v i e w p o i n t

MARSHALL & SULLIVAN

Marshall & Sullivan, Inc. / Registered Investment Advisor

Summer 2018 newsletter

Economic Expansion Equals Earnings Growth

At Marshall & Sullivan, we believe sustainable long-term price appreciation of individual stocks is primarily driven by earnings. If earnings are growing and a company is fairly valued, then its stock price should rise over time. Emotion adds volatility, resulting in periods of time when a company is either over or undervalued.

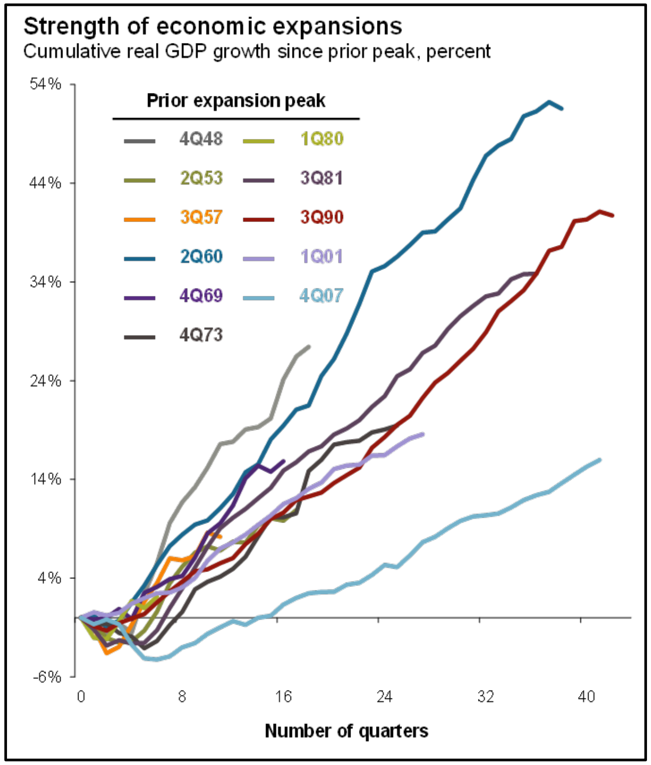
The same concept can also be applied to equity markets. For example, the S&P 500 is currently trading close to its 5 - year average of 16 times earnings. This suggests the market is fairly valued at the moment. This is well off the all-time high of 32 times earnings when emotions were running high.

Market analysts project a US earnings growth rate of 19% for 2018. If earnings grow as expected and the stock market remains unchanged, the S&P 500 would be trading at 13.5 times earnings – far below the historical average of 16%.

Of course, 2018 earnings growth projections are admittedly high and unlikely to be repeated next year since they include one-time adjustments for an assortment of recent corporate tax rate changes. Accordingly, we are focused on 2019 where analysts project growth rates of over 11%. This is still spectacular growth and worthy of our attention.

We believe both the economy and corporate earnings have ample room to grow. As we chug along on one of the longest economic expansions in history, many pundits point to a looming recession. We view things differently – it is not the duration of the expansion that matters, it is its magnitude.

The chart shows how long and how much the US economy has grown from the prior economic peak to the next. The light blue line shows our current expansion where the economy peaked in 4th quarter of 2007.



There have been eleven economic expansions since 1945, with the current expansion being one of the longest and shallowest. We believe this makes for a healthy and, more importantly, sustainable expansion.

Most past expansions have ended when the Federal Reserve has aggressively attempted to slow inflation in an over-heated economy. For example, in the 1970's inflation reached 12% and in the 80's, 14.5%. In both instances, the Federal Reserve raised rates quickly to cut money supply. In each case, Fed actions went too far and slowed the economy to the point of recession.

With low-moderate inflation, this is not an issue today. As long as the economy continues this slower growth mode, we believe the Federal Reserve will exhibit restraint in their rate increases allowing the economy to expand and with it, the earning of the S&P 500.

With that being said, we do expect pull-backs in the market. Remember, emotions are also part of the equation. The good news is that over time emotions level out and stocks return to trading on earnings.

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*Chart source: BEA, NBER, J.P. Morgan Asset Management. *Chart assumes current expansion started in July 2009 and continued through May 2018, lasting 107 months so far. Data for length of economic expansions and recessions obtained from the National Bureau of Economic Research (NBER). These data can be found at www.nber.org/cycles/ and reflect information through May 2018. Past performance is not a reliable indicator of current and future results. Guide to the Markets – U.S. Data are as of May 31, 2018.*