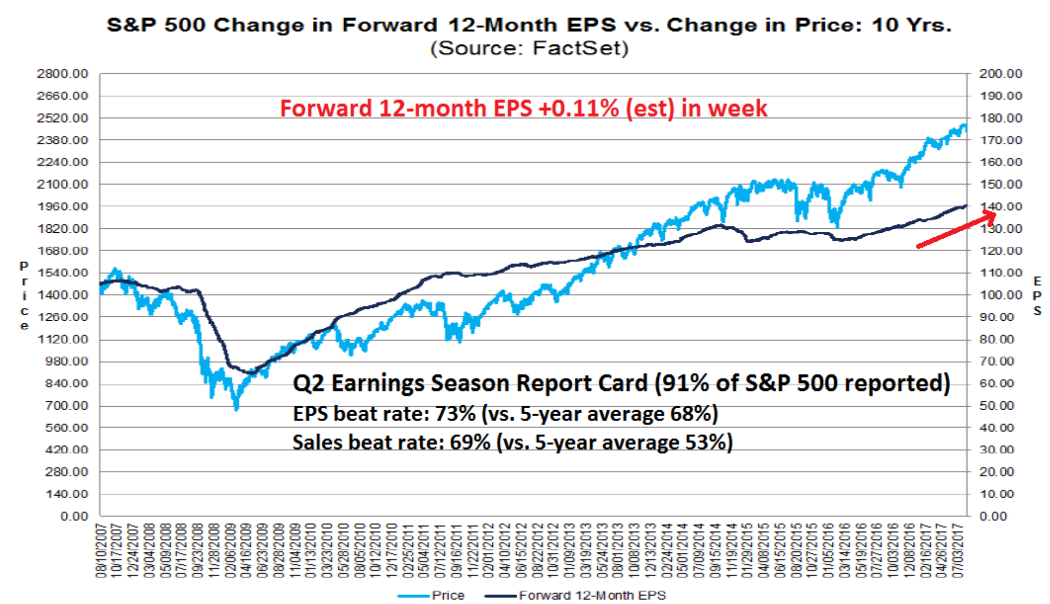
So should investors stay long stocks, as long as the music is playing? That depends on the investment time horizon.

There are several ways for investors to position themselves in this environment of heightened valuation. Balanced fund investors may wish to re-balance the portfolio policy weights from a risk-on profile. Equities have outperformed bonds for several quarters, and investors with balanced fund mandates will have seen their equity weights naturally drift upward. Re-balancing back to policy weight can be viewed as a prudent course of action.

Investors with equity-only mandates may also wish to take steps to prepare for a possible recession in the next 1–2 years by avoiding stocks with high bankruptcy risk. Managers can still outperform by avoiding the losers under a recessionary scenario. We have conducted a full study of our bankruptcy analysis on the non-financial stocks in the S&P/TSX Composite and the Russell 3000. Clients who would like a copy please contact Ed Pennock at (647) 287-6800 or by email at ed@pennockideahub.com.

For traders, the nowcast of short-term indicators remain bullish. The latest update from FactSet shows that results from the Q2/17 earnings season have been solid. Moreover, forward 12-month EPS is still rising, indicating positive fundamental momentum.

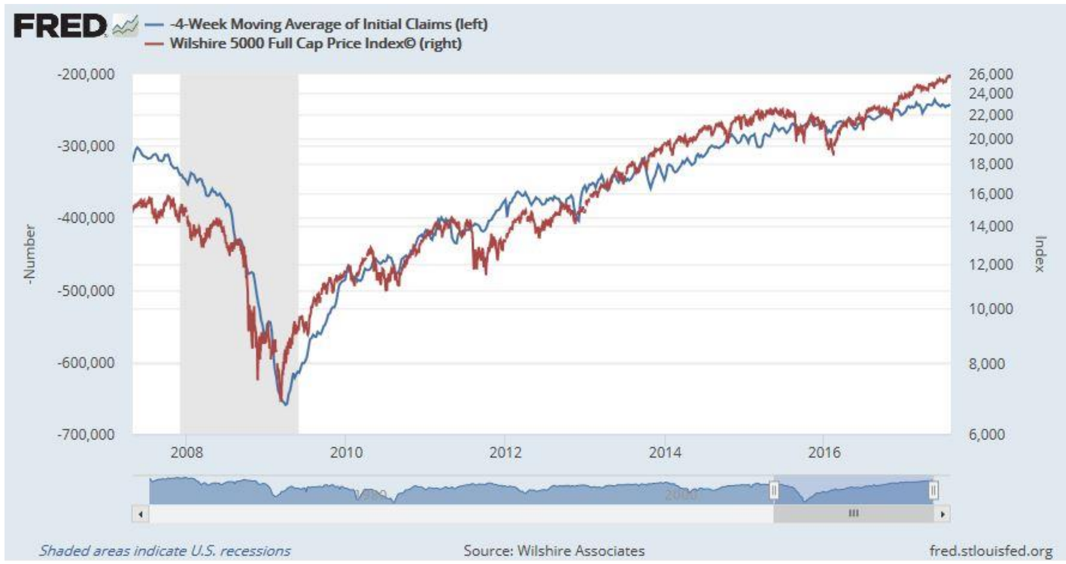
Exhibit 6: Forward 12-month EPS Estimates Still Rising



Source: FactSet Information Systems

The nowcast of the job market remains healthy. The following chart shows the 4-week average of initial jobless claims and the Wilshire 5000. The two data series have shown a remarkable inverse correlation during this expansion cycle.

Exhibit 7: Initial Jobless Claims and Wilshire 5000



Source: FRED, Federal Reserve Bank of St. Louis

In conclusion, there are definite signs that the Risk-On party is getting a little out of hand. Valuations are highly stretched, and sentiment is getting frothy (see our series, *What You Don't See At Market Bottoms; What You Don't See At Market Bottoms: Euphoria and Wild Claims*; and *What You Don't See At Market Bottoms: No Fear Edition*). The neighbours have called the police, and the cops are going to raid the party. On the other hand, the music is still playing. Should you keep dancing?

It depends on how quickly you think you can get out the door in the event of a police raid.

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