Feb 9, 2018

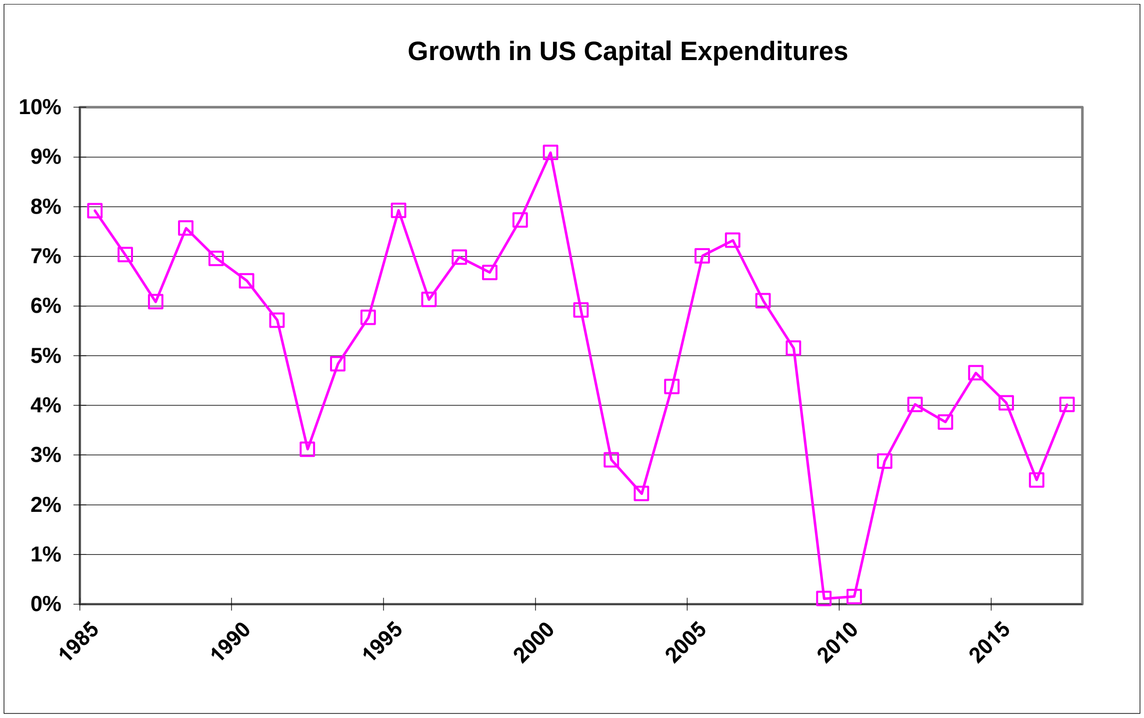
The rally since the November 2016 elections has continued more or less unabated, until recently. The passage of tax reform has added more fuel to the stock market fire. The S&P500 was up 21.8% in 2017 while Alamar Equity gained 21.4%. Since inception in 2010, the S&P500 is up 13.9% annualized and Alamar is up 14.1%. In hindsight, our timing was fortuitous; however, we did not expect such rapid gains so quickly out of the chutes.

There are justifiable concerns amongst many market participants that we have come too far too fast. In this note we will look at the most important driver of returns, corporate profits, to determine if present market levels are justified. We will also explore if corporate animal spirits have been unleashed with the new regulatory regime.

FEDERAL REGULATIONS

One of the drivers missing from this recovery has been capital spending or investments by corporations. Typically, capital spending has increased by roughly 6-7% annually in past recoveries. This time, however, the increase has been much lower - in the order of 4% since the recovery began in 2010. **Figure 1** plots the growth in capital spending over the last 30 years. Notice the anemic recovery since 2010.

Figure 1: Growth in US Capital Spending

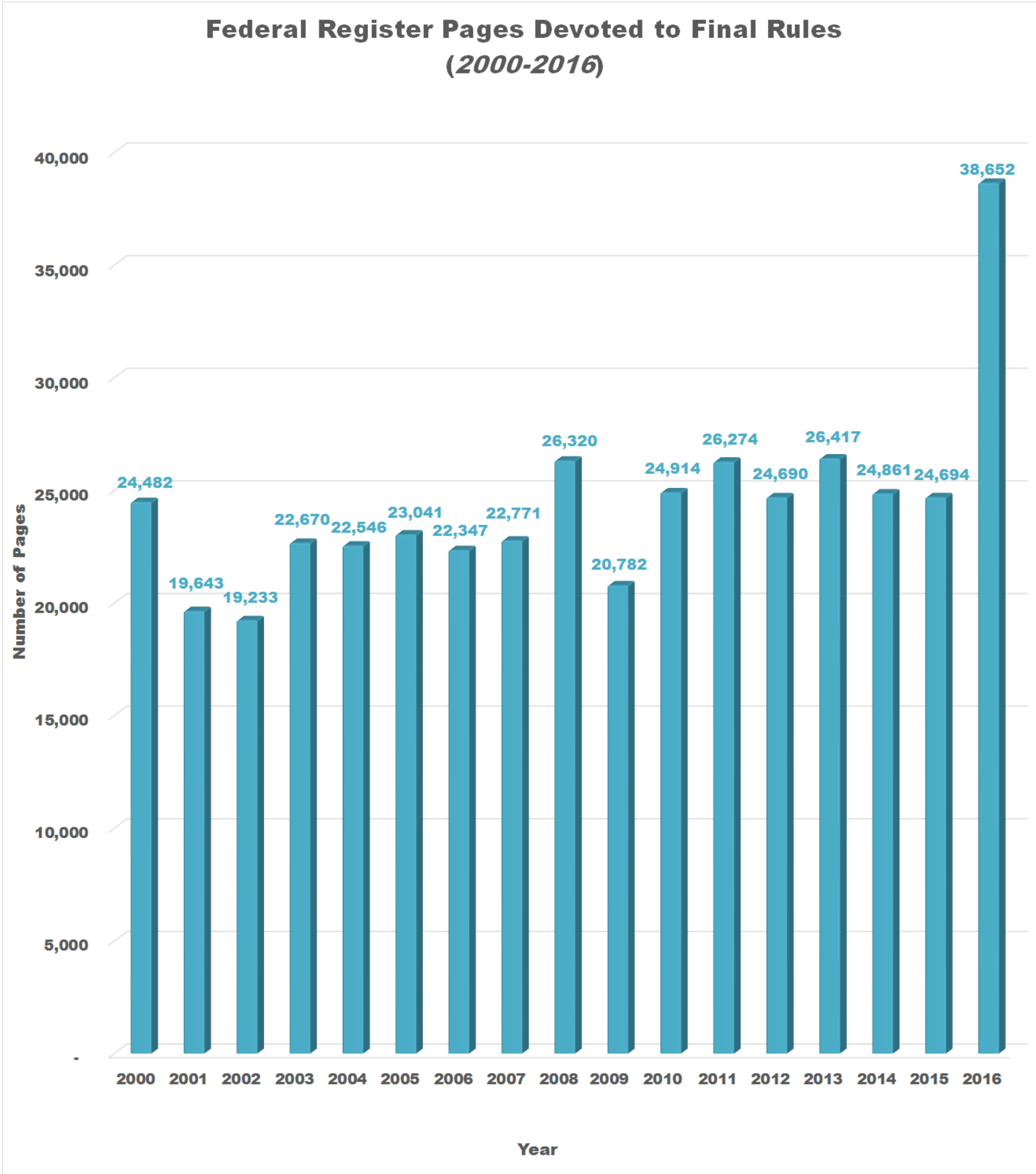


Source: BEA

The data spurs the question – why? Why haven't the animal spirits been unleashed this time? Two potential reasons, repeatedly mentioned by corporate management teams, are relatively high corporate taxes in the US compared to other OECD countries and overly restrictive regulations encumbering new projects. We will revisit taxation in a future missive but for now focus on regulatory barriers.

President Trump came into office vowing to reduce Federal regulations that, in his mind, have hampered investment. He has appointed a number of administrators charged with streamlining the regulatory hurdles including the Environmental Protection Agency (EPA), Food & Drug Administration (FDA) and the Federal Communications Commission (FCC). One, albeit crude, measure of the total number of regulations, is to count the number of pages in the Federal Register where all rules must be published. **Figure 2** plots the total number of pages for final rules since 2000.

Figure 2: Growth in US Regulations



Source: CEI

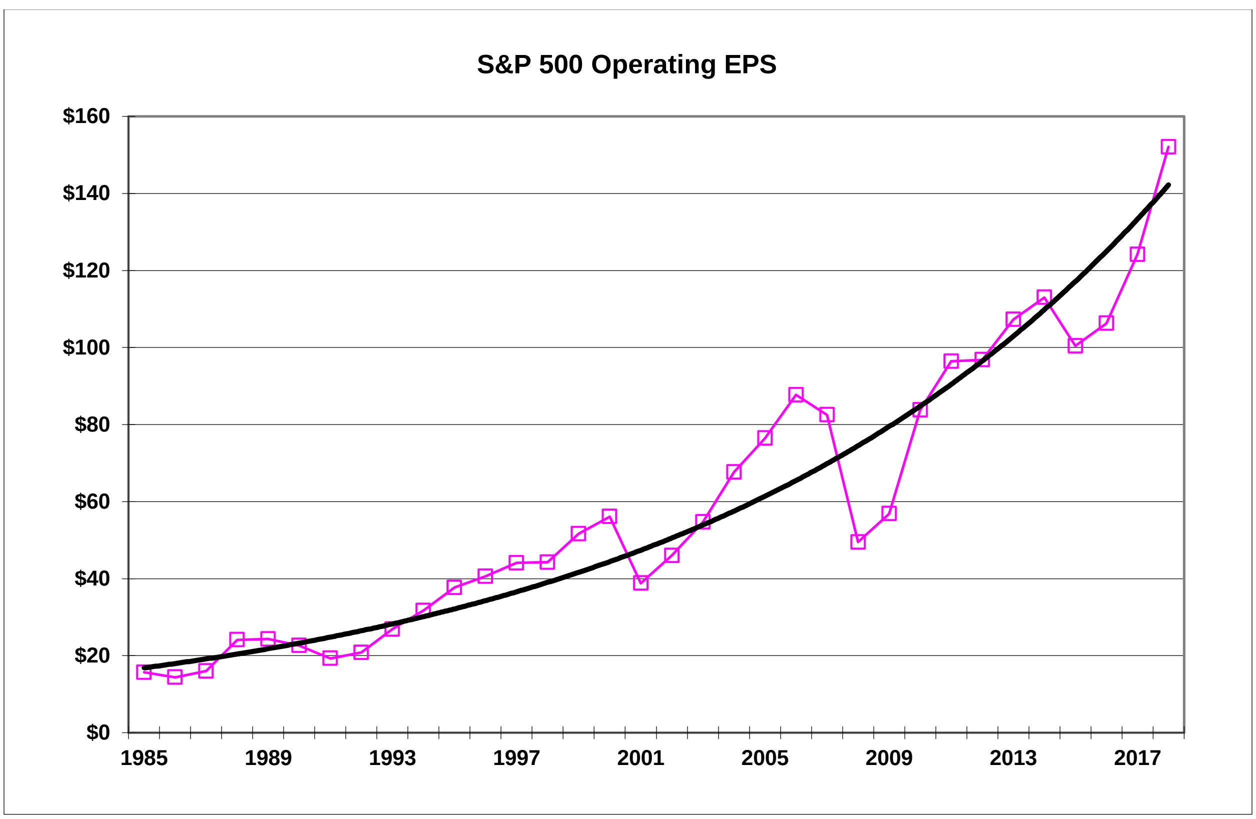
Notice the large jump in the final year of President Obama's term when pages jumped up by 56%! While the final tally for 2017 is still being assembled, early indications portray the new administration has reduced the page count by over 20%. It remains to be seen if the two-pronged thrust of lower taxes and a lighter regulatory touch will finally spur investment, but the early indicators and annual forecasts from corporate executives on year-end conference calls look very promising.

CORPORATE PROFITS

The single most important driver of stock market returns is corporate profits, specifically earnings per share (EPS). EPS growth trumps Fed easing/tightening, change in administrations and numerous other news headlines that capture attention such as North Korea or the latest tweet from the President.

Figure 3 plots the EPS of the S&P 500 index over the last 30 years. I have also fitted a trend-line that best fits the curve. Over the years EPS has grown roughly 6.5% annually, in line with nominal growth in US GDP. Of course, as shown in the graph, it is not a smooth curve up and to the right; there are peaks and valleys in accordance with the booms and busts of the economy. We live in a cyclical world, but the long-term trend is clear. The EPS numbers are tabulated from the bottom up. The profits of all 500 companies in the index are summed to calculate the final number. Note that the 2017 EPS number ($124.2) is still being finalized as companies report their 4th quarter results. Similarly the 2018 EPS ($152) is also subject to change as companies provide their forecasts.

Figure 3: S&P 500 Operating EPS



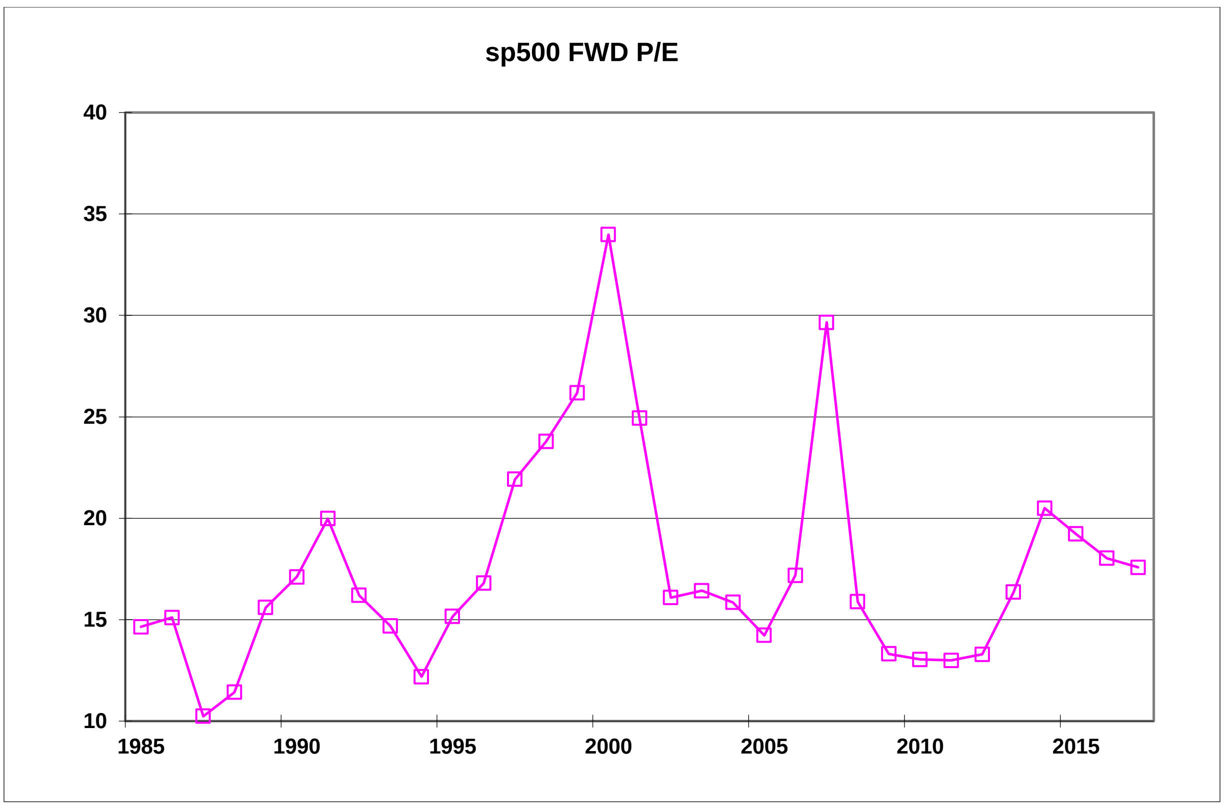
Source: S&P

Notice in the above figure that we are only now, 8 years after the start of the recovery, crossing the long-term trend line in a meaningful manner! We suspect the final EPS for 2018 will be higher than currently expected as the full thrust of lower taxes and higher capital spending get into high gear.

IS THE MARKET OVERVALUED?

Now that we have an estimate of 2018 earnings we can look at price-to-earnings (P/E) multiples to understand if the market is over or under valued. Figure 4 plots forward P/E multiples for the S&P500 since 1985. As you can see, multiples are not very extended compared to historical ranges. The current multiple of 17.5x 2018 EPS is well within normal and nowhere close to the peak multiples in 2000 and 2007. We are happy to purchase stocks at 17.5 multiples for 8-10% earnings growth.

Figure 4: S&P 500 Forward P/E



CONCLUDING THOUGHTS

Economic growth, and therefore corporate profits, could very well pick up after a long period of torpor due to lower taxes, regulations and higher capital spending. The stock market at these levels, we feel, is reasonably priced if current earnings projections come to fruition. We continue to find solid opportunities that meet our investment criteria – well managed companies with good growth trading at reasonable valuations.

Thank you for your continued trust and confidence in Alamar Capital Management.

Sincerely,

George Tharakan, CFA
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Disclosures

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