Wall Street Journal **This Market's Running on Hope, Not Profits**

Investors are citing strong earnings as the reason for this year's rise in stocks. But their bull case is hard to justify

By James Mackintosh Updated Oct. 12, 2017 3:39 p.m. ET

Believers in the bull market have been making a one-word case for why this year's rise in stocks is justified: earnings. With profits on a roll and the world economy in synchronized growth mode, what's not to like?

As the earnings season gets into full swing, analysts are predicting another great set of profit figures. Hurricane effects make the consensus forecast of 5.5% year-over-year growth for the S&P 500 even less certain than usual, but there's no doubt that this year companies have delivered.

The trouble is how investors have reacted. The market is expensive on virtually every measure, which could be justified by strong earnings growth in the future. But when those earnings come through, the market ought to get less expensive. Instead, it's become even pricier, meaning still-faster growth in profits is anticipated. The bull case is even harder to justify.

The simplest way to look at this is to break down price changes into changes in earnings and in valuation. So long as stock prices rise by less than earnings, the valuation, or price-to-earnings ratio, comes down.

The PE ratio can be measured in many ways, but at the moment the two most popular gauges—the price-to-forward operating earnings and the cyclically adjusted PE ratio, or CAPE—have rarely been higher.

In the past, such high valuations were often followed by disappointment for investors, because earnings didn't come through to justify them. There is a good and a bad way for a high PE ratio to drop back down to more normal levels. The bad way is that prices fall, which hurts. The good way is that earnings rise by more than share prices, and the market grows into its valuation.

An extreme example of a company growing into its valuation is Apple. At the top of the dot-com bubble in 2000, Apple's shares traded at 34 times its (paltry) earnings. It now trades at less than 18 times trailing earnings and only 14 times estimates for the next 12 months, according to Thomson Reuters.

Apple has, of course, been a fabulous investment despite the lower valuation, because earnings grew 50-fold in the past 17 years, allowing the stock price to soar even as the PE ratio came down.

Unfortunately for the bulls, this year hasn't been a case of companies growing into their valuations. It hasn't even been a case of forecast earnings going up fast enough that companies might soon grow into their earnings. In fact, it's been the opposite—at least among the S&P 500.

Only 78 companies out of the 490 for which FactSet has comparable estimates grew toward their valuation this year, increasing earnings while their shares rose more slowly. That's almost as many as the 70 where valuations dropped in a way shareholders hate, with shares falling as earnings estimates rose.

The result is troubling. Even as estimated earnings for the next 12 months went up, the market went up more, pushing the S&P's forward PE ratio from 17.2 to 18. Investors became evermore optimistic, meaning an even bigger rise in earnings is needed in the future to avoid disappointment.

The result is that many valuation gauges are flashing red. Strategist Peter Oppenheimer atGoldman Sachs calculates that the median stock is in the top 1%-3% of historical valuations when measured by the price to book, forward PE ratio, total company value to sales or to operating income, and the PE-to-growth ratio.

Weighted by market value, the forward PE ratio—with a history back to the 1970s—has been higher only once since the dot-com bubble burst, while the historical CAPE compiled by Yale Professor Robert Shiller was higher only in 1929 and the dot-com bubble.

This can still work out. A stronger global economy, weaker dollar and low interest rates might mean earnings will accelerate enough to bring down valuations even as share prices rise a little more.

But this is different from the claim that rising earnings justify this year's stock gains.

Consider the technology and telecom sectors. Tech has been reporting big gains in profits and analysts have upgraded their earnings forecasts by more than any other sector, while telecom companies are struggling with a price war and are in the only sector where earnings estimates have dropped this year.

On the face of it, this explains why tech has been the best-performing sector in 2017 and telecom the worst. But shareholders didn't just project the higher earnings of tech into the future, they pushed up the forward PE ratio by about a 10th. Investors assume not just that earnings will be higher, but that earnings will accelerate.

The opposite happened to telecom: Predicted earnings fell, and the forward PE ratio dropped, making it the cheapest S&P 500 sector. Investors expect future earnings not just to be lower, but to fall even faster than they previously thought.

Again, both decisions might be proved right, and it's normal for investors to project the recent past into the distant future. Jonathan Golub, Credit Suisse 's chief U.S. equity strategist, says shareholders typically push up valuations even in the late stages of an economic expansion, and PE ratios come down on average only when recession hits and the market falls.

But the fact that this year's earnings provide a good explanation of what's happened to stock prices doesn't mean they're a good justification. And it certainly doesn't mean investors should sleep easy owning one of the most expensive markets in history.

Corrections & Amplifications
An earlier version of this article incorrectly included charts that showed the S&P 500 12-month forward price-to-earnings ratio in dollar figures, not multiples. The chart has been corrected and replaced

Note: graphics and displays, all missing here, are available in the print edition of the Wall Street Journal, 13 October 2017, at p. B-1/B-10, "Streetwise, A Case for the Bulls Is Hard to Warrant," on at www.WSJ.com, "This Market's Running on Hope, Not Profits"