STENGER FAMILY OFFICE
Weekly Insights
Ep. 122 | August 3rd, 2023

Stocks Can Keep Going Up

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Stock prices are a function of earnings multiplied by price. Simply put, a company's market cap is profits multiplied by what we think earnings will be worth in the future. Companies that grow profits consistently over time get higher multiples than companies with stagnate or declining growth. This is why stocks go up or down over the long run. In the short run though, the Federal Reserve can impact the P (price) in the P/E ratio even if the E (earnings) are strong. When rates were near 0% in 2020, companies with no earnings traded at astronomical levels. When rates started climbing in 2022, companies with strong earnings traded at dirt cheap prices. For 2023, stocks are up nearly 20% with the hope that both earnings will continue to be strong in 2024 and interest rates will be lower by 2025.

Median earnings estimates for 2025 are $273 which would represent a 25% increase from 2022 levels. Remember though, the market trades in advance of expectations and will reach fair value by the end of 2024. Assuming profits remain strong for large cap U.S. companies, the only remaining question is how much are earnings worth? Historical forward P/E ratios have ranged from 10-40 with a long run average of 18. At an 18 forward P/E ratio, the S&P 500 Index would trade at 4,914 by the end of next year. If rates go lower than their 3.5% 2025 projection though, the market could trade at 20 times earnings, placing the market at 5,460 by the end of next year. In either case, we believe stocks will be higher at the end of 2024 than they are today, a reason to stay bullish.

In the long run, we expect more of the same volatility. Inevitably, some Black Swan event will occur and send a panic through the market. Don't panic when this happens, it's a normal part of owning stocks. Just the past 15 years we had significant corrections in 2022, 2020, 2018, 2015, 2011 and 2008, about once every 3 years. Each of these corrections have represented buying opportunities for patient investors.

One slightly different period in market history though was the tech boom and bust of the late 90's and early 2000's. Thanks to fantastic fiscal policy under Ronald Reagan and Bill Clinton who was forced to work with divided government, investors experienced a total return in excess 2,300% from 1981 to 2000. From 1981 to 1997, P/E ratios hovered between 8 and 25, making the market reasonably valued. It wasn't until 1998, when earnings stagnated and prices started jumping. The market's P/E ratio was 24 in 1998, 33 in 1999, 30 in 2000, 28 in 2001 and 46 in 2002. That's why at today's level of 19.5, we feel the market is still fairly valued. As interest rates decline the next few years, don't be surprised if stocks trade for a lot more than 20 times earnings, the key though is remembering that 25+ P/E ratios are eventually unsustainable.

If you invested $100,000 at the beginning of 1998, paying 24 times earnings, your annualized return would have been 7.5% per year until the peak of 2007. If you paid 33 times earnings in 1999, your annualized return through 2007 would have been just 2% per year. This is why price ultimately matters as an investor. Paying the wrong price for even the best stocks can destroy long run returns. We don't think we're in this same position today, but it's something to monitor closely the next few years, especially as the AI craze continues.

Another key difference to note during the tech bubble was the S&P 500's composition. The largest stocks in 2001 were General Electric, Microsoft, ExxonMobil, Pfizer, Citigroup, Walmart, AIG, Intel, Johnson & Johnson, IBM, Time Warner, Merck, AT&T, Verizon, and Coca-Cola. In 2001, GE reported earnings of $13.7 billion, or 30 times earnings. Last year, GE reported a loss of 64 million thanks to a series of bad managerial decisions. To us, this is the main reason why rebalancing and careful stock selection matter. Buying bad companies can kill returns for a long time and could be a re-emerging theme the next few years.

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