Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

The Fed Thinks the Market is Overvalued – Is Trouble Ahead?

By Mitch Zacks
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The Federal Reserve is notorious for making vague and general statements about the state of the markets and the economy. Analysts often parse the Fed minutes and statements looking for signs of changing monetary policy conditions, only to come out empty. That's why it was surprising that the Fed was a bit more direct in talking about stock prices at their last meeting. The minutes said that "some measures of valuations, such as price-to-earnings ratios, rose further above historical norms," and that "some [Fed] participants viewed equity prices as quite high relative to standard valuation measures."

The Fed seems to be clearly implying that valuations are too high and need to come down. Does that mean investors should take heed and sell stocks?

Valuations Matter, But Earnings Matter More

When seeing or reading cautionary statements about stocks, investors' first instinct should be to question the statement and research it further – even if the information is coming from the Fed. This isn't to say that the Fed or other prognosticators are always wrong about stocks. *They just usually are.*

At Zacks Investment Management, we arrive at our own conclusions using our own research, and we have a proprietary decision-making process that has generated competitive returns over long stretches of time. While we agree with the Fed that valuations are high, we do not necessarily think that what goes up must come down. At least not yet.

As of the end of Q1 2017, the S&P 500's forward P/E ratio was 17.5x, which is notably above its 25-year average of 15.9x. It doesn't take an analyst to confirm that valuations are running high. But, it does take one to remember that from 1997 – 2000, valuations were at least that high and actually went much higher, to 24x before the bear market (tech bubble) hit. Here's how the

S&P 500 performed in those elevated valuation years:

- **1997: +33.10%**
- **1998: +28.34%**
- **1999: +20.89%**

Granted, it was during these years that the "bubble" was forming, as valuations were rising much faster than earnings (recall that many new companies didn't even have positive earnings). But that still does not take away from the fact that the market rose even as valuations steepened – an outcome that is possible today too.

The difference-maker this year, in my opinion, is corporate earnings. Remember the basic principle that a valuation is calculated as a price to earnings ratio, or P/E. Since earnings are in the denominator, to the extent that they rise faster than stock prices (the numerator), the valuation falls. So, there is definitely a scenario where valuations can fall while stock prices actually go up! And in fact, it is quite common: the S&P 500 managed to be positive more than 50% of the time during multiple contraction (falling valuations), with a 3% median annual return. If earnings rise as solidly as we think they will in 2017, we could easily see this outcome of falling valuations with modestly rising stock prices.

The key for investors, then, is finding companies that are going to produce on the earnings front. That's where Zacks Investment Management comes in. We have been in the business of deeply analyzing earnings for over 35 years. In 1979, a study conducted by Leonard Zacks proved that the stocks most likely to outperform are the ones whose earnings estimates are being raised. Similarly, the stocks most likely to underperform are the ones whose earnings estimates are being lowered. We've been fine-tuning this analysis ever since.

At any given time, we are monitoring well over 200,000 earnings estimates and brokerage recommendation data points. For any given stock, there may be from 1 to 40 brokerage analysts following the company and making earnings estimates. We try to track them all, and we use the data to make informed investment decisions on our clients' behalf.

Bottom Line for Investors

In a late-stage bull market where valuations are running high, earnings matter tremendously (in my view). That means investors should be cognizant of the earnings records and projections for the companies in their investment portfolio.

-**Mitch**

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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