Boenning Morning Comment

This report is prepared for use by Tower Bridge Advisors July 10, 2017

Stocks rose on Friday after a stronger than expected employment report. This week will be a relatively light one for data. Both PPI and CPI numbers will come out later this week as well a preliminary look at June retail sales. June figures will likely remain weaker than normal given what we already know about gasoline, deflationary pressures on feed prices, and a weak auto market.

Stocks had a very strong first half of the year with leading averages rising close to 10%. Much of that move was predicated on strong earnings. Should stocks fail to react positively to good second quarter earnings, that could be taken as a yellow flag warning. On the other hand, a solid reaction and a strong July would say the bull run is intact.

Curiously, in a market where growth stocks have significantly outperformed value stocks, earnings estimates for growth companies are for gains of 5-6% while earnings estimates for value stocks are for gains of closer to 12%. Part of that can be explained if one looks at the energy sector. Last year's very weak second quarter reflected the bottom of the recent price drop for oil. While prices have been weak lately, they are still far above where they were early in 2016. Thus, on a year-over-year basis, the earnings of energy companies will be much better than they were in early 2016. With that said, however, the relative price performance of growth versus value stocks is diametrically opposed to the earnings performance of the same groups. Obviously, that cannot go on forever. Either earnings for traditional growth names have to accelerate or investors, at some point, will start to favor value over growth. There is no measurement tool to tell us when that will happen. Growth stocks now sell at about 21x forward earnings while value stocks trade about 14x estimates. It's normal, especially this far into an economic recovery, for growth stocks to sell at a higher valuation than value. But there are limits as to how wide the gap may be.

That thought can be extended to the entire market. Our economy has been growing 2% or so with inflation a bit over 1% since the end of the Great Recession. There has been little year-over-year variation and the factors that have been in place for the last 8 years remain in place today, i.e. steady employment growth, adequate capacity, and a strong financial base. Despite Trump tweets to the economy, there is no reason not to expect the same for the next several years. With the President's fiscal agenda bogged down in Congress what has changed is a slight uptick in wage inflation and a slight relaxation of regulations. The two balance out.

But as the economic growth path has remained on the same trajectory, asset valuations have risen. By that I mean P/E ratios. You can rationalize high P/Es any way you want. They are normal for latter stage bull markets. They are consistent with low interest rates. I agree with both. But there is little doubt that owning stocks when P/Es on actual or normalized earnings are high is riskier than owning them when P/Es are low. As P/Es continue to rise, assuming they are doing so in a rising earnings environment, that the stock market will continue to go up. Not only will it go up but it will go up faster than earnings, as we just experienced in the first half of 2017. When does this all end? A stretched rubber band will always break if stretched too far. But no one knows when. Normally, bear markets happen as the economy rolls over to recession or the stock market becomes overwhelmingly euphoric. So far neither condition is in place.

Valuation corrections, when they occur, tend to be both violent and swift. In 1987, during a rather solid economic period, stocks fell about 15% between August and mid-October after a strong first half similar to this year. Then on one particularly nasty Monday in October, the Dow fell 22% in just one day. That, for all purposes, was the end of the correction and the Dow recovered all its losses in a bit over a year. The other extreme, a bear market caused by a major financial dislocation, is what happened in 2007-2009. The seeds for that kind of correction simply aren't in place today. World financial markets are stable, banks are in excellent shape, there is no surge of inflation, and we have adequate capacity. To be sure, there could be regional debt issues in China or the Middle East but these would precipitate a worldwide economic collapse.

In summary, the risks are definitely rising and will continue to rise as long as stock prices increase faster than earnings. A 5-10% correction can happen at any time but the ingredients for a full-fledged bear market are simply not present yet. The path of least resistance continues higher but we need to be watchful of the market's reaction to what promises to be good second quarter earnings. In the meantime, stay true to your asset allocation. If nervous, rebalance more often.

Today Justin Bieber is 23. Jessica Simpson is 37. Sofia Vergara turns 45. How's that for a trio?

James M. Meyer, CFA 610-260-2220