Topics: the re-pricing of secular growth stocks and US equity market valuations

We showed the table below in the introduction to the 2014 Outlook. For those looking for a thumbnail sketch of the view, it showed how we expected 2014 to mark a return to a more "traditional" environment with more modest equity returns and higher volatility.

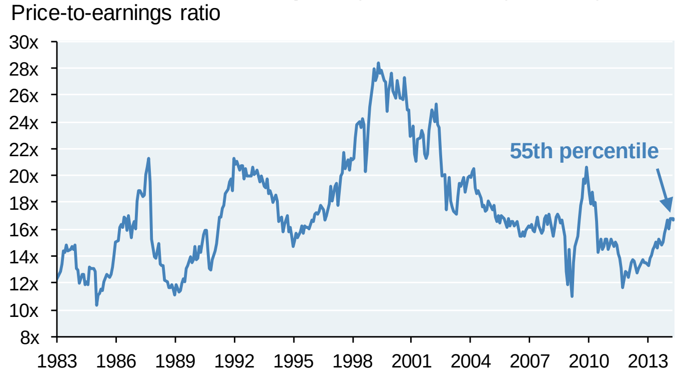
We expect 2014 to mark a return to more traditional risk/return relationships

Time period	Annualized Return	Annualized Volatility
Post Bretton Woods to pre-crisis 10/1972 to 05/2008	10.9%	16.0%
Financial crisis 05/2008 to 03/2009	-53.0%	48.0%
Volatile, high-return post-crisis recovery 03/2009 to 12/2011	22.9%	21.4%
Easy money spreads to ECB, BoJ 12/2011 to 11/2013	23.1%	12.1%

Source: Bloomberg - S&P 500 Index. November 2013.
Past performance is no guarantee of future results.

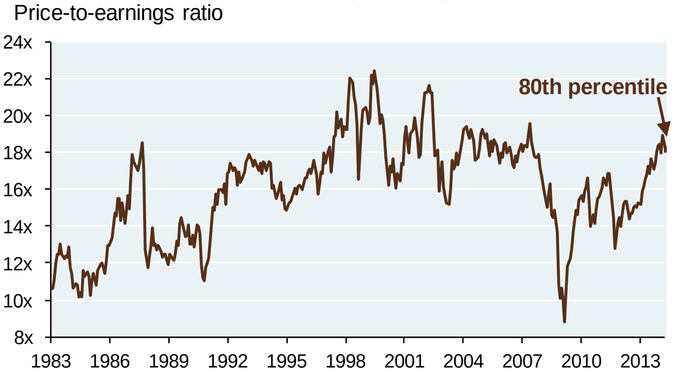
What was the basis for this view? A look at three valuation approaches on US equities explains it. The first chart below is a traditional measure of the price paid for trailing earnings on the S&P 500. Each stock is market cap-weighted, so that the larger stocks have more of an impact on the outcome. In the late 1990's, many large companies traded at a huge premium, while today many large companies trade more cheaply. As a result, this valuation approach ends up with current P/E multiples around average (55th percentile) when looking at the data since the early 1980's. We could start the analysis in the early 1960's, and the current percentile ranking would be almost identical: the very high P/Es of the 1960's offset the very low P/E's of the inflationary 1970's.

S&P 500 P/Es: Market-cap weighted, trailing earnings
Price-to-earnings ratio



Source: Deutsche Bank, J.P. Morgan Asset Management. April 7, 2014.

S&P 500 P/Es: Median, trailing earnings
Price-to-earnings ratio

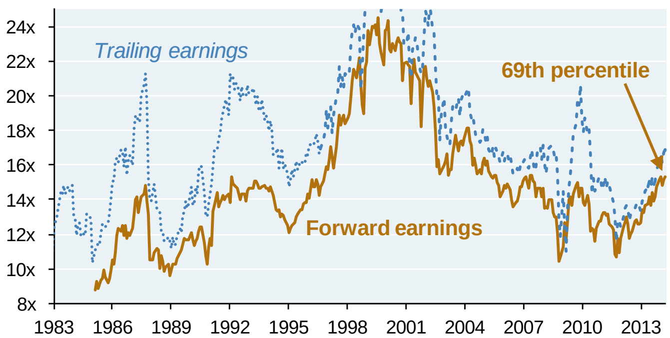


Source: Deutsche Bank, J.P. Morgan Asset Management. April 7, 2014.

However, if we were to look at the P/E multiple of the *median* stock, the US equity market looks more expensive, with current valuations at the 80th percentile of observations since 1983. This approach is shown in the second chart and weights each company in the S&P 500 equally. Both charts above look at current stock prices relative to trailing, realized operating earnings of the S&P 500.

A third approach looks at market valuations relative to earnings expectations over the next year, rather than versus trailing earnings. The logic: if earnings are growing quickly, it might make sense to pay a high multiple versus trailing earnings since companies will grow into their valuations. That was the case in the early 1990's, when earnings were growing at 22% per year: multiples of 20x on a trailing basis were 14x on a forward-looking basis. Today, we do not have the same gap since earnings are not growing as quickly. This particular chart is an exercise in interpretive dance: the current percentile is 69%, but conceptually, the current forward P/E multiple of 15.5x was only higher during the tech boom of the late 1990's. [*See box for comments on the Shiller model*].

S&P 500 P/Es: Market-cap weighted, forward earnings
Price-to-earnings ratio



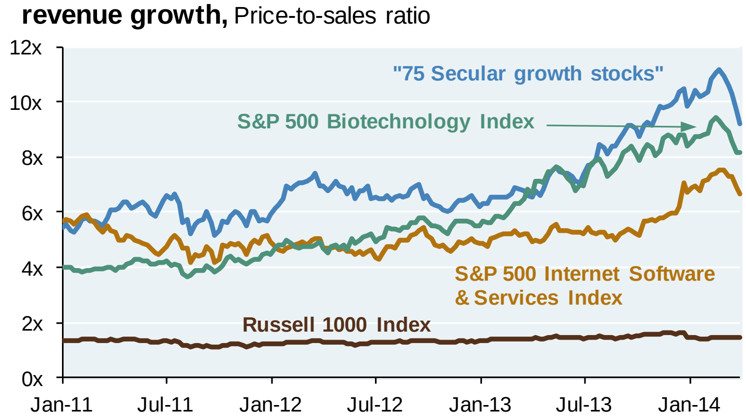
Source: Deutsche Bank, J.P. Morgan Asset Management. April 7, 2014.

What about the Shiller equity valuation model?
I have reservations about the Shiller model which uses 10 years of trailing reported earnings. Doing so at the current time inherently assumes that the mayhem of the financial crisis, when S&P reported earnings fell by 70% on a two-year basis and almost to zero in 2008, is a repeatable occurrence. The chart on page 4 shows earnings draw-downs since 1873. I am not going out on a limb very far to say that I don't think 2008 will be repeated, particularly given the compositional shift in the S&P since 2000 (240 of the 500 companies in the S&P have since changed). We first wrote about this in the Eye on the Market in May 2012; anyone religiously adhering to the Shiller model would have been massively underweight equities since then.

So, that explains the view of 8-10% returns based on earnings growth rather than another year of P/E multiple expansion. This backdrop helps explain as well what happened to high-flying growth stocks over the last month or so, which we review below.

Starting in January 2013, investors bid up the price of "secular growth" stocks, a category referring to stocks whose revenues are expected to perform well irrespective of economic conditions. The price-to-sales ratio of 75 stocks in this category[1] are shown below vs. the Russell 1000 Index. This group includes a lot of internet stocks, some biotech and a handful of names in healthcare, retailing and other services. We also show the S&P Internet Software/Services and Biotech indexes as other points of comparison. By February 2014, price-to-sales on these secular growth stocks rose sharply compared to the market. Since then, many of these stocks have declined sharply, with S&P internet and biotech stock categories down 15%-30%.

Tracking the premium paid for expected consistent revenue growth, Price-to-sales ratio

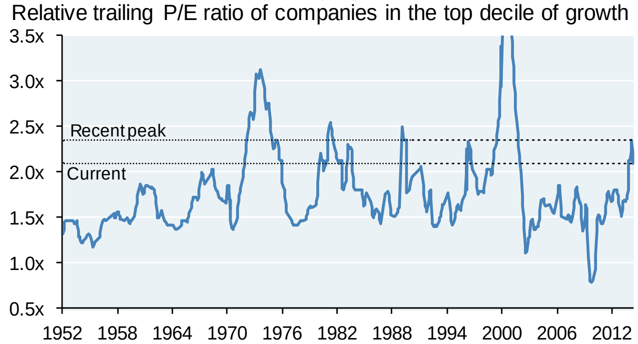


Source: Bloomberg. April 2014.

[1] The screening process from Empirical Research Partners incorporates actual and expected revenue growth, revenue stability, estimates of earnings quality, and the ability to fund future growth (return on earnings, and the earnings reinvestment rate).

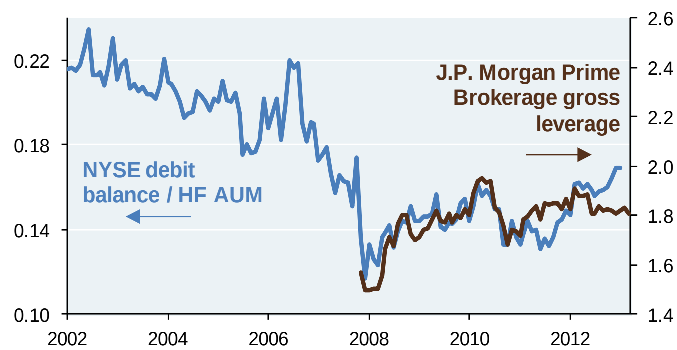
A similar analysis looks at the P/E multiple of these companies vs. the P/E of the market. As shown, the February 2014 peak was exceeded significantly only by the Nifty Fifty episode of the mid-1970's and the Tech bubble of the late 1990's. A simple conclusion one can draw is that around half of the premium paid for these stocks since January 2013 has been erased. This was clearly a crowded trade; Morgan Stanley reported this week that a basket of stocks consistent with hedge-fund overweights lagged a hedge fund underweight basket by 7.7% from March 20 through April 4. I don't think leverage played a dominant role here; as explained in our March 3rd Eye on the Market, data from J.P. Morgan's Prime Brokerage department (which tracks the cash equities gross leverage of the hedge funds it does business with) looks stable over the last couple of years.

Recent premium for secular growth stocks only exceeded by tech boom and Nifty Fifty episode of the 1970's
Relative trailing P/E ratio of companies in the top decile of growth



Source: Empirical Research, Corporate reports, NBER. April 2014.

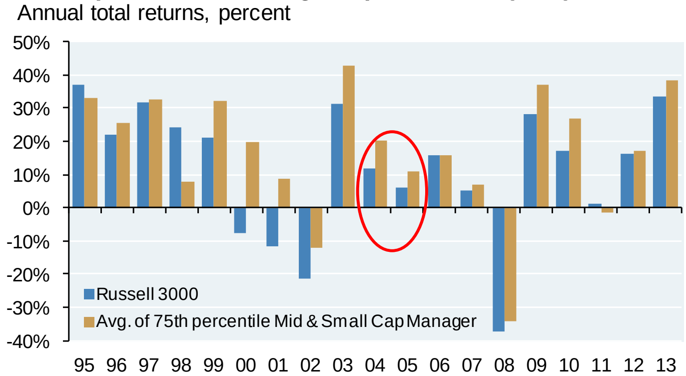
Two measures of hedge fund equity leverage
NYSE debit balance / HF AUM | JPMS Gross leverage



Source: Bloomberg, NYSE, J.P.Morgan Securities LLC. February 2014.

The economic data in the US has taken a positive turn recently (manufacturing surveys, vehicle sales, commercial and industrial loans, payrolls), but that's not a surprise as the impact of a cold winter wears off, and a lot of that news was expected already. **All things considered, this feels like a mid-cycle year**. The fact that many of the "old tech" companies rallied over the last month (HP, IBM, Cisco, Intel, Microsoft, Seagate and Corning) suggests that recent volatility is more about market leadership than anything else. Mid-cycle years are often characterized by positive but lower equity market returns and a greater frequency of interim corrections, increasing the importance of contributions from active managers. In the last chart, we show the contributions from top quartile small and mid-cap managers alongside the returns on the Russell 3000 Index. In 2004 and 2005, these contributions were meaningful in the context of overall portfolio returns. The contribution from median mid cap and small cap managers in 2004-2005 was positive as well.

The importance of manager alpha in mid-cycle years
Annual total returns, percent



Source: Lipper. 2013.

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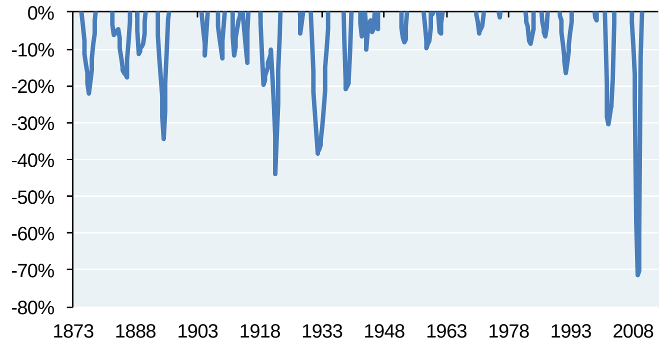
Additional chart:

S&P 500 reported earnings drawdowns
2-year percent change, annualized



Source: Robert J. Shiller, Standard & Poor's. 2013.

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