



THE P/E SUMMARY: PERIODIC SUPPLEMENT TO THE P/E REPORT

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NOTE: This report provides intra-year updates to key tables and graphs from The P/E Report, Crestmont's annual review of P/E, earnings, and related outlooks.

AS OF: SEP 30, 2018	<u>REPORTED</u>	<u>ADJUSTED¹</u>	<u>CRESTMONT²</u>
"P" Closing Price (S&P 500 Index) ³	2914	2914	2914
"E" Current Estimate (S&P 500 EPS) ⁴	\$131	\$90	\$86
P/E Price/Earnings Ratio ⁵	22.3	32.3	33.9

Notes:
(1) adjusted using the methodology popularized by Robert Shiller (Yale; Irrational Exuberance), as modified for quarterly data
(2) based upon historical relationship of EPS and GDP as described in chapters 5 & 7 of Probable Outcomes and chapter 7 of Unexpected Returns; useful for predicting future business cycle-adjusted EPS
(3) S&P 500 Index is the value at the date listed in the table
(4) 'Reported' is based upon actual net income for the past year (trailing four quarters); 'Adjusted' is an inflation-adjusted multi-year average; 'Crestmont' see note 2
(5) P divided by E

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CURRENT STATUS (Third Quarter 2018)

In the third quarter, the stock market surged 7.2%. As a result, normalized P/E increased to 33.9—significantly above the level justified by low inflation and low interest rates. The current status remains “significantly overvalued.” Note that stock market valuation is in a zone of exuberance such that each higher level (or slight decline) is equally “high.”

The level of volatility rose modestly during the past quarter. The period of record-low volatility during 2017 may be over. High valuation and low volatility were a risky combination for the market; high valuation and rising volatility may indicate a correction in the near future.

Note: The comments provided above about the current status of market valuation do not incorporate the concepts discussed in the new article titled The Big Shift [see Featured Items at CrestmontResearch.com]. Until the likelihood of such secular realignment can be validated, this report and its conclusions will be based upon historical relationships and data.

Figure 6. Stock Market Gain/Loss To Low Inflation P/E Levels

AS OF: SEP 30, 2018			<u>CRESTMONT²</u>
“P”	Closing Price (S&P 500 Index) ³		2914
“E”	Current Estimate (S&P 500 EPS) ⁴		\$86
P/E	Price/Earnings Ratio ⁵		33.9
		<u>P/E</u>	<u>EPS</u>
	<u>3-Year Restoration (3Q2021)</u>	22.5	
	Projected Normalized EPS ²		\$97
	Implied S&P 500 Index		2175
	Annual Compounded Gain		-9.3%
	<u>5-Year Restoration (3Q2023)</u>	22.5	
	Projected Normalized EPS ²		\$105
	Implied S&P 500 Index		2355
	Annual Compounded Gain		-4.2%
<i>Notes 1-5: see footnotes in Figure 1</i>			
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Figure 7. Crestmont Research Outlook (S&P 500 Total Return)

AS OF: SEP 30, 2018	TOTAL ANNUALIZED RETURN FOR S&P 500 <i>(nominal returns)</i>		
	Ending P/E Ratio (P/E10)		
<u>YEARS</u>	<u>10</u>	<u>15</u>	<u>22.5</u>
5	-17.6%	-10.9%	-3.5%
7	-11.5%	-6.3%	-0.9%
10	-6.9%	-3.2%	0.8%
20	-0.7%	1.3%	3.4%
<i>Notes 1-5: see footnotes in Figure 1; also, includes dividend yield of 2%</i>			
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CONCLUSION

Today's P/E is 33.9; the stock market remains in secular bear market territory—clearly above the mid-range of fair value assuming a relatively low inflation and low interest rate environment. It is historically consistent for secular bear markets to present shorter-term periods of strong returns (*cyclical* bull markets) followed by periods of market declines (*cyclical* bear markets).

The only way to reposition into a secular bull market is to experience a decline in the stock market due to significant inflation or deflation. This can occur either by a significant decline over a short period of time (e.g. the early 1930s secular bear market) or by minimal decline over a longer period of time (e.g. the 1960s-1970s secular bear market).

This summary assesses the current valuation level in the context of the longer-term market environment. The goal is to help investors and market spectators to assess more quickly the current conditions.

In this environment, as described in chapter 10 of *Unexpected Returns*, investors should take a more active “rowing” approach (i.e. diversified, actively managed investment portfolio) rather than the secular bull market “sailing” approach (i.e. passive, buy-and-hold investment portfolio over-weighted in stocks).

Ed Easterling is the author of Probable Outcomes: Secular Stock Market Insights and the award-winning Unexpected Returns: Understanding Secular Stock Market Cycles. He is currently president of an investment management and research firm. In addition, he previously served as an adjunct professor and taught the course on alternative investments and hedge funds for MBA students at SMU in Dallas, Texas. Mr. Easterling publishes provocative research and graphical analyses on the financial markets at www.CrestmontResearch.com.