GAMBLE JONES
CELEBRATING 60 YEARS

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It has been said that corporate earnings are the lifeblood of the stock market. When earnings are flowing properly, the market typically thrives. However, when that flow becomes stagnant, the market tends to struggle. In fact, earnings growth has proven to be the single strongest driver of stock prices over the long term, as evidenced by the roughly 90% correlation between the S&P 500 and the earnings of its component companies over time. However, there has been a breakdown in this relationship recently as the market continues to hover near all-time highs even as earnings in the just completed quarter are expected to have declined for the sixth quarter in a row.

The main reason the market has remained strong in the midst of weak overall earnings is that it has been supported by the historically low interest rate environment that has been fostered by the Federal Reserve and other central banks around the world in their effort to boost economic growth. Ultralow rates have suppressed yields on fixed-income securities, making equities more attractive on a relative basis and driving the stock market steadily higher. However, given that central banks are already about as accommodative as they can be, it is unlikely that stocks will receive a significant lift from further monetary stimulus. In fact, the Fed is likely to begin removing a little bit of the punch from the monetary punchbowl by raising rates in the coming months. And while we fully expect that this process will be extremely gradual and that an equity-friendly low-rate environment will remain in place for some time to come, the market is not likely to react well to any rate hikes unless accompanied by a pickup in earnings growth.

Another big boost to the market in recent years has come from a sharp rise in the amount of corporate stock buybacks. In fact, buybacks have served as the largest source of demand for stocks in recent years, including well over $1 trillion of purchases made over the past two years alone. Buybacks serve to drive up share prices and prop up the per-share earnings of companies by reducing the number of shares outstanding. The rise in buybacks is in part a function of the low-rate environment, which has allowed many companies to finance a considerable portion of their buybacks through debt issuance. And though corporate balance sheets are still generally in pretty decent shape, debt levels have risen considerably over the past few years. As a result, the recent pace of buybacks financed through debt is not likely to be sustainable over the long term, particularly if interest rates begin to creep up.

Given that stock valuations have already received a significant lift from low interest rates and an elevated level of stock buybacks, the next major boost to the market is likely to have to come from good old-fashioned earnings growth. While corporate earnings as a whole have been mired in a recession for several quarters, there is cause for optimism as two of the main factors that have pressured overall earnings have eased in recent months. The collapse in the price of oil has weighed heavily on the profits of energy firms over the past couple of years, while the substantial rise in the U.S. dollar has served to reduce the profits of U.S. multinational companies. However, with the price of both oil and the dollar now more stable, these significant headwinds to overall corporate profitability are likely to fade, and the earnings recession should soon come to an end. Even so, with the economy continuing to push forward at a steady but uninspiring pace, we think that earnings growth as a whole is likely to be just moderate for the foreseeable future.

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With stock gains outpacing overall corporate earnings growth in recent years, the forward price-to-earnings ratio of the S&P 500 has steadily risen to around 17, a level that is now above its historical average of 15. Given our expectations for moderate earnings growth, we think that the valuation of the stock market as a whole is a bit stretched, even in the context of a low interest rate environment. Even so, while fewer in number than in recent years, there are still some quality individual companies that are growing earnings at a healthy clip and trading at reasonable valuations. With market volatility likely to increase as we approach both the election and a potential rate hike from the Fed later in the year, we think there will be additional long-term investment opportunities to take advantage of in the months to come.

Sincerely,

Alison J. Gamble, President