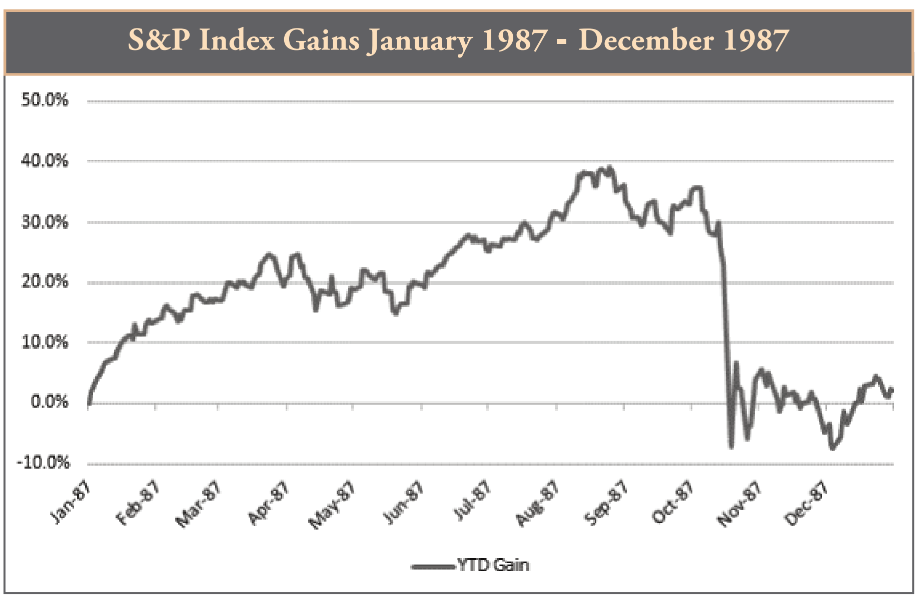
TO SPEND OR NOT TO SPEND

I hear rumblings of market declines in 2020. In my 24 years in the investment business and as a Chartered Investment Manager (CIM®) I have learned that market fluctuation is a fact and that investors invariably react to their personal emotions. Let's look at history and compare where we seem to be today to see if a steeper than normal corrective period is possible or warranted.

On October 19, 1987, the Dow Jones Industrial Average dropped 500 points or 20% per past Raymond James statistics, of that market's value. If we extrapolate that today, that would be about 5,000 points or a 21.50% downdraft.

The chart below from Bloomberg illustrates the effects of the drop in 1987:



Source: Bloomberg Charts

From top to bottom the S&P 500s market drop erased -33.5% of shareholder value. However, per market statistics, stocks had gained 39% from January to August in 1987. According to research from Bloomberg, these gains seems to have occurred due to multiple expansions with the S&P trailing price to earnings ratio ascending from 16.3X to 23.4X. That's a big multiple increase. It means that investors were asked to spend about 7X more for a dollar of a company's expected earnings, but the economy wasn't growing that fast to support those expectations. A bubble had formed……

By end of 1987 the S&P 500 index was up 2%, with average dividend yields of 3.8%, for an annual total of 5.8%. The market returned to value levels. I counsel clients in elevated markets to focus on value styles for dividend investment. A good role for your investment advisor is to assist your understanding of market cycles and economics as it affects your family. Today dividend paying companies in consumer staples, REITs, financials, certain utility types and health care are emphasized for dividend portfolios while classes of bonds with shorter maturities and less sensitivity to interest rate movements are warranted. Manage to your tailored objectives paying close attention to your asset allocations and investment styles with appropriate amounts and forms of fixed income to buffer equity changes.

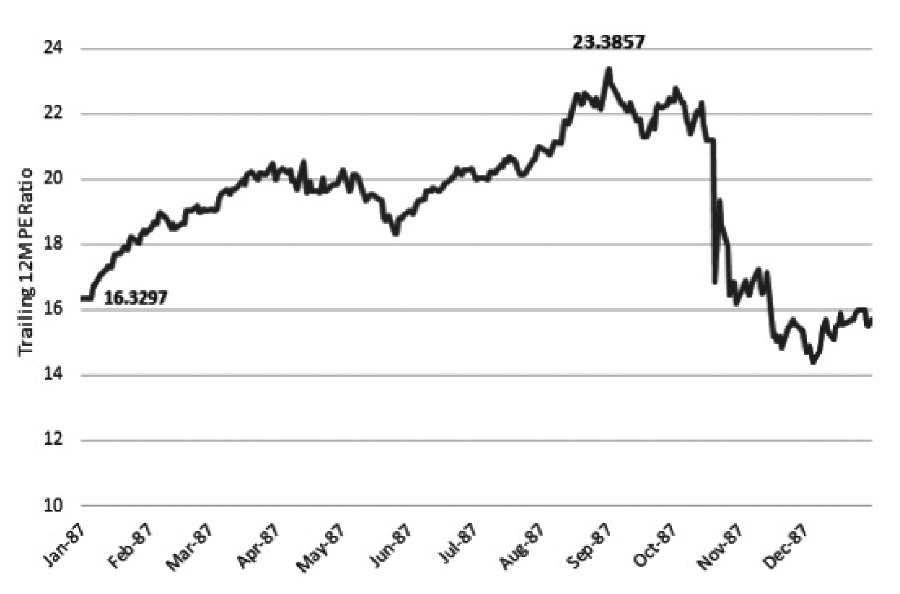
MICHAEL KORMAN

RAYMOND JAMES®

WHERE ARE WE TODAY?

Are North American financial markets overvalued? Today, many economists and financial firms collectively assign an index multiple to the S&P 500 somewhere in the 21.9X as of October 9, 2019 range. Ironically on January 1, 2008, this multiple was recorded as 21.5X. * Are you willing to peer 21 years and nine months into the future to bet on a consistent stream of a company's earnings announcements? In my years at Raymond James, I prefer to focus on operating cash flows reported and other balance sheet metrics. To me, these are solid indicators of a company's ability to generate cash from its core business. For more information on portfolio management with operating cash flow call us at 416-493-8786 and we'll send you information on how to build a portfolio based on operating cash flow.

S&P Index Trailing 12M PE Ratio - January 1987-December 1987



Source: Manulife Investments Investment Note October 2017

Fast forward to October 2019, it seems prudent that caution in elevated markets is warranted. Trimming stock weights in portfolios or selling some stocks outright to raise some cash at current levels or adjusting portfolio mix to higher cash flow companies with better balance sheet valuations is a good choice for investors to consider.*

***Source: www.multiple.com history ratio tables**

As a financial advisor, I look for stocks that don't correlate well together. If you want to be the crowd, it's easy to buy an ETF general market index or financial product which may be richly valued. Try to own companies or financial products with strong cash flows and solid dividend history that have behaved reasonably well in past volatile markets. I feel that gains in this environment seem to be occurring due to actual cash flow increases at the industry level on the back of unsustainable low costs of money, current inflation levels and low central bank rates. As an indicator of the future for wage inflation, I note the bargaining occurring at General Motors. It is natural that wage inflation should occur as industry borrows at ridiculously historically low rates while paying workers much less than profitability growth rates. The cycle can begin anew.

OPERATING CASH FLOW VS. EPS

And what about looking at stocks from an earnings viewpoint? While earnings can be looked at from the context of interest rate and inflation expectation, it is core operating cash flow that may drive the compounded profile of stock prices longer term. I think this is especially true in a mature stock market. According to Manulife, in1987 inflation was increasing with year over year CPI climbing to 4.5%*in October of that year while the Fed rate sat at 6.88%* Today I see a Fed funds rate range of 1.75% to 20% down from 2.25 % in 2018. US inflation range is now 1.75% down from 2.44% while Canadian inflation ranges at 1.5%.

**Source: Federal Reserve and Bank of Canada, 2019*

Some economists may argue that the market with current multiples, does not seem like the valuation bubble that existed in 1987. Corrective activity presents opportunities to buy more dividend stocks at better levels in normal portfolio operation. We will always have global and domestic market noise. Today it is Washington, China and Brexit dominating global news flows.

In summary, remember that stocks are composed of company share prices that most often reflect the discounted present value of longer - term cash flows. With your advisor's help this should always represent a solid basis for portfolio construction. If you wish a review of your capital and just what valuation risk lay in your portfolio or you require additional income, please call our office at 647-696-0140 at Raymond James.

Talk to us at 647-696-0140
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