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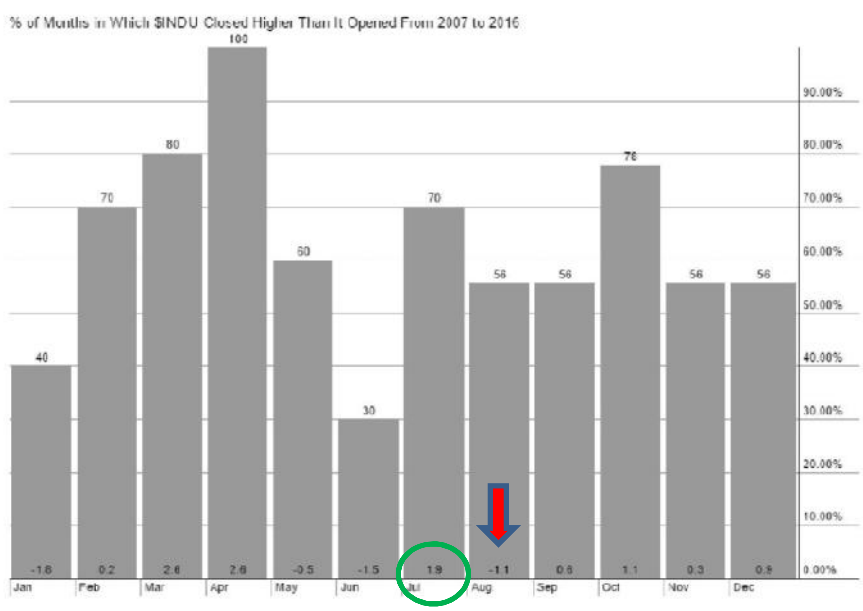
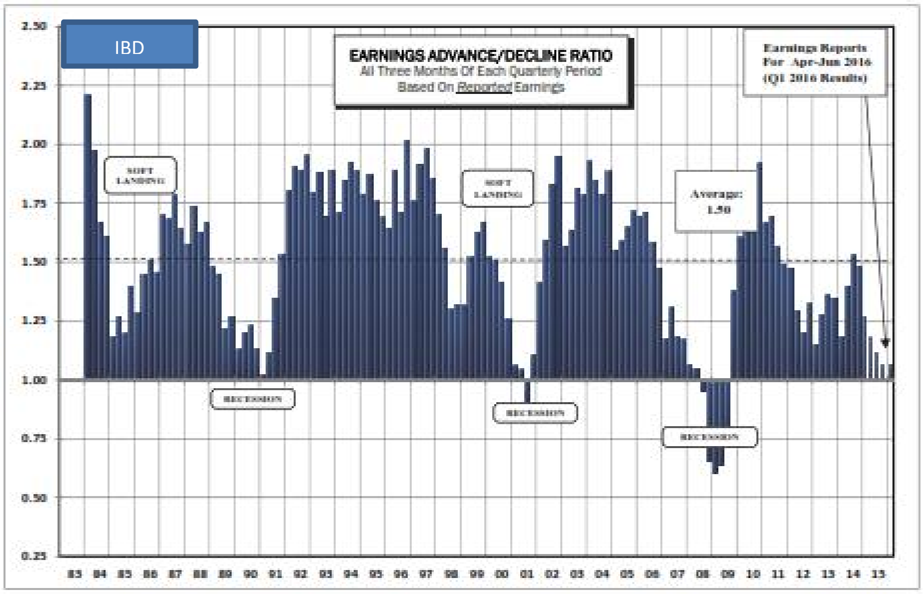
Archer 2016 Mid-Year Update and Outlook:

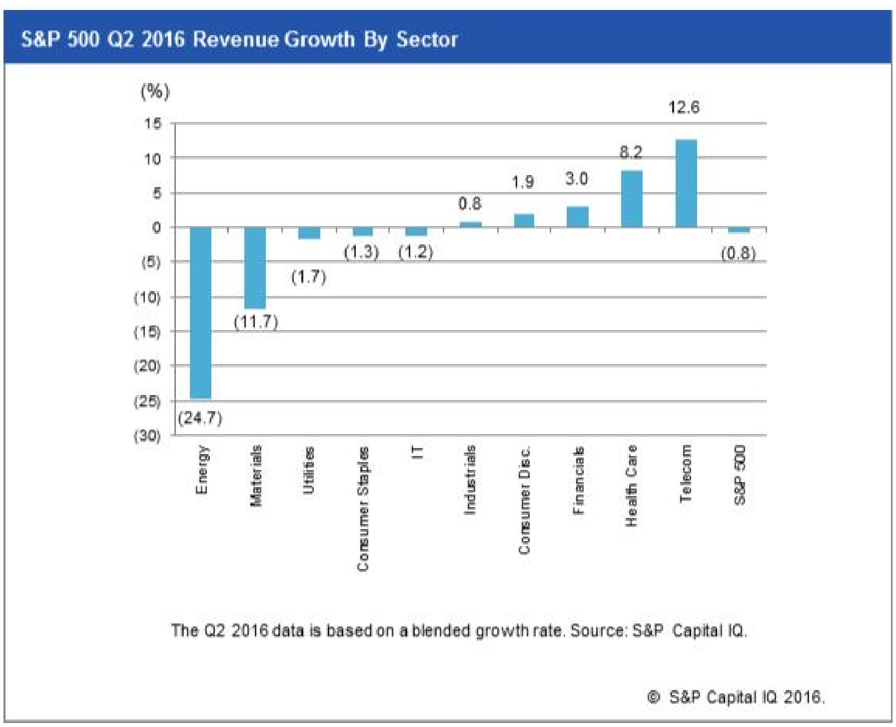
Where are the earnings driving this market higher? This is the question we pose for investors as we look out into the rest of 2016 and early 2017. So far in 2016, we have seen the market show some gains just after the BREXIT vote. The markets were scared to death of the unravelling of the European Union, now it seems as if it really does not matter. Trade will continue, companies will forge new ventures, etc.

The bears may have sharpened their claws, but they have still yet to use them. Even in the face of political uncertainty in the U.S., so many commentators on the idiot box have declared ruin to the stock markets. In spite of this and BREXIT, the market as of this writing has moved to new highs. Some of this can be traced to the seasonality of the stock market. In fact the chart below shows the month of July has increased 70% of the time over the last 10 years on average of 1.9%. However, August is followed up by an average drop of -1.1% and drops nearly half the time. This year may be no different. We will examine some additional charts later in this Update to show the valuations of the markets are fairly valued by all accounts but one or two. We will discuss those in more detail a bit later.



If you have sat on the sidelines like Carl Icahn and George Soros who have both shorted the market and bet against stocks, you may be licking your wounds here a bit. However, a 5% move in the market higher does not create a trend up. In fact, there is still plenty to be worried about, and only earnings will ultimately drive the market higher. In light of these anticipated earnings it is worth noting the market breadth of stocks advancing vs. declining suggests markets have plenty of momentum to move higher. However, we believe only earnings will accelerate the next leg of the bull market. Look at the next chart and you can see earnings have severely stalled and are indicating a slowdown in the market. Many will say this is just Energy related, however, the S&P 500 through the second quarter earnings releases have shown an overall -.8% decline in sales.





With the Year over Year earnings looking dismal, how can the market possibly move higher? Great question. If you look at the chart below we can see the market is overvalued by most accounts. Even Utilities which have been on a tear and ran up wildly are now trading at a trailing P/E of 22.3x vs a Median of 14.7 back to 1990. I highly doubt Utilities are growing at a 15-20% clip to keep these valuations for the near term. So why are utilities trading at a P/E high? Simple, interest rates are low, extremely low.

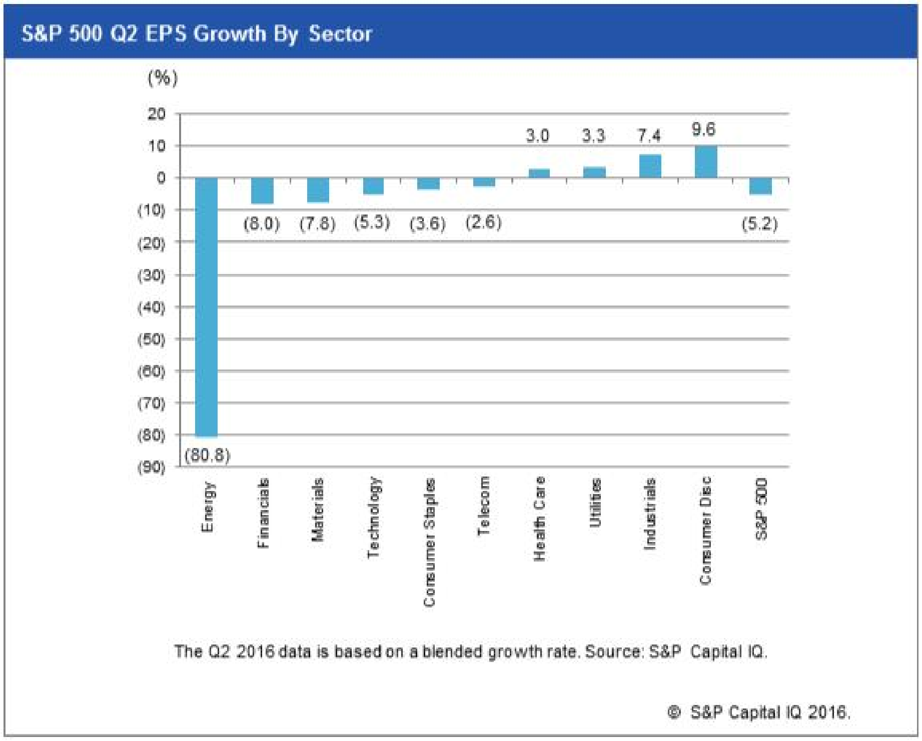
	S&P 500		
	5/31/2016	Median 1991-2016	% Rank
Price / Sales	1.88	1.47	90%
EV / Sales	2.20	2.05	58%
Price / EBITDA	10.9	7.3	100%
EV / EBITDA	12.7	10.5	90%
Price / Net Income	19.4	18.5	60%
EV / Net Income	22.8	27.8	25%
EBITDA / Sales	17.2%	19.3%	21%
Net Income / EBITDA	56.0%	36.2%	99%
EV / Market Cap	1.17	1.47	7%

S&P 500 data, calculated on a monthly basis, 1991 through May 31, 2016. Bloomberg data

Why would one metric be so high and yet another so low? EV (Enterprise Value) equals the level of debt a company holds + the Market Capitalization of a Company. EV has averaged roughly 50% higher than Market Cap over time. Today, stock prices have increased tremendously while the price of corporate debt has not risen nearly as fast. Further, this can be explained by the level of debt companies have taken on to their balance sheets (or the market value of that debt). Companies are cash rich and therefore have paid down debt, in turn making the company look much more enticing. In addition, as investors have been driven to purchase equities, especially those with some kind of dividend, the market values have grown of those companies and clearly the debt levels have not grown or kept up proportionately with the market capitalization of stocks.

Small Cap stocks look very similar, but the EV/Market Cap for small stocks is at an 83% rank which suggests they are overpriced historically. This is because Small Caps typically borrow more to keep up with their growth, however, they look a bit overpriced as well.

So as the very first chart showed as well as the following chart, earnings, which have stagnated, will be the next leg of this market if it is to move substantially higher. We need to see corporate profits grow. The main reason we have been so timid in our projections over the last couple of years is we have seen a vast slowing of profits and sales. Companies can only cut costs so much and then they need to drive an increase in sales to get more money to the bottom line. From this standpoint, we see the market finishing the year a few percent higher than it is currently somewhere in the 2200 area.


S&P 500 Q2 EPS Growth By Sector
(%)
20
10
0
(10)
(20)
(30)
(40)
(50)
(60)
(70)
(80)
(90)
(80.8)
(8.0)
(7.8)
(5.3)
(3.6)
(2.6)
3.0
3.3
7.4
9.6
(5.2)
Energy
Financials
Materials
Technology
Consumer Staples
Telecom
Health Care
Utilities
Industrials
Consumer Disc
S&P 500
The Q2 2016 data is based on a blended growth rate. Source: S&P Capital IQ.
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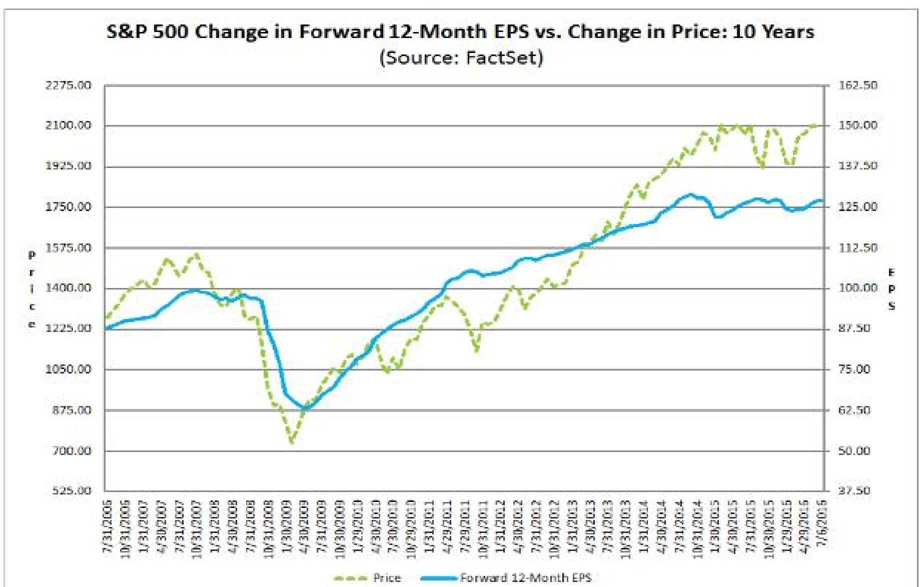
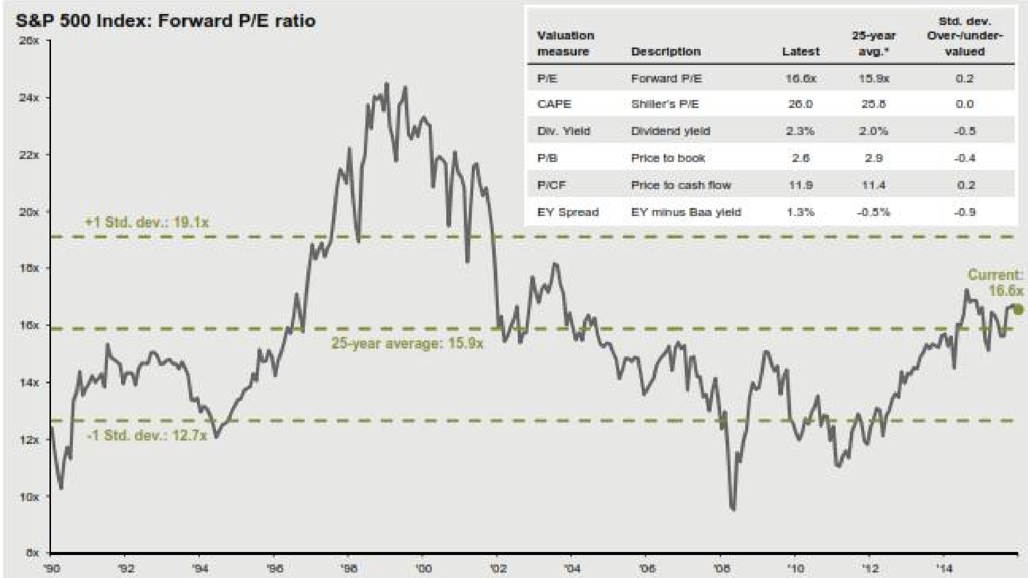

S&P 500 Change in Forward 12-Month EPS vs. Change in Price: 10 Years
(Source: FactSet)
2275.00
2100.00
1925.00
1750.00
1575.00
1400.00
1225.00
1050.00
875.00
700.00
525.00
Price
162.50
150.00
137.50
125.00
112.50
100.00
87.50
75.00
62.50
50.00
37.50
EPS
Price
Forward 12-Month EPS



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-valued
P/E	Forward P/E	16.6x	15.9x	0.2
CAPE	Shiller's P/E	26.0	25.6	0.0
Div. Yield	Dividend yield	2.3%	2.0%	-0.5
P/B	Price to book	2.6	2.9	-0.4
P/CF	Price to cash flow	11.9	11.4	0.2
EY Spread	EY minus Baa yield	1.3%	-0.5%	-0.9

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management.
Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-month consensus dividend divided by most recent price. Price to book ratio is the price divided by book value per share. Price to cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure. *P/CF is a 20-year average due to cash flow data availability.
Guide to the Markets – U.S. Data are as of June 30, 2016.

J.P.Morgan
Asset Management

Looking Ahead:

With the second quarter behind us and having declines in earnings and sales year-over-year in the S&P 500, many analysts have driven down expectations to very low levels. Oftentimes the market reacts based on expectations. With expectations so low it may just be easy to beat these lower levels and thus drive the market higher. Any increase from here in earnings should translate to a proportional increase in the market if we lived in a "perfect market world." Since we do not, we should expect the market to rise another 3% from this level into year-end. However, we anticipate some turbulence along the way.

There is another way for the market to rise higher and by this standard, much higher. If central banks continue to "print money", it could cause inflation and in this market, a little inflation is not a bad thing. This could potentially move the market much higher than it is today as companies revenues and profits would accelerate. Not from the sale of additional goods and services, but merely due to higher prices. We will discuss this further next quarter if we see this coming to fruition.

Regards,

The Archer Team

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