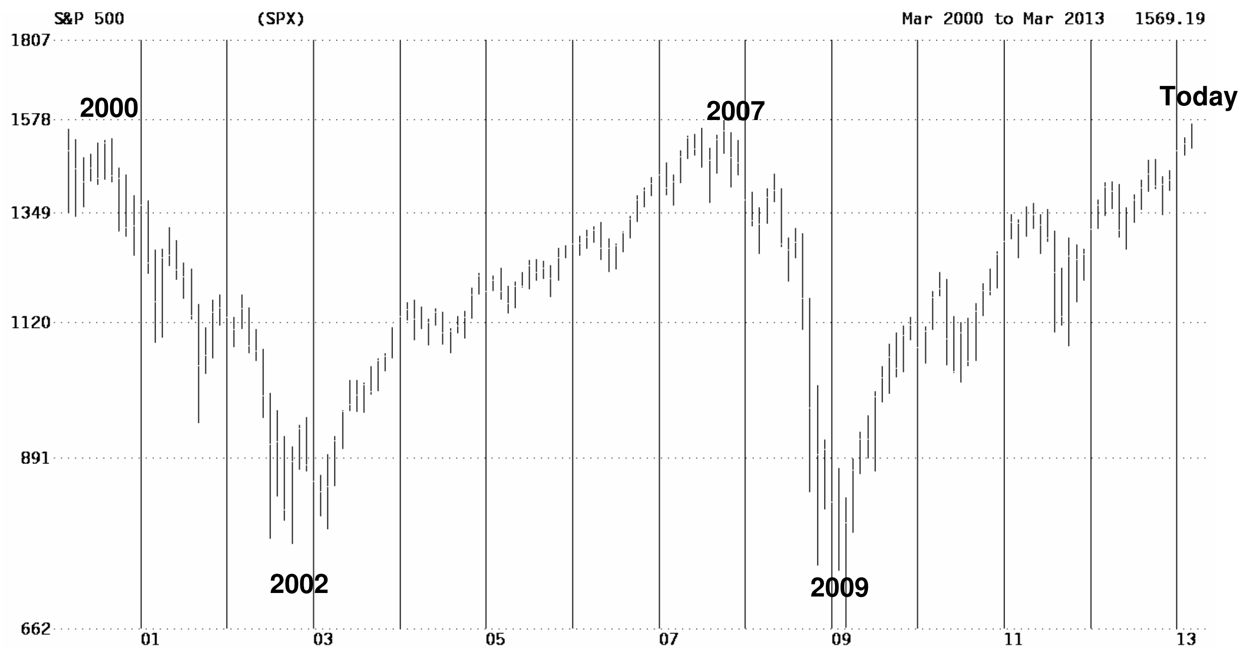
Quarterly Point of View

Navigating the W

April 18, 2013

Putting it mildly, it's been an interesting period of time for the stock market since the turn of the century 13 years ago. Looking at the chart of the U.S. market over that time as illustrated by the S&P500 below, you can see a distinct 'W' formation, with three clear-cut peaks (2000, 2007, today) and two clear-cut bottoms, made in 2002 and 2009.



Just recently, the S&P500 inched ahead of the old crest made six years ago to a reach a new all-time high, but the market finds itself essentially where it was 13 years ago. The good news is that dividend-focused investors likely performed much better over that period than the price chart above would indicate, as over $2,000,000,000,000 (yes, that's *trillions*) in cash payments were made in that time frame by companies comprising the index, making 'total return' more attractive. The vast majority of those dividend payments though, were made by a minority of the index constituents that felt, rightly we might add, paying legitimate dividends was part of their duty to shareholders. In any case, the price chart has barely budged in well over a decade and begs the question, 'what's different now than the previous two tops'? We think there's quite a bit different now, and that's predominantly positive.

Many valuation and fundamental metrics reveal a more attractive stock market than they did in 2000 and 2007. Firstly, overall debt levels of U.S. companies in the S&P500 are much healthier.

Total leverage, defined as the ratio of total debt to total equity, now stands at almost half the level of both prior peaks, a significantly understated positive. Price to earnings ratios, the most common measure of valuing stocks, are also markedly different. In March of 2000 with market euphoria peeking, the S&P500's trailing P/E stood at an astounding 30 times. By 2007 it had come down dramatically to 17.5, and today it has dropped even further, residing around 15 based on last year's earnings. In other words, the total earnings per share of all the companies in the index in 2000 equaled $51, and today it is $102 – while the price level of the index has risen only slightly. Price to book levels also tell us that today's market is more attractively valued, as that ratio has moved from 5.4 in 2000 to 3.0 in 2007, to a current level of 2.3. The market's dividend yield has also progressed positively for the average stock, from 1.1% in 2000 to 1.8% in 2007 and now at 2.1% in 2013. But because most companies still pay out a far too modest portion of their earnings in the form of cash dividends, the best way to illustrate the relative value of today's overall market versus the prior peak periods is probably to evaluate the 'earnings yield', and then compare that with interest rate levels. The earnings yield is simply the inverse of the price to earnings ratio, or stated differently, the 'yield', if all the year's earnings of the index were paid out in relation to its current price level. Below is a chart outlining the spread between the stock market's earnings yield and the 10 year treasury at the two prior peaks compared to today:

Year	2000	2007	2013
S&P500 Earnings Yield	3.30%	5.70%	6.70%
10 year Treasury Yield	6.20%	4.70%	1.80%
Yield 'Spread'	-2.90%	1.00%	4.90%

Source: Standard and Poor's, JP Morgan

As can be seen, the market's current earnings yield is more attractive than in 2007 and much more so than in 2000, when viewed on an absolute basis. When related to interest rates the yield comparison is highly favorable for stocks at this juncture.

The good news is that materially different readings today reflect a healthier, more attractively valued market than at the prior two 'W' peaks. One of the biggest factors supporting the yield comparison argument in favor of stocks is the level of interest rates however, and this is where a possible caveat arises.

There are three components that make up long term total returns for stocks - dividend yields, earnings growth and valuation adjustments (P/E ratios moving up or down). Dividends are the most important so let's start, and ultimately finish, there. The reason they are the most important is because they are the only component of total return that never has a negative impact. This is very compelling when dissecting long-term market returns. Both earnings growth and valuation adjustments can have an adverse impact on a stock's total return, but dividends are always positive – it's simply a matter of magnitude. That's why we choose to make the search for high, durable and growing dividends the primary ingredient in our investment process. The second component, earnings growth, is closely related to economic growth, and the outlook for this over the longer term is harder to gauge. With that said, we do believe that outside of cyclical growth 'spurts' and barring an energy revolution in the United Sates (which could occur with proper nurturing), overall economic growth will be less than robust. Why? Simply put, the decades long debt 'super-cycle' has ended and we are going to be in a prolonged period of public sector deleveraging across the globe. This belt tightening is inherently a suppressant to growth.

The third component is valuation adjustments - meaning the level or change in P/E ratios, and this is where the interest rate caveat may apply. Higher interest rates increase the long term return that stocks need to produce to remain competitive, while lower rates decrease that hurdle. Consequently, we should expect that higher interest rates would be associated with higher earnings yields/lower P/E's while lower interest rates are associated with lower earnings yields/higher P/E's. We remain in a very low interest rate environment, which helps make the earnings yield spread for stocks over bonds so attractive at the moment and could continue to do so for some time. What's liable to matter for P/E multiples looking into the future however, is the trend, or direction of interest rates from these levels. Given that interest rates have declined for three decades, and the 10 Year Treasury currently yields around 1.8%, it will be harder and harder - clearly - for the trend to remain down. If over the longer term interest rates rise, which we believe they will, that may serve to remove the valuation adjustment component from exhibiting any positive impact on stock returns. In the event of a trend in rising rates, it wouldn't be improbable to experience occasional cyclical periods of rising valuations, but over the full length of a rising rate period we are unlikely to see P/E multiple expansion to any degree.

With valuations at the mercy of the interest rate environment, and earnings growth apt to be a modest positive, let's revisit the dividend component. The 1970's was the last calendar decade investors experienced a significant, trending rise in interest rates. The 10 year US Treasury yield rose from a low of 5.53% in 1971 and ended the decade with a yield exceeding 11%. This doubling of yields crushed bond investors and was a serious headwind to stock P/E multiples (they declined as we would expect). For the decade, the S&P500 Index rose at a cumulative total slightly exceeding 17% when looking at price only. However, when dividends and dividend growth are included, the return jumps to almost 77%, with dividends contributing over 70% of total return for the decade.

There is a lot more to like about the stock market at this juncture in the 'W' versus 2000 and 2007. We believe it to be critical though that investors have portfolios prepared for a scenario where one component of total return generation may be absent as interest rates rise. Portfolios need to have healthy exposure to high quality enterprises generating reliable and dependable earnings - then importantly - sharing those profits in the form of tangible, durable and growing cash dividends. Portfolios missing these elements may find a rising rate environment particularly burdensome.

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Respectfully,

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