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Stocks finished in negative territory on Thursday, one day after the Dow crossed 21,000 for the first time. (Dow -0.53%, NASDAQ -0.73%, S&P 500 -0.59%). Crude-oil futures fell 2.3% to $52.61 a barrel, and gold futures dropped 1.39% to $1,231.56 an ounce. Utilities and consumer staples outperformed, while financials and telecommunications trailed the broader market indices. Small-cap stocks retreated: Russell 2000 (-1.27%). The VIX dropped 5.82% to 11.81. In economic news, the Labor Department said jobless claims declined by 19,000 to a seasonally adjusted 223,000 last week.

Morning Markets Briefing

Market Commentary: March 3, 2017

A SNAPSHOT OF THE MARKETS THROUGH THE LENS OF CONVERGEX.

This presentation is not intended for retail clients.

Valuation (Alone) Doesn’t Matter

Summary: Valuation won’t ever tell you if a stock is heading higher or lower. Valuation is math, and math is not an investment edge; it is only helpful because it tells you what the market believes. Figure out why that’s wrong (and it generally is), and now you have something useful. Take the companies of the Dow Jones Industrial Average. On average, they trade for 18.6x 2017 consensus earnings, and 16.6x next year’s estimates. Built into those numbers is expected earnings growth of 11% from 2017 to 2018. Since corporate earnings have been relatively stagnant for the last 3 years, that’s the first hurdle to jump. Beyond that, you need a point of view on how much better/worse things will be. The best case scenario (every Dow stock earns what the most optimistic Street analyst thinks they can earn) leaves us with US equities trading at 14.8x next year. That is clearly cheap. And if every Dow stock earns only what the most pessimistic analyst has in their model? Then US stocks trade for 18.6x next year. With US rates as low as they are, that is expensive but not horribly so. Bottom line: if you believe that some parts of the “Trump agenda” will pass at any point this year, the upside earnings case is correct (if not low). And if you don’t, sell. Now.

“There are two times in a man’s life when he should not speculate; when he can afford it, and when he can’t.” Mark Twain

“The wages of sin are death, but by the time taxes are taken out, it’s just sort of a tired feeling.” Paula Poundstone

“Dogs have no money. They’re broke their entirely lives. You know why dogs have no money? No pockets.” Jerry Seinfeld

No reason for those quotes, aside from a little “Feel good Friday” levity. It’s been a long week, with the post-Trump speech rally, the market suddenly realizing the Fed may be serious about raising rates this month, and today’s Snap IPO all making for a busy time. And it’s not quite over yet. Fed Chair Yellen has a speech to the Executives’ Club of Chicago at 1pm on Friday afternoon.

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Therefore we'll keep this note brief and simply address one question: "Are US stocks too expensive to either buy or continue to own?" No, it's not an easy question. And its only truthful answer is, sadly, another question.

"What do you believe?" Since asset prices reflect the market's baseline investment scenario, valuation analysis is really the business of measuring how different you are from the herd that sets those prices. Simply doing a Price-Earnings ratio isn't much of an investment edge. Everyone has access to a calculator. But by knowing the market's expectations for financial results and operating metrics, you can place your beliefs in sharp relief with the market's perspective. When your expectations are markedly different from those that other investors believe, you've got yourself an investment case.

Let's take a simple example – the companies of the Dow Jones Industrial Average. The 30 companies of the Dow have scores of Wall Street analysts following them, each publishing an earnings model with estimates for 2017 and 2018 earnings. Some are higher than average, and some are lower. Typically, investors assume that the most likely outcome is close to the average, plus a few pennies (companies tend to beat the consensus by a few percentage points).

Based on the consensus numbers, here's the current valuation for the Dow:

- **On average, analysts expect the 30 companies of the Dow to grow earnings by 11% from 2017 to 2018.**
- **Mean valuation multiples for the Dow companies are 18.6x 2017 earnings estimates and 16.6x next year.**
- **On balance, analysts expect that every Dow company will grow their earnings per share in 2018 versus this year.** The range here goes from 3% (IBM and Verizon) to 16/18% (Visa and ExxonMobil) to 32-42% (Chevron and Caterpillar).
- **Based on this data, most investors would say that US stocks are "Fairly valued" on this year's almost-19x multiple.** The more charitable ones might say "If you can wait until the end of this year, you might see stocks trend higher because that 16.6x multiple on 2018 is still cheap."

Now, here's the trick to this analysis: it's wrong. It is either:

- **Too high** because analysts always start out too high and bring their numbers down as the year progresses.
- **Or too low** because despite a very obvious equity rally on expectations for lower corporate taxes and infrastructure investment, not one analyst we know has yet raised their numbers to reflect that fact.

We went through and pulled not just the consensus earnings numbers for the Dow names, but also the highest and lowest numbers any analyst is willing to put in print. That analysis is included in a table in the attachment/PDF link at the top of this note.

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The upshot of this analysis is the following:

- **If every best-case-scenario estimate is correct, the Dow trades for 17.3x this year's earnings per share and 14.8x next year.** Instead of 11% earnings growth, these numbers work out to 16% growth.

- **If the worst case scenario is correct, those multiple are 19.7x and 18.6x for 2017/2018 numbers, respectively.** Average Dow company earnings growth in this scenario is just 6%.

- **Remember: best case scenario estimates still include little-to-no adjustments for lower tax rates from a Trump economic plan.**

- **While admitted a crude measure, PE ratios of 17x/14x for the bull case look cheap and 20x/19x for the bear case are clearly too expensive for 6% earnings growth in a rising rate environment.** (Remember those 3 rates increases we're baking into asset prices for the year?)

My takeaway: this valuation work shows two things:

- **You have to believe there will be some change in US fiscal policy to continue to own equities.** Stocks are too expensive otherwise. Now, it doesn't have to be the Trump Trifecta of lower personal/corporate taxes, deregulation and infrastructure. Any two of the three in sufficient scale probably gets us more than 11% earnings growth next year. Frankly, changes to the tax code alone probably get us there if corporations end up paying 20% instead of 35% of pretax profits.

- **Everything else has to go right.** Remember that corporate profit margins are higher than long run averages, unemployment is relatively low, and long term interest rates are still below 2.5% on the 10 year US Treasury. At current valuations we can't afford to lose any of those natural tailwinds to economic growth and corporate earnings.

It could well be that US investors are taking to heart the words of Oscar Wilde: "Anyone who lives within their means suffers from a lack of imagination." US stock markets clearly do not have that problem at the moment.

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Bank	FY End	Symbol	Price	2017 Avg P/E	2018 Avg P/E	% Change in Earnings	2017 Low P/E	2018 Low P/E	% Change in Earnings	2017 High P/E	2018 High P/E	% Change in Earnings
Goldman Sachs	Dec	GS	$251.06	13.2	11.6	13%	14.1	12.6	12%	11.9	9.9	20%
IBM	Dec	IBM	$180.53	13.2	12.8	3%	14.7	14.2	4%	13.0	12.1	7%
3M	Dec	MMM	$189.89	22.0	20.3	9%	22.6	21.2	6%	21.6	18.6	16%
Boeing	Dec	BA	$182.99	19.7	18.1	9%	20.6	22.0	-7%	18.9	16.2	17%
UnitedHealth Group	Dec	UNH	$167.31	17.6	15.7	12%	17.7	16.1	10%	17.3	15.3	13%
Home Depot	Jan	HD	$147.95	20.6	18.2	13%	20.8	19.3	8%	20.1	15.7	28%
Apple	Sept	AAPL	$138.96	15.5	13.7	14%	16.3	15.4	6%	14.4	12.0	21%
McDonalds	Dec	MCD	$128.23	20.8	19.4	7%	21.6	20.1	7%	20.4	18.7	9%
Travelers	Dec	TRV	$124.52	13.1	12.6	4%	13.7	13.5	2%	12.4	10.8	14%
Johnson & Johnson	Jan	JNJ	$123.63	17.6	16.8	5%	17.7	17.6	1%	17.1	16.3	5%
Chevron*	Dec	CVX	$113.36	24.6	18.7	32%	31.5	31.1	1%	15.4	12.0	28%
Disney	Oct	DIS	$110.59	18.6	16.4	13%	19.2	17.1	13%	18.0	14.5	24%
United Technologies	Dec	UTX	$112.69	17.2	16.1	7%	17.6	16.9	4%	17.1	15.6	10%
Caterpillar	Dec	CAT	$94.36	30.6	21.6	42%	33.1	25.5	30%	23.8	16.5	44%
Procter & Gamble*	June	PG	$90.91	22.8	21.1	8%	23.3	21.6	8%	22.2	20.0	11%
JPMorgan Chase	Dec	JPM	$92.14	14.1	12.3	14%	14.6	13.3	10%	13.3	9.7	36%
Visa	Sept	V	$88.53	26.7	22.9	16%	27.2	25.1	8%	26.0	21.5	21%
Exxon Mobil	Dec	XOM	$83.30	20.2	17.1	18%	24.6	21.9	12%	14.6	13.0	12%
American Express	Dec	AXP	$80.10	14.2	12.8	11%	16.0	14.6	9%	13.2	11.0	20%
Dupont	Dec	DD	$79.73	21.7	19.8	9%	22.7	22.0	3%	20.4	18.7	9%
Wal-Mart	Jan	WMT	$70.76	16.4	15.6	5%	17.3	17.7	-3%	15.7	14.7	6%
Merck	Dec	MRK	$66.08	17.3	15.7	10%	17.7	16.5	7%	16.8	14.3	17%
Microsoft*	June	MSFT	$64.01	20.5	18.8	9%	21.7	20.3	7%	19.1	16.6	15%
Nike	May	NKE	$57.80	24.7	21.9	13%	26.0	23.7	10%	23.1	19.9	16%
Verizon Communications	Dec	VZ	$49.98	13.0	12.6	3%	13.6	13.7	-1%	12.7	11.9	6%
Coca-Cola	Dec	KO	$42.47	22.7	21.9	4%	23.1	26.2	-12%	22.4	18.9	18%
Intel	Dec	INTC	$35.91	12.9	12.3	5%	14.4	13.8	4%	12.4	11.0	12%
Pfizer	Dec	PFE	$34.51	13.5	12.4	9%	14.1	13.0	9%	13.0	11.9	9%
Cisco Systems	July	CSCO	$34.39	14.4	13.4	8%	14.6	14.5	1%	13.5	12.6	8%
General Electric	Dec	GE	$30.19	18.5	15.8	17%	18.9	17.0	11%	18.0	15.1	19%
			Avg	18.6	16.6	11%	19.7	18.6	6%	17.3	14.8	16%
*MSFT, PG, & CSCO adjusted for calendar year												Source: Yahoo Finance

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U.S. EQUITIES

Caterpillar (-4.28%) and American Express (-2.22%) weighed on the Dow (-0.53%). Snap (+44.00%) priced its initial public offering at $17 per share and opened at $24 a share. Joy Global (-0.14%) reported an adjusted quarterly loss and revenue below expectations. Shake Shack (-2.63%) matched adjusted quarterly profit forecasts and exceeded revenue estimates. Box (-8.05%) posted a smaller than expected quarterly loss and revenue above expectations. Broadcom (+1.00%) beat adjusted quarterly earnings and revenue forecasts.

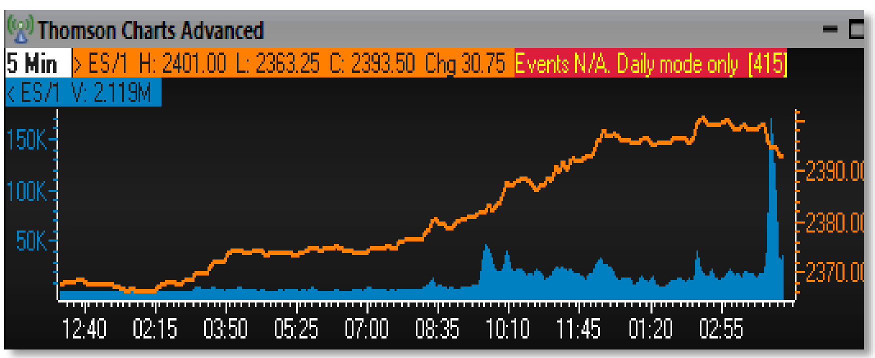
Important Earnings Today (with Estimates)

- WPP.L: N/A

Source: Yahoo Finance

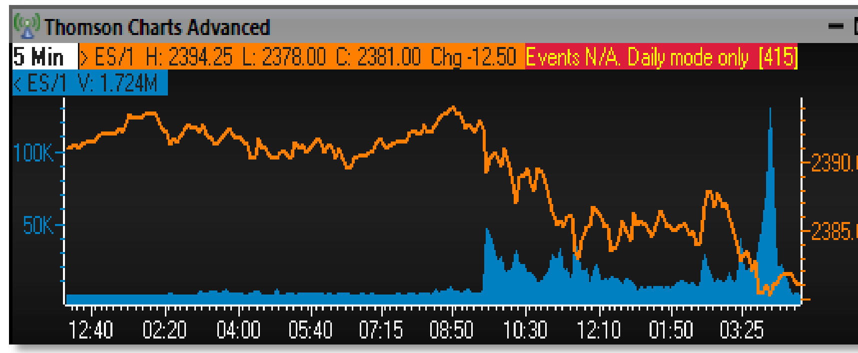
Important Conferences/Corporate Meetings Today:
N/A

Prior Day ES/1 (High – 2401.00; Low – 2363.25; Close – 2393.50):

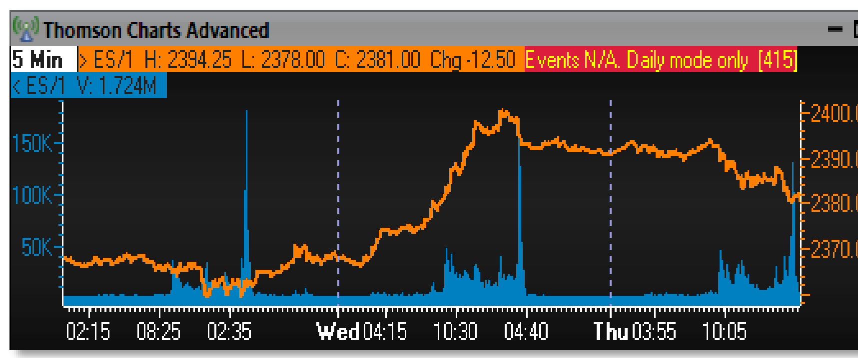


S&P Futures

One Day (High – 2394.25; Low – 2378.00):



Three Day (High – 2401.00; Low – 2363.25):



Source: Thomson Reuters

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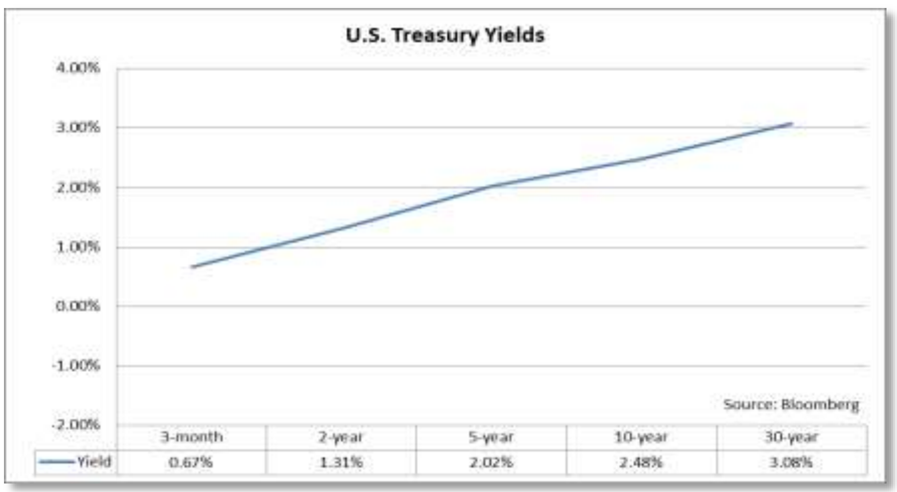
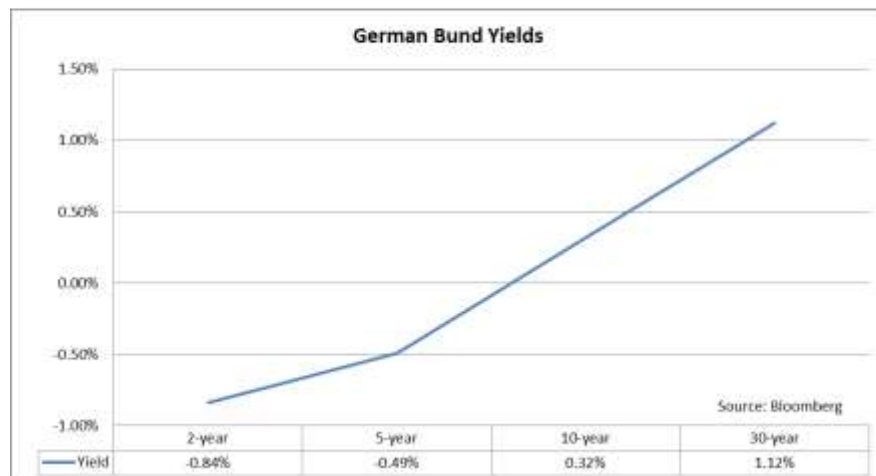
FIXED INCOME

Treasuries continued to fall Thursday on expectations for a rate hike by the central bank this month. Fed Funds futures give a 79.7% chance for an increase in near-term rates by the Fed in March and a 92.2% probability in June. The 30-year Treasury yield increased to 3.08%, and the 10-year and 5-year yields rose to 2.48% and 2.02% respectively.

Today's Important Economic Indicators/Events (with consensus estimates):

- PMI Services Index (9:45am EST)
- ISM Non-Mfg Index (10:00am EST): 56.5/56.5
- Charles Evans and Jeffrey Lacker Speak (10:15am EST)
- Jerome Powell Speaks (12:15pm EST)
- Baker-Hughes Rig Count (1:00pm EST)
- Janet Yellen Speaks (1:00pm EST)
- Stanley Fischer Speaks (1:00pm EST)





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International Market Summary

Asian Markets

Asian markets mostly rose on Thursday following record highs in U.S. markets overnight. (Nikkei +0.88%, HSI -0.20%, ASX 200 +1.26%). In China, the Shanghai Composite Index and Shenzhen Composite Index dropped 0.50% and 0.54% respectively. In Hong Kong, Bank of China lost 1.03% and HSBC Holdings added 0.64%. Property shares were mixed: Henderson Land Development Co Ltd (+0.33%), China Vanke Co Ltd (-0.10%), and China Resources Land Ltd (-0.24%).

In Japan, the yen weakened against the dollar. Auto stocks gained: Toyota Motor Corp (+0.06%), Honda Motor Co Ltd (+0.62%), and Nissan Motor Co Ltd (+0.31%). Technology shares also rose: Sony Corp (+1.53%), Toshiba Corp (+2.70%), Sharp Corp (+0.29%), and Panasonic Corp (+0.51%). Bank shares followed suit: Mitsubishi UFJ Financial Group Inc (+1.98%), Sumitomo Mitsui Financial Group (+0.74%), and Mizuho Financial Group Inc (+1.33%).

In Australia, mining shares broadly advanced: Fortescue Metals Group Ltd (+0.30%), Newcrest Mining Ltd (-0.37%), BHP Billiton Ltd (+3.30%), and Rio Tinto Ltd (+3.52%). Bank shares rallied: Westpac Banking Corp (+1.03%), Commonwealth Bank of Australia (+1.27%), ANZ Bank (+1.00%), and National Australia Bank Ltd (+1.06%).

Important Economic Indicators/Events (with Consensus estimates):

Japan

- Nikkei Services PMI (12:30am EST): -/51.9
- Nikkei Composite PMI (12:30am EST): -/52.3
- Consumer Confidence Index (5:00am EST): 43.5/43.2

China

- Caixin Composite PMI (1:45am EST): -/52.2
- Caixin Services PMI (1:45am EST): -/53.1

European Markets

European markets were mixed on Thursday following a slew of economic and corporate earnings reports. (FTSE -0.01%, DAX -0.06%, CAC 40 +0.06%). On the economic front, Eurozone annual flash inflation increased by 2% in February compared to 1.8% in January. In corporate news, Anheuser-Busch InBev SA/NV (-2.50%) reported earnings below expectations. Adecco Group AG (-2.89%) beat fourth quarter earnings forecasts. In Germany, Deutsche Bank and Commerzbank dropped 0.82% and 0.17%. Auto shares gained: Volkswagen (+0.35%), BMW (+0.59%), and Daimler (+0.07%). In France, Engie SA (+8.24%) posted a drop in full-year operating profit. Bank shares advanced: BNP Paribas (+0.14%), Credit Agricole (+0.42%), and Societe Generale (+0.33%).

In the U.K., Travis Perkins PLC (-6.13%) reported a 67% fall in pretax profit. Melrose Industries PLC (+10.53%) reported full-year revenue above estimates. Bank shares mostly rose: HSBC Holdings PLC (+0.24%), Barclays PLC (-1.46%), Lloyds Banking Group PLC (+0.10%), and Royal Bank of Scotland Group PLC (+0.45%). Energy shares followed suit: BP PLC (+0.05%), Royal Dutch Shell PLC (+2.36%), and Tullow Oil PLC (-0.26%). Mining shares retreated: Anglo American PLC (-2.52%), BHP Billiton (-0.55%), and Rio Tinto PLC (-1.51%).

Important Economic Indicators/Events (with Consensus estimates):

Eurozone

- Retail Sales y/y (10:00am EST): 1.5%/1.1%

Germany

- Retail Sales y/y (7:00am EST): 0.7%/-1.1%

Great Britain

- Markit/CIPS Services PMI (9:30am EST): 54/54.5
- Markit/CIPS Composite PMI (9:30am EST): 55.6/55.5

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Additional Reading (Online Blog and News Stories)

(Please click on the titles below to view the links)

CBS News

Legendary Music Executive Tommy Mottola Talks "A Bronx Tale"

A Wealth Of Common Sense

Video: Mark Cuban Talks To The Young Investors Society

Ed Thorp's Advice On How To Live A Good Life

The Capital Spectator

Total returns: Major Asset Classes | February 2017 | Performance Review

The Irrelevant Investor

New study: Can You Predict Bubbles?

Impact of hedge fund fees on returns: Two Point Seven Five & Twenty-Seven

The Reformed Broker

S&P 500: Longest Streak In 53 Years

Stats on revenues and users: Snap vs Facebook vs Twitter Cheatsheet

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