Blue Chip or Blue Sky…Part III

By: Dave Lavigne

I am a microcap analyst, which essentially makes me a stock picker. However, I also have a bend toward trying to understand macroeconomic issues and trends, with the notion that those trends often play a big role in the pricing of assets in terms of sectors (gold miners vis-à-vis gold prices) but overall as well (the rising tide raises all boats). Macro issues involving liquidity are especially topical to me, because the equity markets, and perhaps more specifically the microcap equity markets are particularly sensitive to liquidity (or a lack thereof). In my view, when it comes to asset pricing, all roads lead to (and from) liquidity, so it may be the mother of all macro issues. To that end, in this column one year and two years ago, I provided some cautionary language regarding the central banks and liquidity as well as some equity metrics that I think are worth revisiting.

Just to recap a bit, the title of my letter one year ago was ***Blue Chip or Blue Sky…Redux?*** I started this exercise in February of 2017 with a column called **Blue Chip… or Blue Sky,** thus the "Redux" portion of the follow up article. Obviously, this is the third annual installment of this analysis.

As the title implies, I was questioning equity valuations back then (February 2017), when the DOW was 20,624, the S&P 2351, and the Nasdaq 5839. One year later the DOW was 19.3% higher, the S&P 500 was 13% higher, and the Nasdaq 19.6% higher. So much for my market timing skills, however, the following year, (2018) saw much more subdued performances in the indices. For 2018, the DOW was down roughly 5.6%, the S&P 500 lost 6.2%, and the NASDAQ in lockstep finished about 3.9% lower. I would add, the Russell 2000, which is more representative of our universe, lost just over 12%, which frankly, dovetails into our liquidity theme. Recall, the equity markets had a tough time in late 2018 as the reality of Fed tightening began to impact pricing. Specifically, at the time it was beginning to look like the Fed was serious about finally taking away the punchbowl they have been filling for the past decade. Like I said, liquidity drives asset prices. Of course, the start of 2019 has marked a stark reversal in equity prices as the Fed (presumably after seeing the impact of their tightening mantra on equity prices) reversed course and indicated that all rates hikes are now under review until further notice effectively kicking the can further down that ten+ year long road.

Again, to refresh this exercise started with something I read in 2017 that I still find hard to wrap my mind around. Here is that excerpt:

From: http://247wallst.com/investing/2017/02/06/just-14-stocks-have-created-20-of-all-stock-market-gains-since-1924/

"In what truly is one of the most amazing statistics to ever come across our desks here at 24/7 Wall St., we recently saw a chart that showed that just 14 stocks have created 20% of all stock market gains in dollars

since 1924. That is a phenomenal figure, considering the sheer number of companies that have come and gone in that time, and the overall wealth created in the stock market in the past 93 years".

Their list of 14 stocks:

1. Exxon Mobil Corp. (XOM)
2. Apple Inc. (AAPL)
3. General Electric Co. (GE)
4. Microsoft Corp. (MSFT)
5. International Business Machines Corp. (IBM)
6. Altria Inc. (MO)
7. General Motors Co. (GM)
8. Johnson & Johnson (JNJ)
9. Wal-Mart Stores Inc. (WMT)
10. Procter & Gamble Co. (PG)
11. Chevron Inc. (CVX)
12. Coca-Cola Co. (KO)
13. AT&T Inc. (T)
14. Amazon.com (AMZN)

From that observation, we generated a chart of these Bluechip bellwethers, (and added a few of our own for good measure) to see how some of these stocks were priced via some typical valuation metrics. The chart below reflects that data, but we have added some columns to reflect current balances versus those of a year ago and two years ago:

Company	02.17 P/E ttm	(18) 2.18 P/E ttm	(18) 2.19 P/E ttm	13-Year Median P/E	Current P/E as a % of Median	PEG @ 02.13.17	(18) PEG @ 02.12.18	(18) PEG @ 02.12.19	2017/2019 PEG ^	Price @ Px. 02.13.17	(18) Price @ 02.12.18	(18) Price @ 02.13.19	2017 to 2018 % ^	2018 to 2019	2017 to 2019
Exxon Mobil Corp.	38.85	16.51	27.1	12.6	215%	0.61	0.75	1.18	93%	$ 83.00	$ 76.42	75.4	-7.93%	-1.33%	-9.16%
Apple Inc.	16	16.77	15.36	15.11	102%	1.40	1.15	1.24	-11%	$ 133.29	$ 162.71	$ 170.89	22.07%	5.03%	28.21%
General Electric Co.	25.82	n/a	n/a	16.51	n/a	1.49	3.01	2.46	65%	$ 30.04	$ 14.82	$ 9.59	-50.67%	-35.29%	-68.08%
Microsoft Corp.	31	72.46	26.89	16.02	168%	2.30	2.06	1.84	-20%	$ 64.72	$ 89.13	$ 106.44	37.72%	19.42%	64.46%
Int. Business Machines Corp.	14.6	24.68	14.65	12.83	114%	4.99	3.65	10.40	108%	$ 179.36	$ 151.40	$ 136.05	-15.59%	-10.14%	-24.15%
Altria Inc.	27.09	12.3	15.42	15.68	98%	2.76	2.00	1.94	-30%	$ 72.04	$ 65.35	$ 49.66	-9.29%	-24.01%	-31.07%
General Motors Co.	4.05	n/a	6.88	9.59	72%	1.12	0.45	0.38	-66%	$ 35.52	$ 42.00	$ 38.65	18.24%	-7.98%	8.81%
Johnson & Johnson	20.24	277.17	24.55	18.58	132%	2.73	2.01	2.32	-15%	$ 115.88	$ 130.27	$ 133.28	12.42%	2.31%	15.02%
Wal-Mart Stores Inc.	14.7	26.43	43.55	15.26	285%	5.46	3.17	5.84	7%	$ 67.77	$ 99.55	$ 96.45	46.89%	-3.11%	42.32%
Procter & Gamble Co.	23.55	21.69	24.91	21.35	117%	3.06	2.55	3.69	21%	$ 88.31	$ 81.33	$ 99.26	-7.90%	22.05%	12.40%
Chevron Inc.	n/a	23.5	16.19	10.65	152%	0.93	0.24	0.47	-49%	$ 113.91	$ 113.98	$ 117.54	0.06%	3.12%	3.19%
Coca-Cola Co.	24.63	42.36	30.2	21.29	142%	10.58	4.70	4.13	-61%	$ 40.62	$ 43.97	$ 49.23	8.25%	11.96%	21.20%
AT&T Inc.	17.29	7.64	10.77	14.27	75%	1.66	1.10	1.88	13%	$ 40.65	$ 36.37	$ 29.81	-10.53%	-18.04%	-26.67%
Amazon.com	191.64	225.4	85.02	143.72	59%	2.93	5.88	1.41	-52%	$ 836.53	$ 1,386.23	$ 1,638.01	65.71%	18.16%	95.81%
McDonalds Corp.	23.58	25.74	24.58	18.27	135%	2.33	2.48	3.43	47%	$ 125.54	$ 163.90	$ 172.87	30.56%	5.47%	37.70%
Home Depot	22.71	25.56	18.73	20.94	89%	1.57	1.57	1.61	3%	$ 139.87	$ 184.06	$ 184.15	31.59%	0.05%	31.66%
Nike	25.31	24.62	65.86	22.88	288%	1.90	3.61	2.27	19%	$ 56.09	$ 65.98	$ 84.49	17.63%	28.05%	50.63%
Netflix	387.03	206.36	134.87	122.04	111%	1.62	1.15	1.78	10%	$ 143.20	$ 257.95	$ 359.97	80.13%	39.55%	151.38%
Alphabet, Inc. (Google)	29.98	57.72	27.1	27.85	97%	1.25	0.98	1.43	14%	$ 819.24	$ 1,051.94	$ 1,121.37	28.40%	6.60%	36.88%
Totals					**136.18%**				**5.09%**				**15.67%**	**3.26%**	**23.19%**

Notes:

(1) From Yahoo Finance trailing 12 months P/E ratio
(2) From Gurufocus.com 13-year Median P/E ratio
(3) From Gurufocus.com trailing 12-month EPS growth excluding **N**on-**R**ecurring **I**tems
(4) From Gurufocus.com 3 year average EPS growth excluding **N**on-**R**ecurring **I**tems
(5) From Yahoo Finance PEG based on 5-year projected earnings growth estimates
(6) From SEC filings trailing 12-month Operating Income Growth

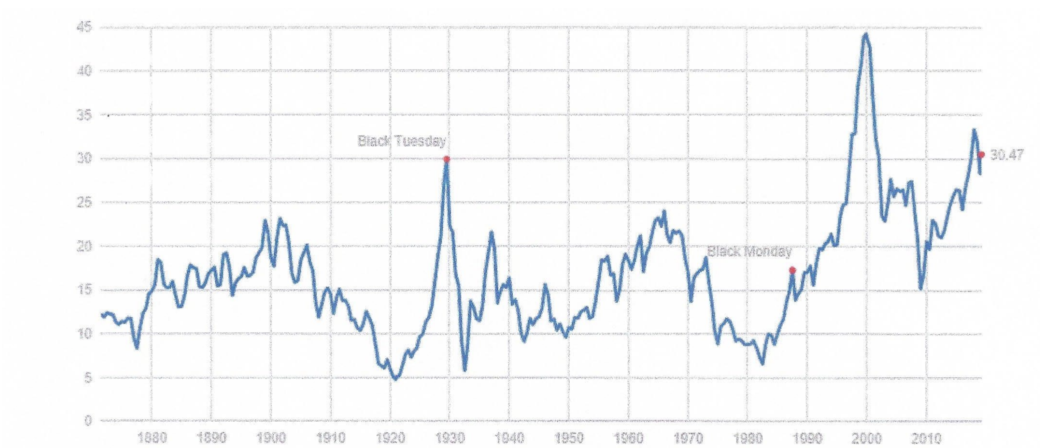
* From SEC filings trailing 9-month Operating Income Growth
**From SEC filings trailing 6-month Operating Income Growth
***From SEC filings trailing 3-month Operating Income Growth

All columns reflect numbers from 02/12/17 except those that include the notation **(18)**.

Recall, one of the cornerstones of my original cautionary tone came from my assessment of the elevated PEG ratios many of these stocks were (are) trading at. In this case, *my sense* of fair value is based on Peter Lynch's old notion that stocks should trade at P/E multiples roughly equal to their earnings growth rates. By that measure, a PEG of "1" would indicate fair value, and thus PEG's over "1" would indicate overvalued and those below "1" undervalued. As the table indicates, in the aggregate, PEG ratios for the period 02/17 thru 02/19), have actually increased, which in my view suggests that valuations are becoming even more stretched. Given the current backdrop of a slowing economy (which Fed policy appears to support), it seems counterintuitive to me that multiples would be increasing. Succinctly, the fact that many of these companies are achieving operating income growth in the low single digits (while some are negative), yet still have PEG ratios well beyond "fair value levels of 1, is in my view, alarming. Some of these PEG ratios are nothing short of eye-popping.

I think that point may also be demonstrated in the column reflecting the changes in relative price-to-earnings ratios. We denoted in green those with higher P/E ratios today than in 2017. It's hard to believe that despite marked advances in underlying valuations over the past two years, some of these shares have *even higher* price-to-earnings ratios than they did two years ago.

The chart below from www.multpl.com illustrates just how historically stretched the S&P might be in terms of another metric I like called the Shiller PE Ratio. As www.multipl.com notes, *The Shiller Price-to-earnings ratio is based on average inflation-adjusted earnings from the previous 10 years, and is also known as the Cyclically Adjusted PE Ratio (CAPE Ratio), , or "PE 10".*



Again, from a historical perspective, current CAPE levels look ominous in that only a few periods in history demonstrated higher CAPE ratios, and the periods following those thresholds did not end well.

Aside from valuations, there is another piece to this analysis that is also concerning, and that is an extension of last month's article that addressed rising corporate debt. In most of the cases above, company debt has been steadily rising, while share counts have been steadily falling. One must wonder how sustainable a picture of increasing stock repurchases and/or dividends in conjunction with rising debt levels can possibly be? Moreover, that continued leveraging of the balance sheets is happening as valuations continue to expand.