Views From The Heartland

Investment Perspective of Buena Vista Investment Management

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HOW HEALTHY IS THIS AGING BULL MARKET?

A correction would not necessarily signal an end to this bull market

For all of us, as we get into our later years, we need to be more aware of our health. For example, we need to have our blood pressure and cholesterol checked more regularly. And, depending on the numbers, we may need to make adjustments in our eating or exercise habits. Well, now that this bull market is 67 months old, we think it’s appropriate to check some of its vital signs as well. So, we decided to run some tests to get a better gauge as to how healthy this market is. For the purpose of this analysis, the market will mean the S&P 500.

In looking at the health of any market, valuation is always a good place to start. The most basic measurement of valuation is the Price to Earnings ratio (PE). However, there are many different approaches to measuring PE. Some approaches are based on future corporate earnings while others look at historic earnings data.

One way to look at historical valuation is to use 5-year normalized earnings. This “smoothing” mechanism aims to create a more accurate picture of the PE multiple by averaging 4 and one half years of historical earnings and two quarters of estimated future earnings. Using this approach the market is currently valued at 21.2 times. According to the Leuthold Group, this puts the current market valuation at a level higher than 70% of the readings since 1957.

Still another historical approach is the Cyclically-Adjusted-Price to Earnings Ratio (CAPE). This approach looks at 10 years earnings and then applies a formula developed by Dr. Robert Shiller of Harvard. The current CAPE reading is 26.3. The 25 year average for this indicator is 25.2.

Finally, the most basic, and probably most referenced valuation measure, is the 1 year forward and/or trailing PE on the S&P 500. Currently, the estimated 1 year *forward* PE is 15.6. This compares to the 25 year average of 15.5. Looking back, the one year *trailing* PE is 19.7 versus the historical average of 17.

None of these approaches are perfect in assessing whether the market is unhealthy (overvalued) or healthy (undervalued). However, none of these 4 approaches indicates that the market is undervalued and this means that the upcoming earnings season and future economic activity will be extremely important as to determining the future direction of the stock market.

With respect to future economic activity, the Conference Board Leading Economic Index (LEI) can also help assess the future of economic growth and corporate earnings. The LEI was developed in the 1960s and is comprised of 10 economic and market statistics. The LEI for the U.S. increased 0.2 percent in August to 103.8 (2004 = 100), following a 1.1 percent increase in July, and a 0.7 percent increase in June. It is rare for a bull market to end with the LEI going up.

(OVER)

DOES THIS “BULL” MARKET STILL HAVE LEGS? (Continued)

Another way of determining the health of this market is to look at market breadth. In this approach we are looking at the ratio of advancing S&P stocks to declining S&P 500 stocks. Historically, you will see breadth begin to deteriorate before the end of a bull market.

Currently this bull market is displaying one of the strongest advances in breadth in over 40 years according to InvesTech Research. The chart to the left illustrates where we are in terms of breadth with the data going back to 1990.

The level of IPO (initial public offering) activity can also shed light on the health of a bull market. Increased IPO or speculative activity can sometimes signal the end of a bull market. Currently, the IPO market is the highest it’s been since 2000. In the first half of this year, 147 companies went public and 29 more have gone public in the 3rd quarter, for a total raise of $27.4 billion year to date, not including the $21.8 billion Alibaba deal. Things are different today, in terms of market valuation and the type of IPOs being listed versus 2000, however, it makes sense to keep an eye on a very hot IPO market.

And lastly, let’s look at the age of this market. Just like people, bull markets don’t live forever. The average age of a bull market since 1956 is 48 months. That puts this market well above average. <u>However, the longest bull market, which spanned most of the 1990s, lasted 118 months</u>. Although this market is older than most, there is recent history that shows bull markets can last much longer than 67 months. We believe that this may directly relate to the evolution of a larger global market.

So, after checking the vital signs of this market, how healthy is it? The various signs we checked would indicate that this bull market is still relatively healthy. However, keep in mind we have not had even a 10 percent correction since June, 2012. We could see that type of correction in the coming weeks or months, although that is not the same as seeing the end of this bull market. To borrow a quote from Mark Twain, who upon being told of his obituary in the New York Journal, replied, “the news of my death has been greatly exaggerated”. In other words, this bull market is not dead yet, and could live on for some time.

For additional supporting data on this newsletter please see the “communications” section of the Buena Vista Investment Management website

BUENA VISTA INVESTMENT MANAGEMENT LLC

<u>LONG-TERM MARKET INDICATORS</u>

Buena Vista Conservative Buy/Sell Discipline:	Bullish (turned positive 1-2012)
Leuthold Major Trend Index:	Neutral (turned neutral 8-2014)
InvesTech Negative Leadership Composite:	Neutral (turned neutral 10-2014)
S&P 500 Stock Index:	1,927.29 (4.27% thru 09-30-14)
Dow Jones Total Market Index:	21,233.90 (5.39% thru 09-30-14)

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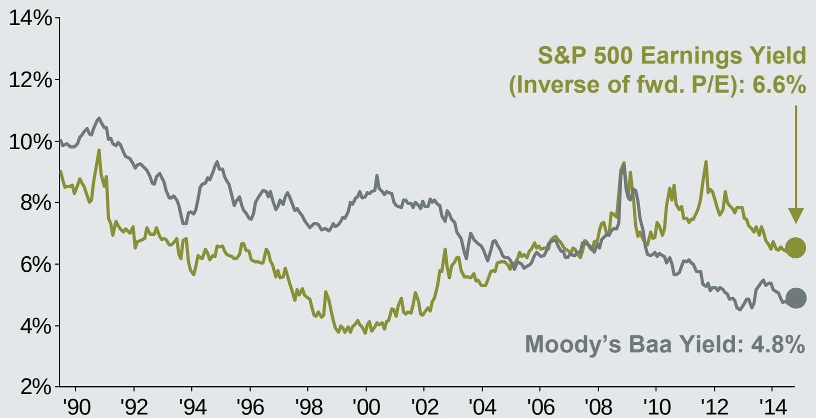
Stock Valuation Measures: S&P 500 Index

U.S. Equity: Valuation Measures			Historical Averages			
Valuation Measure	**Description**	**Latest**	**1-year ago**	**5-year avg.**	**10-year avg.**	**25-year avg.***
P/E	Price to Earnings	15.2x	14.2x	13.4x	13.8x	15.6x
CAPE	Shiller's P/E	26.3	25.0	22.1	22.9	25.2
Div. Yield	Dividend Yield	1.9%	2.0%	2.0%	2.0%	2.1%
REY	Real Earnings Yield	3.8%	3.7%	4.2%	3.2%	2.2%
P/B	Price to Book	2.8	2.6	2.3	2.4	2.9
P/CF	Price to Cash Flow	10.8	10.6	9.2	9.7	11.3
EY Spread	EY Minus Baa Yield	1.8%	1.5%	2.1%	1.2%	-0.7%

S&P 500 Index: Forward P/E Ratio

S&P 500 Earnings Yield vs. Baa Bond Yield

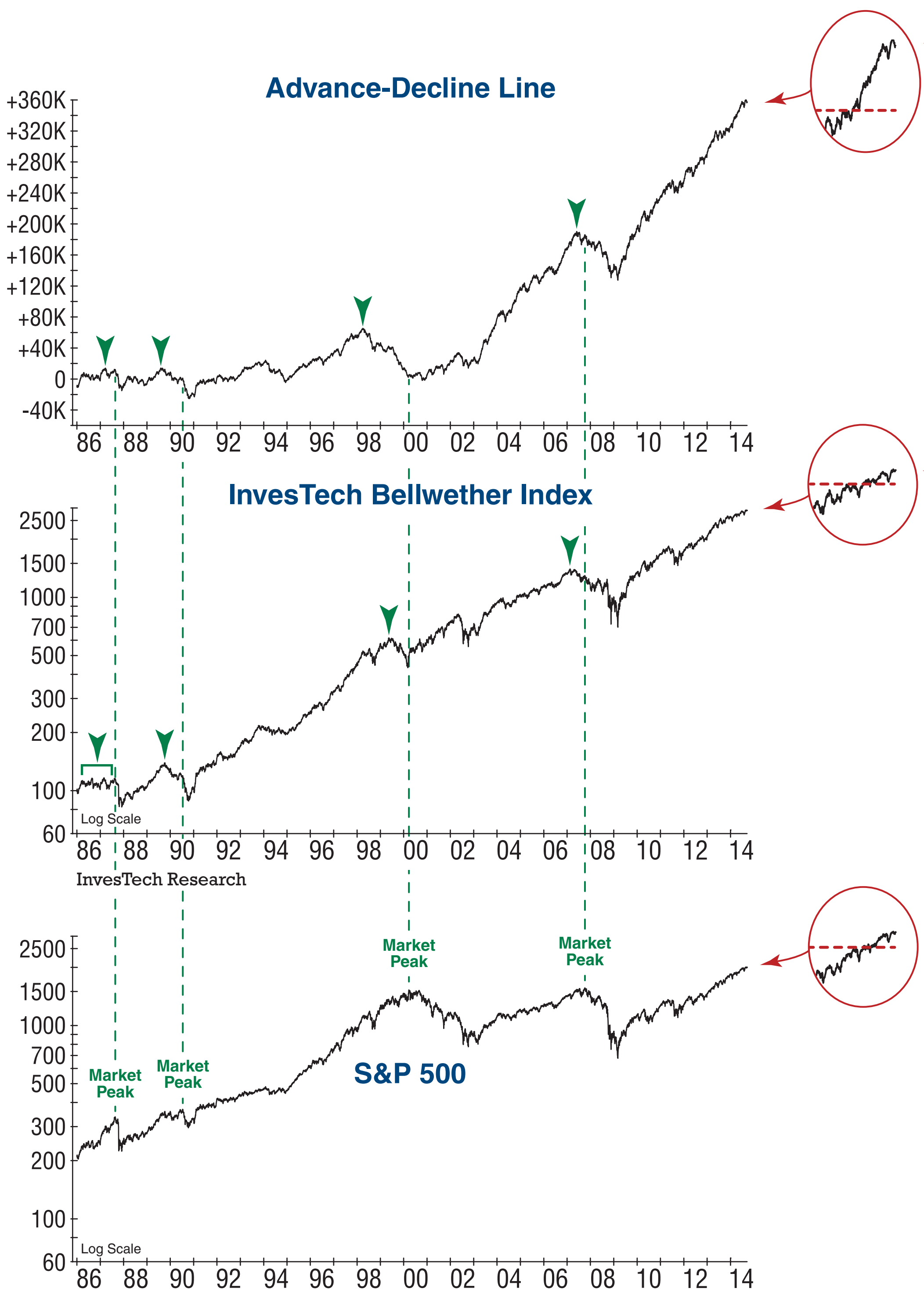


Source: Standard & Poor's, FactSet, Robert Shiller Data, FRB, J.P. Morgan Asset Management. Price to Earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months. Shiller's P/E uses trailing 10-years of inflation adjusted earnings as reported by companies. Dividend Yield is calculated as the trailing 12-month average dividend divided by price. Price/Earnings to Growth Ratio is calculated as NTM P/E divided by NTM earnings growth. Price to Book Ratio is the price divided by book value per share. Price to Cash Flow is price divided by NTM cash flow. EY Minus Baa Yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. *P/CF is a 20-year avg. due to cash flow data availability.

Breadth & Bellwethers: No divergence in sight…

Historically, a divergence in breadth (participation) and economically-sensitive bellwether stocks is one of the most prominent and reliable warning flags of a potential market top. And even with the latest rally to new highs in blue chip indexes, there are no signs of trouble in these two technical gauges.

The current bull market has displayed one of the strongest and longest advances in market breadth (A-D Line) in over 40 years. And judging by the size of positive breakout in this latest advance, market breadth is suggesting this coming quarter might be even stronger than expected in the 4th quarter of a mid-term election year.



Bellwethers, too, are confirming a breakout to new highs in the blue chip DJIA, S&P 500, and in the Nasdaq Index. So this tool also seems to give the market a "green light" for the rest of the year.