



S&P hits record high on 18 trailing PE, PE will be sensitive to Treasury yields

PE at post-crisis high on delayed Fed hike expectations, boosts S&P to record S&P grinds higher despite continued soft macro data on dovish central bank communications. S&P trades at 18x trailing 4-qtr EPS (2Q14-1Q15), the highest since 2010. Fed lowered its 2015-16 FF rate outlook in March and the April minutes dismiss the June hike. Market liftoff expectations are slipping to after Sept. ECB reiterates its asset purchase goals. Liftoff accompanied by Fed forecasts of a 2% plateau rate this cycle would pave the road for a S&P trailing PE of 18.5 at 2015 end and perhaps higher in later years if 10yr Treasury yields do not materially exceed 3%. But waiting too long to hike raises the risk of unit labor cost acceleration and a disorderly climb to higher 10yr yields.

Median stock PE remains high, PEs being above historic norms is broad based. Many metrics suggest S&P valuation is full and dependent on low bond yields. S&P's 18 trailing PE and 17.3 forward PE are 12% and 22% above the averages since 1960. The median trailing PE of all S&P stocks is 18.7, 2 full points higher than its historic average. The index is entering 1997-2000 valuations ex. Tech.

It's time to buy the Big & Low 25 stock basket again as Energy names fall out. The 25 stocks that most lower the S&P PE are attractive again. These stocks have big market cap and earnings weights and trade at low PEs vs. the S&P. These 25 stocks are: 9 Financials (JPM, C, WFC, BAC, GS, MET, PRU, AIG, COF), 8 Tech (AAPL, IBM, HPQ, CSCO, MU, QCOM, INTC, ORCL), 2 Airlines (AAL, DAL), 2 Telecom (VZ, T), 2 Autos (GM, F), 1 Health Care (GILD), and 1 Energy (VLO). The aggregate PE on 2015 EPS of these 25 stocks is 12 vs. 20x for the S&P excluding them. We see value at Telecom, but return it to EW from the OW set Jan end and put Media/Cable back to EW from UW. We OW HealthCare, Tech, Financials & Utilities. We UW Energy, Indus. & Materials.

Market complacency re-emerges in both cash equities and derivatives. Our PE/VIX market emotion indicator climbed to 1.3 on S&P trailing PE of 18 and 3m avg VIX of 14. A level between 1.2-1.5 signals complacency. There was similar complacency going into summer last year, with S&P trailing PE at 17.5 and a calm market kept VIX at 10-14. The complacency persisted to July but then faded as the risk of higher yields came on falling unemployment, but yields ultimately stayed subdued preventing any major summer sell-off. Yet a selloff began in late Sept as oil prices started cracking and the dollar climbing.

Risk of a near term 5%+ dip is high

We believe the probability of a 5%+ dip is high this summer and our tactical call remains Down given the S&P now at an even higher PE than a year ago, heightened uncertainty in 10yr yields, weak earnings growth and continued soft economic data. We haven't had a 5%+ dip this year. Historically 5%+ dips are common and happen at least once a year since 1960, except 1964, 1993 & 1995. It has been 916 trading days (3.6 years) since a 10% correction. Selloff triggers could be a further rise in 10yr yields especially if UE keeps falling amidst slow economic growth and Fed remains unclear on first hike timing, or a jump in the dollar upon the Fed expressing firm intentions to hike in Sept.

There is also the possibility of central banks competing to out-dove each other this summer, such that yields climb upon delayed Fed hikes (PE bad) & yet the dollar climbs too (EPS bad) as other central banks stay determined to keep their currencies weak vs. dollar. We know central banks want to be supportive of markets and confidence, but this has its risks now especially in the US.

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S&P 500 Key Forecasts

Price	2130.82		
Next 5%+ move	Down		
	2014	2015E	2016E
Year-end Target	2058.90	2150	2300
EPS	\$118	\$118	\$128
Target P/E	17.4x	18.2x	18.0x
Current P/E	18.1x	18.1x	16.6x
DPS	\$38.75	\$42	\$46

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