



Bradley, Foster & Sargent, Inc.

Quarterly Market Commentary

October 2016

Is the Stock Market Currently a “Bubble”?

Let me again suggest that the future has never been clear to me (give us a call when the next few months are obvious to you – or, for that matter, the next few hours).

Warren Buffett, 1966

The biggest big business in America is not steel, automobiles, or television. It is the manufacture, refinement and distribution of anxiety.

Eric Sevareid, CBS, 1964

With the current bull market 7½ years old, some of our clients have asked us about the advisability of selling stocks or even getting entirely out of the market. And, as September and October have been historically the most volatile months for the stock market, the number of calls has increased with the advent of autumn. Few investors are still alive who experienced the October, 1929 Crash, but many of us lived through the Crash on October 19, 1987 when the Dow Jones dropped 22.6% – the largest one-day percentage drop in U.S. history. And even more of us experienced the stock market’s meltdown during September and October, 2008, when the S&P 500 tumbled more than 33%. Adding fuel to the fire have been statements by presidential candidate Donald Trump that the Federal Reserve has created an “artificial stock market.” He has opined that “when they [the Federal Reserve Bank] raise interest rates, you’re going to see some very bad things happen...,” and the markets are in a “big, fat, ugly bubble” and will crash when interest rates return to their normal level. This all ends up creating a sense of impending doom for some investors. Accordingly, the intent of this investment commentary is to examine conditions in the stock market to see if investor anxiety about a bubble is warranted. We define bubble as a market where prices for securities or commodities are priced greatly in excess of their intrinsic value driven by exuberant market behavior.

Is the Bull Market Getting Long in the Tooth?

The chart below shows that the stock market has more than tripled since the March, 2009 bottom during the Panic of 2007-2009:



Source: Bloomberg

This powerful bull market is now halfway through its eighth year, and many investors appear to believe that the length of the bull market is a matter for concern. The Germans have a proverb: “Die Bäume wachsen nicht in den Himmel.” This can be translated as follows: trees don’t grow up into heaven. In other words, trees stop growing eventually and either fall down or are cut down. In the same way, a bull market runs out of steam and declines. And, of course, bull markets eventually do come to an end, when bear markets set in. But a secular bull market does not necessarily come to an end solely due to its length. Events such as a recession, significantly higher interest rates, or a geopolitical event usually cause a bull market to end. The table below shows the duration of some of the longer U.S. bull markets over the last century:

Length of Selected Bull Markets

Index	Years	Days	Price Appreciation
Dow Jones	1949-1961	4,566	354.8%
S&P 500	1987-2000	4,494	582.2%
S&P 500	2009-2016	2,764	225.6%
S&P 500	1974-1980	2,248	125.6%
Dow Jones	2002-2007	1,826	94.4%

As the table above shows, the two longest bull markets lasted 12+ years. In both instances, a case can be made that the bull markets lasted much longer. The bull market that began in 1949 experienced a very brief bear market in 1961 and then continued its extraordinary run until 1966. The bull market which President Reagan’s policies launched in 1982 and which continued until early 2000 under Presidents Bush and Clinton actually lasted 17 years, but the Crash of 1987 divided the bull market into two. Despite the 30% sell-off during the fall of 1987, the S&P 500 turned in a modest positive total return in 1987.

The current bull market is less than half as long as the 1982-2000 and 1949-1966 bull markets. Both of these long-running, 17-year bull markets followed lengthy periods of economic and/or political disruption. The current bull market may trace this same pattern and become one of the longest bull markets, as it follows the traumatic sell-off of 2000-2002 (when the NASDAQ fell 78%) and the U.S. financial meltdown which occurred in 2007-2009. A lengthy bull market would be welcome news to the many investors who have seen substandard total returns from stocks since 2000. The S&P 500 has only risen 47% since 2000 – an annualized total return of 4.3% during this 16¾-year period. This is less than half of the average annualized total return of the S&P 500 index for the 89 years since 1926.

Valuation of the U.S. Stock Market

One of the key measures in seeking to determine how the stock market is valued is the P/E ratio (price/earnings). Is the market cheap or in a “bubble”? The P/E ratio is fundamental to valuation. The current forecast for the 2016 operating earnings of the S&P 500, according to First Call estimates, is \$117.46. With the S&P 500 trading at 2160 (as this is written), the P/E ratio based on 2016 earnings is 18.4. The table on the following page shows how the current market P/E ratios compare with market valuations over the past 30 years:

S&P 500 Earnings and Market Valuations 1987–2016

Year-end	S&P Operating Earnings	S&P 500 Index	P/E Ratio
1987	\$ 16.04	247.08	15.4
1992	\$ 20.87	435.71	20.9
1999	\$ 51.68	1469.25	28.4
2007	\$ 82.54	1468.36	17.8
2013	\$110.51	1848.36	16.7
2016*	\$117.46	2163.46**	18.4

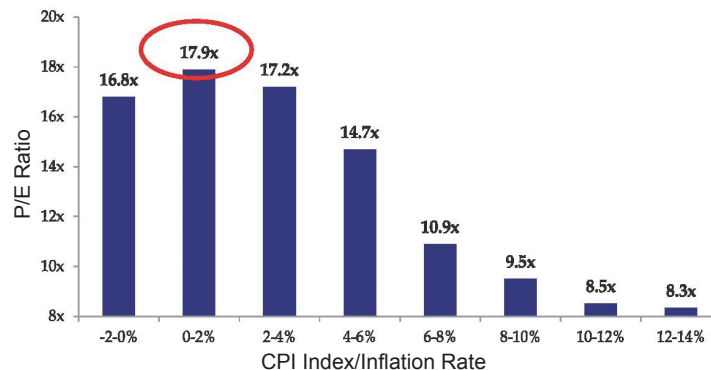
* Based on 2016 year-end earnings estimates

** October 10, 2016

It is important to note that investors usually tend to look at forward earnings when determining valuations. First Call’s estimate for the S&P 500’s 2017 operating earnings is \$135.42. This translates into a P/E ratio of 15.9, which means that the market’s valuation on this basis is close to the average P/E ratio on S&P 500 operating earnings of 16 over the past four decades.

Another traditional method of calculating an appropriate valuation of the stock market is the Rule of 20, about which we have written before. This rule of thumb suggests that the market’s P/E ratio should be the last twelve months’ inflation rate subtracted from 20. For example, the inflation rate in the U.S. over the past 12 months, according to the CPI statistics calculated by the Bureau of Labor, was 1.1%. When you subtract 1.1 from 20, the resulting 18.9 means a reasonable valuation of the stock market at this inflation level is a P/E of 18.9. The table above shows that the current P/E is 18.4 so the stock market is close to where it should be, based on this methodology. The chart below shows the S&P 500’s P/E ratio since 1950 when taking into account inflation:

**Average S&P 500 P/E at Varying Rates of Inflation
1950–2016**



Source: Strategas Research Partners

Sector Valuations in the Stock Market

As we have written before, the stock market is composed of individual stocks in different sectors. Currently there are certain sectors whose valuations are, indeed, very expensive. Others are inexpensive and modestly valued. The table on the following page lays out the valuations of certain key sectors of the stock market as of September 30, 2016:

**S&P 500 Select Sectors Valuation
September 30, 2016**

Sector	YTD Total Return	Price / Earnings Multiple			PEG Ratio
		2015	2016	2017	
Energy	18.7%	25.0	123.3	29.9	9.5
Information Technology	12.5%	17.0	18.5	16.4	1.3
Consumer Staples	7.6%	21.0	21.4	19.5	2.2
Consumer Discretionary	3.7%	20.5	19.0	17.2	0.9
Financials	1.4%	14.8	14.2	11.8	1.5
Health Care	1.4%	17.2	16.2	14.8	1.3

Source: Standard & Poor's

The table shows that the energy and consumer staples sectors stand out as expensive at this time, although for different reasons. The P/E and PEG (P/E ratio divided by earnings per share growth projections) ratios for energy stocks are currently elevated due to the drop in the price of oil. This drop has caused depressed earnings, which are expected to rebound over the next several years. The consumer staples sector is richly valued because quality companies in this industry have great brands, robust cash flows, strong and growing dividends, and are generally seen as defensive in a recession. On the other hand, financial and health care stocks are both relatively inexpensive. Financials are cheap because the low interest rate environment hurts their business models, and the regulatory environment causes investors to view them as utility-like stocks. Health care stocks are inexpensive due to the political rhetoric unleashed by the presidential campaign. In fact, mature biotechnology companies are at their lowest valuations in the past decade.

Summary

There are other reasons why we at Bradley, Foster & Sargent do not believe that the stock market is a “big, fat, ugly bubble” waiting to burst. A key reason is that investors are anxious and worried about the country, the economy, and the stock market. So far this year, investors have yanked over \$146 billion out of domestic equity mutual funds. Bubbles occur when there is a feeding frenzy of buyers, as in the Internet bubble at the turn of the last century or the housing bubble that took place 10 years ago – not when investors are pessimistic. Interest rates are, in fact, at the lowest level ever seen in the U.S., but this reflects the rock bottom level of inflation, which the Federal Reserve is seeking to raise from 1.1% to 2% or more. If interest rates were to rise 1% or more from their current level, it is unlikely that the P/E ratio of the market would change materially, although one or two quick corrections could occur as investors adjust to rising interest rates. A recession would cause a nasty sell-off, but the U.S. economy seems likely to grow between 1-2% next year. In brief, we advise investors not to succumb to the “... manufacture, refinement and distribution of anxiety” that Eric Sevareid warned about at the beginning of the commentary. With the Dow Jones having advanced from 66 to 11,497, a 17,320% increase, in the 20th century, and now at 18,300, we agree with Warren Buffett that the risks of being out of the market are huge compared to the risks of being in it.

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