Bradley, Foster & Sargent, Inc.
Quarterly Market Commentary

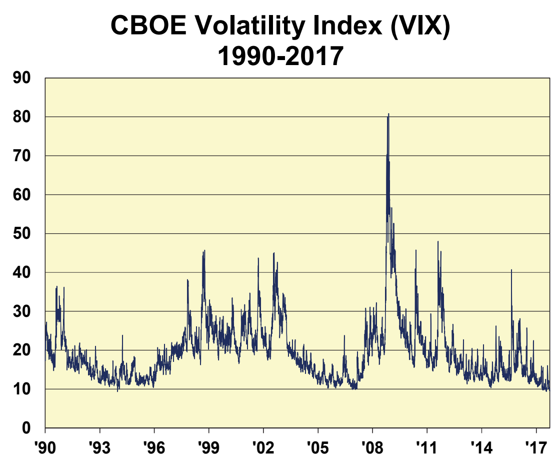
October 2017

Is It Different This Time?

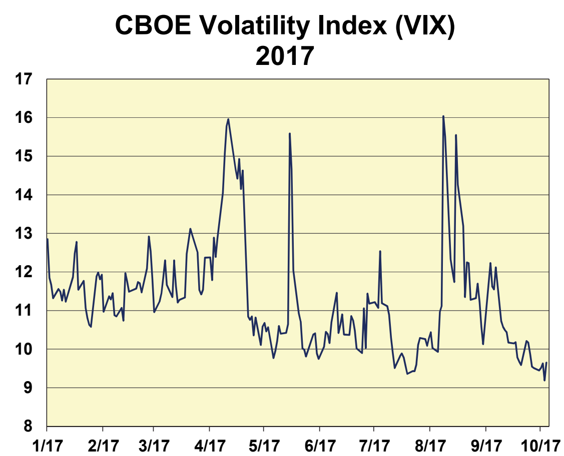
> Iconic value investor Seth Klarman of the Baupost Group plans to return some capital to his investors by year end because his hedge fund does not see enough opportunity in the markets.
>
> *Bloomberg Markets*, September, 2017

> "Stock valuations make sense with interest rates where they are... Being short America has been a loser's game. I predict to you that it will continue to be a loser's game."
>
> Warren Buffett, September, 2017

Over the last several weeks, the S&P 500 Index hit new highs almost every day. On Thursday, October 5, it touched an all-time high of 2,552.48 — up 14% from the start of the year. The Dow Jones also hit an all-time high on that day. The NASDAQ Composite reached its all-time high as well on Friday, October 6. The U.S. stock market is on a roll. This roaring bull market is now more than 8½ years old, having commenced its run on March 6, 2009. And it shows no signs of peaking. Furthermore, the Chicago Board of Exchange Volatility Index, the "VIX," widely known on Wall Street as the "fear gauge," fell 4.6% to 9.19 on October 5, 2017 — which was a record low, surpassing its previous record low of 9.31 set in December, 1993. The chart on the left below chronicles the path of the VIX over the past 27 years, and the chart on the right is a closer look at the VIX this year:



Source: Bloomberg



Source: Bloomberg

What are we to make of this remarkable complacency of investors? One would think that with a president with very high unfavorability ratings, the conspicuous disarray in the Republican party in Congress, the worrisome behavior of North Korea's Kim Jong Un, the ongoing war in the Middle East, and the continuing terrorist attacks throughout the world, stock market volatility would be much higher. Instead the largest pullback of the S&P 500 Index so far in 2017 has been the 3.2% drop in March. What is going on? In this investment commentary, we will seek to make sense of the stock market's behavior by looking primarily at the valuations of stock markets around the globe in the context of rock bottom interest rates.

U.S. Stock Market Valuations

Prices in the stock market are driven by many factors. As Gerald Loeb famously wrote, "Market values are fixed only in part by balance sheets and income statements; much more by the hopes and fears of humanity; by greed, ambition, acts of God, invention, financial stress and strain, weather, discovery, fashion and numberless other causes…" But, absent the madness of crowds and geopolitical events, stock market prices primarily reflect the earnings trajectory of a company or a market in combination with the level of inflation or interest rates. The table below shows market valuations of the S&P 500 at different points over the past 30 years (based on estimated operating earnings for the current year):

S&P 500 Earnings and Market Valuations
1987-2017

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	$124.19	2238.83	18.0
2017	$131.98*	2549.33**	19.3

* Based on 2017 year-end earnings estimates
** October 6, 2017
Source: Bloomberg

As can be seen from the table above, the current stock market P/E is significantly below that of 1999 at the peak of the Internet bubble when the S&P 500 was valued at a P/E of 28.4 — the highest it has ever reached. But the current stock market P/E is well above the average P/E ratio of 16 over the past 40 years based on the operating earnings of the current year. However, it is important to note that investors tend to look at the forward earnings when determining valuations. Bloomberg's estimate for the S&P 500's 2018 operating earnings is $146. This translates into a P/E ratio of 17.4. If corporate earnings were actually to increase 12% or more next year, the market's valuation of 17.4 would not be too different from the long-term market average.

Another metric which some investors use to measure the valuation of the stock market is to compare the total value of all publicly traded stocks with the country's GDP. In an interview with *Fortune* in 2001, Warren Buffett opined that when the value of all stocks is 80% of the size of the economy, buying stocks is likely to work very well for you. But he said that when total equity value exceeds the size of the economy, it is a sign that investors are getting too giddy and greedy. Currently, the total value of all U.S. equities, using the Wilshire 5000 as a reasonable proxy, is $26 trillion; U.S. GDP is approximately $19.4 trillion. According to this measure, the value of all U.S. stocks is 134% of the U.S. economy — a warning sign for investors. Critics of Buffett's theory point out that this benchmark does not take into account the growth of foreign profits for U.S. companies over the years. Currently, foreign profits represent more than one-third of total U.S. corporate profits. Another flaw in this yardstick, the critics say, is that many private companies have been acquired by U.S. public companies, which naturally inflates the Wilshire 5000. But even taking into account these criticisms, Buffett's measuring rod does point to the fact that the U.S. stock market is no longer cheap.

Global Stock Market Valuations

For the seven years between 2010 through 2016, the U.S. stock market outperformed stock markets in both international developed markets and emerging markets by a wide margin. Investment managers who automatically allocated assets to foreign equity markets during this period did not help their clients. The chart below tells the story:

S&P 500 Compared with International Equity Markets
1/1/2010-12/31/16

	Average Annual Return	Cumulative Return*
S&P 500 Index	12.81%	132.73%
MSCI EAFE (Europe, Australasia and Far East) Index ETF	4.38%	35.06%
EEM ETF (Emerging Market ETF)	0.79%	5.67%

*Total Return

Source: Bloomberg

This dramatic outperformance by the U.S. stock market, among other things, has resulted in lower stock valuations currently in international markets than in the U.S. This has caused cash inflows of over $200 billion into foreign equity markets this year, as investors have sought cheaper valuations. The table below demonstrates the differences in stock market valuations of selected international markets compared with the U.S.:

P/E Ratios on Earnings Estimates
2017 and 2018

	2017	2018
S&P 500 Index	19.5	17.4
Dow Jones	18.4	16.9
NASDAQ Composite	24.0	18.9
Russell 2000	20.2	18.2
FTSE (U.K.)	15.2	14.0
Nikkei (Japan)	17.4	15.8
Hang Seng (Hong Kong)	12.6	11.6
DAX (Germany)	14.1	13.2
MSCI EEM (Emerging Markets)	13.6	11.6

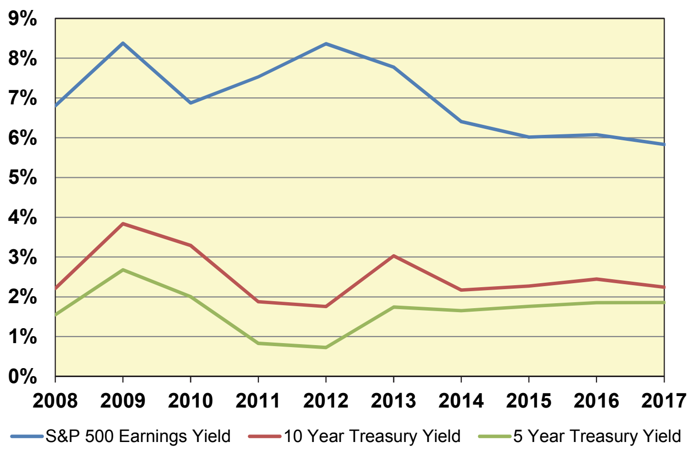
Source: Bloomberg

Reviewing the above data, one can understand why the international markets have outperformed the U.S. thus far in 2017, with both the EAFE ETF and EEM ETF up more than 20% through the first three quarters of 2017, while the S&P 500 was up 14% for the same period. It may well be time to consider investing in some of these international markets, but before allocating assets into foreign equity markets, investors need to consider the additional risks. The primary ones are currency risks as well as political risks, such as the disintegration of the E.U., or Russian or North Korean military aggression. Also, in severe global bear markets such as in 2000-2002 and 2007-2009, both international developed and emerging country stock markets were down significantly more than the U.S. markets.

Why the U.S. Stock Market May Continue to Rise

Despite the feeling that the 8½-year-old bull market may be getting long in the tooth and the fact that data show that U.S. stocks are no longer inexpensive, a strong case can be made that U.S. stock market valuations still make sense. Perhaps it is different this time. This is what Warren Buffett opines on the first page of this commentary. The reason for this optimistic outlook is the rock bottom level of interest rates. Interest rates in the U.S. are at levels rarely if ever seen in the U.S. And U.S. interest rates are higher than in other developed countries. The U.S. 10-year Treasury note currently yields 2.36%, while 10-year sovereign debt for Sweden, France, Germany, and Japan each yields less than 1%. Comparable debt for the U.K. and Spain yields less than 2%, and the 10-year sovereign debt for Italy, whose GDP has contracted almost 10% since 2008, yields less than the U.S. 10-year Treasury note. The reasons for these remarkably low interest rates have to do with the absence of inflation and the specter of deflation. Frightened by the prospect of deflation, central banks embarked on round after round of quantitative easing in an effort to promote inflation, but without success. In the U.S., for example, inflation averaged just 1.6% over the past seven years. This is the root cause of low interest rates. If investors are given the choice of investing in bonds with yields of 1-2% and stocks with earnings yields of 6%, the choice for stocks makes sense. (The earnings yield of a stock is calculated by dividing the earnings per share by the price.) The chart below tells the story:

Earnings Yield on the S&P 500 vs. Yields on U.S. Treasuries 2008-2017



Source: Bloomberg

As discussed above, stock prices depend largely on earnings and interest rates. Currently, we do not see a recession on the horizon. Even in the absence of tax reform, corporate earnings are likely to rise in 2018 with less regulation and more corporate investment. Interest rates also affect stock prices in a major way. Adding to his comments above, Buffett explains that one measures putting money into an asset in relation to what you are going to get back. And the basic yardstick is U.S. government bonds. So if yields on the 10-year U.S. Treasury note decline to 1% over the next few years, *stocks will look cheap currently*. If the yield jumps to 4%, *stock prices will re-rate to a lower valuation*. At Bradley, Foster & Sargent, we do not claim to be able to forecast where interest rates will be in one year, much less three years. So while interest rates are at rock bottom levels, some caution is warranted, as rates may rise, showing once again that some of the most dangerous words in the market are: "It is different this time." Nevertheless, by focusing on quality companies with great brands, wide moats, strong balance sheets, and robust cash flow, we continue to believe that investors who have a long-term approach to the stock market face more risk being out of the market than being in it.

Bradley, Foster & Sargent, Inc.
Investment Management

Principals & Portfolio Managers: Robert H. Bradley • Cameron H. Burns • Nancy W. Donadio • Timothy H. Foster
John R. Gilbert • Charles J. Herbert • David P. Korzendorfer • Keith G. LaRose • Felicia M. Lazor • Roger H. Manternach
Jeffrey G. Marsted • Gregory M. Miller • William R. Peelle, Jr. • Robert A. Penney • Joshua O. Peteet • Thomas D. Sargent • Stephen L. Willcox

CityPlace II • 185 Asylum Street • Hartford, CT 06103 • 860-527-8050 • www.bfsinvest.com