A Gnawing Unease

Are Valuations in Need of a Reassessment ?

While the U.S. stock market, by many broad, historical valuation measures, is alarmingly expensive, it remains reasonably priced in terms of the short-term profit perspective.

The price to 10-year earnings, the price to replacement cost, and the total stock market value relative to the size of the economy are all flashing warning signs. However, based on a short-term earnings measure, such as the current price to earnings ratio and the current earnings yield, the market is still within a reasonable range. It is possible some catalyst, such as an economic slowdown or sharp interest rate increase, could change the short-term dynamic at a time that historic valuation methods would not support current stock prices.

The adjusted ten-year average earnings ratio is currently at 33. This level is higher than it was at its peak before the 1929 stock market crash. The only other time this ratio has been higher than it is now was just before the bursting of the great “dot com” bubble in 2001. Another measure, the stock market capitalization to GDP ratio is currently 145 percent, the second highest level ever recorded. The record high was in the year 2000, and it too preceded the coming great “dot com” bubble. The Q Ratio, the total stock market value divided by the total replacement cost of all companies, is currently at its second highest level in history. The Q Ratio historical high occurred in the year 2000. Extremely high readings in these valuation measures presaged the severe stock market correction of 2000 to 2002. In the two years after the bubble popped the S&P 500 declined 27.38 percent and 43.19 percent respectively.

Valuation models that rely on current earnings present a more optimistic picture. The current price to earnings ratio, based on the past twelve months, is 21. The average has been 17 for the past sixty years. The valuation may appear to be high, but when adjusted for current interest rates and recent earnings growth, it is reasonable. The current earnings yield (earnings divided by total market value) is 4.8 percent. This compares very favorably to the 2.8 percent yield on the 10-year U.S. Treasury bond and lends support to the stock market.

The Achilles’ heel of the short-term measures of support for the stock market is earnings. Historically, corporate profits are around 6 percent of gross domestic product (GDP). They have averaged approximately 9 percent since the economic crisis in 2008. The past decade has been one marked by historically low interest rates and a ready supply of labor. Most recently, corporate earnings have benefited from a significant reduction in corporate taxes. These factors have enabled corporate profits to stay above the historic trend for a decade.

Higher wages and rising interest rate may bring earnings back in line with the historic trend and force a reassessment of stock prices.

The broad historic valuation of the stock market lends little support to current stock prices and an adjustment of valuation based on current earnings would precipitate a significant stock market correction. In a situation like the 2007-2008 financial crisis, it is impossible to identify the market top, but prudent investors should be standing near the exits.

U.S. Stocks

There is good short-term potential due to very strong year-over-year earnings growth. U.S. stocks have been the best performing asset class over the last several years and now trade at higher valuations than most other stock markets around the world. This stellar performance is a result of strong economic growth in the U.S.

Due to valuation, it would be prudent to hold a target weighting and sell into significant rallies. Volatility may increase if earnings growth slows in the third and fourth quarter. We now have a market weighting for the tech, commodity and banking sectors. We are neutral on all sectors and market caps.

International Stocks

The synchronized global economic expansion is over for now. Pockets of weakness have appeared in some foreign economies because of geopolitical uncertainty, trade concerns and weak consumer demand. There are no signs of a recession yet, but there are some possible early indicators of economic weakness. We are neutral on stocks in developed economies outside the U.S. and we recommend maintaining a market weighting.

Emerging Markets Stocks

This is an attractively priced asset class. These stocks trade at a price to earnings multiple of twelve and are in the early stages of the business cycle. Many of the emerging market (EM) economies have undergone structural reforms, which have improved their credit profile and enhanced their financial stability. Unfortunately, EM have suffered this year because of the strengthening U.S. dollar. Also weighing heavily on EM are weak commodity prices (excluding oil) and trade uncertainties. The resultant turmoil tempers our enthusiasm for EM. Move from overweighting to target weighting.

Fixed Income

Interest rates have reached their highest levels since 2010 as the Federal Reserve continues its series of 0.25 percent rate increases. The Fed has raised interest rates twice this year and seven times in this cycle. The expectation is that rates will be raised two to three more times this year. Until the bond market adjusts to the Fed's policy of interest rate increases bond prices will be under pressure. The bond index has lost 1.62 percent through the first half of the year and is expected to remain under pressure for the balance of 2018. Maintain market weighting with the emphasis on short to intermediate maturities. Prefer high credit quality corporate bonds and U.S. Treasuries. Laddered maturities of U.S. bonds to mitigate interest rate risk.

Municipal Bonds Due to recent events in the first half of the year, the municipal bond market has become more attractive for individual investors. Tax reform legislation and two U.S. Supreme Court decisions have combined to transform the municipal bond landscape.
The new tax law passed by Congress is a net positive for individual municipal bond investors. The deduction for state income taxes is now limited to $10,000 for federal income tax filings. This makes tax-free income from municipal bonds more attractive to high-income earners in heavily taxed states.

The U.S. Supreme Court issued two decisions that offer some long-term support to the credit viability of municipal bonds. The first decision struck down mandatory fees for public employee union members to cover the cost of contract negotiations and representation. Market observers believe this will enable state and local governments to lower labor costs. The second decision allows states and local government to increase the collection of sales taxes on internet retailers. Tax revenues are estimated to increase somewhere from $8 to $26 billion dollars annually.
Both decisions should enhance municipal bond issuers' ability to meet their debt obligations.

Municipal bond prices may suffer if interest rates continue to climb. They are attractive for high-income households, especially now in states with high income taxes. We prefer investment-grade bonds with a combination of short and long maturities. Buyers of individual bonds should do so with the intention of holding the bond to maturity. Those needing greater liquidity should consider a mutual fund or ETF.

Segment	Benchmark	Year To Date
Commodities	BLMBG COMMODITY TR COMT	-2.5%
Emerging Markets	MSCI EMERGING EM (EMERGING MKTS) (USD)	-7.6%
Foreign Stocks	MSCI DEVELOPED EAFE (USD) (TRG)	-1.5%
US Intermediate Bonds	BLOOMBERG BARCLAYS AGGR BOND INDEX INTERMEDIATE	-0.8%
International Bonds	BLOOMBERG BARCLAYS GLOBAL AGGREGATE GLBL AGGREGATE	-1.9%
Municipal Bonds	BLOOMBERG BARCLAYS MUNI BOND INDEX COMPOSITE INDX	-0.1%
REITs	DOW JONES WILSHIRE U S INDEX REAL ESTATE	0.9%
US Stocks	RUSSELL INDEX 3000 WITH/DIV	8.0%
As of 8/6/2018		

Hanover Advisor Bulletins

Special Reminders to all Hanover Clients

- **New enhancements to our portfolio reporting system**. All Hanover clients have free access to or internet-based reporting system known as Black Diamond. This robust system provides comprehensive performance reporting, asset allocation and risk assessment on clients' portfolios. The system will have a new look and major enhancements starting this fall. Our office is available to assist in accessing and utilizing the Black Diamond system.

- As a reminder to our clients that Hanover Advisors, Inc. now has an office in Greenville, SC. Meetings can be scheduled at either the Greenville office or our conference facilities at Concourse Parkway in Atlanta. Please see our website, HanoverAdvisorsInc.com, for detailed contact information.

- **Be Our Guest!** Join us this year at the Rainwater Conference Center in Valdosta, GA for Volume VI of American Soundtrack. Live concert and hors-d'oeuvres start at 6:30 PM. Don't forget to RSVP @ 770-392-3998 x105

- We want to invite all clients to contact our office to schedule a portfolio review. We would be happy to coordinate a sit down meeting, a conference call, or an online meeting at your convenience. Please call our office to schedule an appointment.

- Due to a error in their software systems upgrade, Pershing Advisor Solution has been mistakenly charging clients $10.00 per mutual fund exchange. The fee is in error. Clients of Hanover Advisors pay no transaction fees in their accounts. The error is in the process of being corrected and all fees mistakenly billed to clients will be reversed.

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