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Dow Nears 20,000; Valuations High but not out of Line

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As the Dow is now less than 2% from breaking 20,000, many are asking: Have stocks run too far ahead of earnings? Certainly, on the basis of *past* earnings, current valuations are very high. At 2250 on the S&P, stocks are selling at 22.1 times 12 month S&P operating earnings of $101.62 ending September 30, and a whopping 25.2 times $89.29 GAAP earnings. But these ratios are going to decline markedly. Earnings for this quarter are expected to reach record highs for both operating and GAAP earnings, and on the basis of current estimates, the S&P 500 is selling at only 20.6 and 22.5 times 12 months ending December 31. Furthermore year-end adjustments, which took a heavy toll on GAAP earnings last year, are not expected to be as severe and might even provide tailwinds. That is because oil prices are above year-ago levels, which should raise valuations in the energy sector, and long-term Treasury yields, used to compute pension shortfalls, are also higher than last year.

But the most important factor driving stocks are 2017 earnings prospects. The principal driver is corporate tax reform which could add as much as $10 to S&P earnings. Although the full details of the plan are still being debated, there is little question that corporate tax reform will be substantial and will come before any substantive changes in the personal tax code. Current estimates of 2017 S&P earnings are $131 for operating and $123 for GAAP, which gives us P-E ratios of 17.2 and 18.3 respectively. These earnings are likely too optimistic , but even if we trim each by $10, that brings us down to ratios 18.2 and 19.5, much closer to post World War II averages. And although interest rates are rising, they are still quite low by historical standards. The ten year TIPS is 43 basis points, hardly a challenge for stocks whose dividend yield is still over 2%.

One should not fail to mention the significant rise in consumer sentiment in recent surveys. Today, the University of Michigan Survey jumped to 98.0 from 87.2 two months ago. This level is higher than the average level of consumer sentiment during the housing boom from 2002 through 2006, although still a bit lower than the euphoria in the last years of the internet boom in the late 1990s. The same can be said on the Conference Board's estimate released late last month. That index jumped to a 9-year high, also higher than during the housing boom. Bloomberg's weekly Consumer Comfort Index, at 45.1, is near the upper end of its two year range and well above at lows of 23 reached from 2008 and 2011. Although I have not seen any corporate surveys, the buzz is clearly that corporate executives are very upbeat, expecting corporate tax reform and reduced regulation to be a boon to their business. Of course, only time will tell if all this optimism is justified, but this is not the time to fight the trend.

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