Morris Capital Advisors, LLC

Investment Commentary
March 31, 2017

Valuation is in the Eye of the Beholder

I have noticed a dramatic increase in commentary regarding over-extended valuation levels in the stock markets. It is not limited to those "perma-bears" who seem to make a living finding reasons to convert your investments to cash, gold, or highly leveraged put option strategies that only they can execute profitably. The topic has been discussed by research analysts at prominent financial institutions and well-regarded market commentators. The question has been posed to me by clients, business associates, even late night at the bar with my hockey teammates. I haven't been stopped and asked on the street by strangers, but I do wonder if that is next.

There are a number of good reasons to have this discussion, and to have this discussion now. First, the strength and duration of the market rally that began late last year has surprised many people. The move has been fueled by a change in investor expectations amid the potential for regulatory and tax reform, rather than underlying measurable economic improvement. The rally extended valuation metrics stretched over the last several years as central bankers employed controversial policy measures to influence economic activity and the markets. Finally, valuations should always matter when investing in shares of operating companies rather than market index proxies.

The problem with all of this is that there is really no single valuation measure, or group of valuation measures, that can be considered a consistently reliable indicator. Valuation measures may look elevated on an absolute basis, but might be more or less attractive on a relative basis due to changes in shifting comparisons. The perceived importance of valuation measures has also changed due to changes in investor habits and expectations.

A recent report by Bank of America analyst Savita Subramanian illustrates the problem. She reviewed 20 different valuation metrics relative to their historical levels, concluding that the index is overvalued based on 18 of the twenty measures, some by as much as 85%. The forward price earnings ratio of the S&P 500 of 17.5x, is at its highest level since 2002, with trailing P/E and Shiller P/E at comparable highs. Subramanian points out that the only way stocks look cheap is relative to bonds, but after all, isn't that the alternative? She also notes that among those 20 valuation measures stocks look cheap based on price to free cash flow, which also happens to be one of our preferred valuation measures. Curiously, Subramanian ends by raising her year-end price target for the S&P 500 because valuations fundamentals typically take a back seat to sentiment and technical factors in the later stages of a bull market. Hmmm.

Bill Gross, in his latest monthly commentary, takes a slightly less data driven approach to advise investors to lower their market expectations. He makes the case that stocks need economic growth of 3% to drive earnings and higher P/E's, and that 3% growth is unlikely unless productivity rises above the 0.5% rate of the past five years to historical levels closer to 2.0%. He considers that unlikely, citing an IMF report that the current trend in productivity is an offspring of negative real interest rates, misallocation of capital, and slowdown in business creation resulting from policy measures implemented by the Fed in response to the financial crisis.

Goldman Sachs ties the issues of valuation levels more closely to the influence of the Fed and central banks over the capital markets, a factor that we have written about many times. Simply stated, the willingness of the Fed to support the markets in times of stress, or to flood the markets with liquidity to achieve broader economic goals, has given investors no reason to fear market declines. They have been conditioned to expect that the Fed will intervene when the market drops, and that the greater the decline, the greater the expected central bank response. It is hardly surprising that fundamental valuations seem elevated with investors conditioned this way for almost two decades. Unmentioned in all of this is the impact of index investing on valuation measures. For an index investor the only valuation measure that matters is market capitalization. The greater the market cap of an underlying company in the index the greater the proportion of the investment.

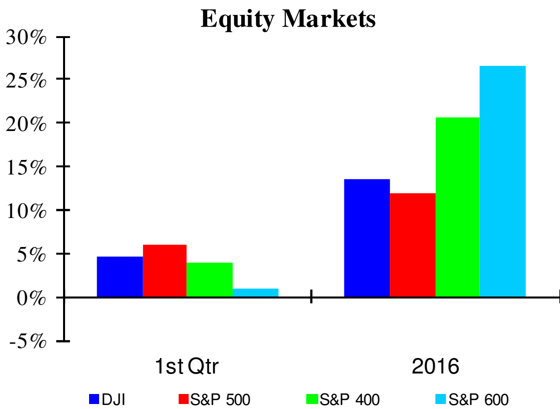
The preponderance of evidence dismissing valuation measures overlooks the fact that markets are never static. The Fed and other central banks are looking at ways to shrink their over-extended balance sheets and reduce the distortions that their policies have inflicted on the markets. As the massive borrowing and liquidity injections are reversed fundamental valuation measures will return as the primary drivers of stock market performance. It will happen sooner than most investors expect, and when it does we will be ready.

Sincerely,
Daniel A. Morris

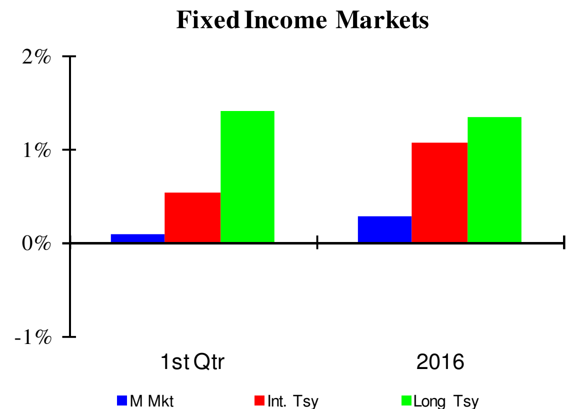
Market summaries on reverse page

Morris Capital Advisors, LLC

Market Summary
March 31, 2017



Equity markets in the first quarter of 2017 continued the rally that began after the election last year, but the character was quite different. Last quarter was dominated by beneficiaries of policy initiatives promised by president-elect Trump. So far this year market participants appeared to be reading the fine print attached to those promises. For example, beneficiaries of deregulation and infrastructure spending underperformed as legislation appears to be stalled. Companies adversely affected by the proposed border tax were volatile as prospects for adoption waxed and waned. Economically sensitive names corrected as doubts about rebounding activity crept in. Yet large-cap growth names, especially in the technology sector, appreciated sharply. In general, large-cap names outperformed small-cap indices, and growth stocks outperformed value stocks.



Treasury securities across the yield curve traded in a fairly narrow range during the quarter, leading to modestly positive returns. Trading seemed to mirror the tug of war between optimists expecting an acceleration of economic activity following the change of administration, and pessimists who look to long-term trends of sub-par growth and inflation, both seemingly resistant to policy initiatives. Toward the end of the quarter the pessimists appeared to be in the ascendancy, leading to positive price action in longer-term bonds.