2018 picked up right where 2017 left off. The global stock markets jumped to new highs in January with the S&P 500 gaining over 7% in only a few weeks. Unfortunately, the gains were short lived as the S&P 500 Volatility Index, often referred to as the "VIX", spiked and the equity markets began a correction on January 26th leaving most equity indexes slightly below where they began the year at quarter-end. This broke a streak of nine positive quarters for the S&P 500 and was only the second negative quarterly return in the past five years. The correction also marked a significant departure from one the lowest volatility periods in market history. Only adding to investor frustration in early 2018, interest rates moved higher triggering most bond indexes to trend lower during the quarter.

Despite the recent increase in volatility, we continue to favor a diversified mix of equity exposure relative to fixed income and other interest rate sensitive investments. Based on the fundamentals a compelling case can be made for the equity markets over the next twelve to twenty-four months. As I write this commentary the S&P 500 currently trades around the 2600 level putting the price to earnings (P/E) multiple at around 21x times trailing twelve months actual earnings. It's hard to argue that 21x times earnings is inexpensive compared to a historical average closer to 15x. However, this does not account for anticipated growth over the next few years and interest rates that are still historically low. Due in large part to improving global economic conditions and the recent corporate tax cuts in the U.S., Wall Street strategists have continued to raise "bottom-up" earnings estimates for 2018. Bloomberg reports consensus estimates now call for approximately $161 in earnings over the next 12 months. Incorporating these estimates into the analysis shifts the P/E from 21x trailing earnings to approximately 16x future earnings. These levels are still not "cheap" by historical standards, yet they are certainly more palatable.

Let's assume interest rates continue to creep higher and concerns regarding policy uncertainty in Washington D.C. bring the market multiple down from 21x to 18x. When applied to next twelve months estimated earnings of $161, the math suggests that the S&P 500 could climb to around 2900. This represents a 300-point increase or a gain of approximately 10-12% from current levels, even after allowing for a certain amount of P/E compression. Furthermore, consensus estimates call for S&P earnings to grow by another 7% the following year to approximately $172. The quick math of an 18 multiple on $172 earnings would hypothetically put the S&P 500 at close to 3100 two years from now.

We recognize that our analysis is fairly simplified and that P/E ratios, historical averages and Wall Street estimates leave plenty of room for "error." However, behavioral finance has shown that collective estimates and market forces are often better predictors than any individual alone. We accept that there is close to zero chance that exactly twelve months from today the S&P 500 will be precisely at 2900. Yet we are fairly confident that earnings will be above current levels and that even at lower valuations there appears to be upside to the equity markets. Equities also remain attractive on a relative basis. One way to compare the valuations of stocks versus bonds is to take the earnings yield of the S&P 500 and compare it to the 10-year Treasury. The earnings yield is simply the inverse of the P/E ratio. Using the current 21x P/E equates to an earnings yield of approximately 4.8% compared to current 10-year Treasury yield at 2.8%. An expectation of ongoing tightening by the Federal Open Markets Committee and rising market interest rates (which weigh on bond prices) only furthers the case for equity exposure.

During the first quarter volatility moved to the front of investors' minds following several years of markets that seemingly only went up. We expect the return of even historically average levels of volatility to have outsized influence on the risk tolerance of investors. With this in mind our approach to portfolio construction has shifted in part from the "level of returns" to the "expected path of returns" over the next few years. As such, we are increasingly evaluating how to provide the "smoothest" path to our clients' target returns in what we expect will be an increasingly less certain market environment.