FARR MARKET COMMENTARY

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The News Isn't All Bad

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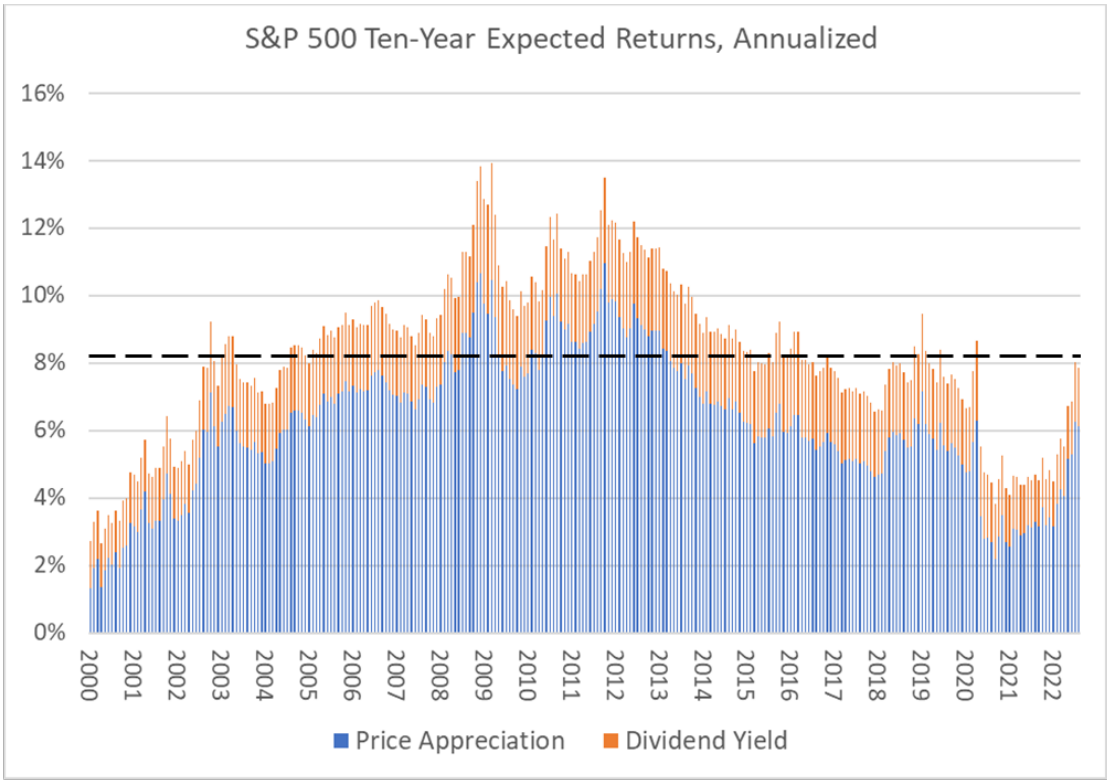
Following the worst half for stocks since 1970, it's hard to find good news. But there is some. Stock valuations haven't been this attractive for quite a while. Except for a very short-lived blip after COVID arrived in March, 2020, we'd have to go back to mid-2019 to find stocks as attractive as they now appear to be. The S&P 500 is currently trading at just 16.1x the consensus estimate for earnings over the next year. In fact, the price-to-earnings (P/E) ratio is now below the average of about 16.3x since 2000.

First, a caveat. We have been talking for months how earnings estimates have yet to budge despite a tidal wave of bad news. As it currently stands, the consensus estimate is calling for 10% earnings growth in 2022 and another 9% earnings growth in 2023. In a typical recession, earnings tend to fall by about 20% on average. So, if we do end up going into a recession, there could be significant downside revisions to earnings estimates as well as additional declines for the stock market. But if we do somehow avoid a recession and earnings estimates actually hold up, long-term investors could be well rewarded by buying stocks at today's level.

The chart below shows estimates for the total expected return on the S&P 500 over 10 year periods since the year 2000. We assume that earnings grow at a rate of 6.0% for all 10-year periods. We start with the P/E ratio and dividend yield as of the date of purchase, and we assume that the P/E ratio reverts to the long-term average of 16.3x over the ensuing 10 years. The results show that if investors were to buy the S&P 500 today, they would have an expected annualized return of about 7.9%, consisting of 6.1% from capital appreciation and a 1.7% dividend yield, over the next 10 years. This is just slightly below the historical average of 8.2% since 2000. Given that the expected return had dropped to as low as 3.8% as recently as August, 2020, we think those with long-term investment horizons should begin the process of looking for opportunities.



Source: FactSet. Assumes P/E ratio reverts to average since 2000 of 16.3x.

Rudimentary analyses such as this can help provide perspective during periods of intense noise. Does this analysis lead us to confidently call a market bottom? Of course not, especially since earnings estimates have yet to fall in any material way. But we certainly believe the long-term investment case for stocks has improved materially as valuations have dropped sharply over the past couple of years. And we'd continue to favor high-quality companies with fortress balance sheets as we put new money to work.

Peace,

Michael

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