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Is the stock market undervalued? The data says yes

By Paul Dietrich | Published December 14, 2018 | Opinion | FOXBusiness

After a few weeks riding the stock market roller-coaster, financial journalists are trying to explain what is causing this extreme volatility.

There seems to be a new "fear of the day" knocking down the stock market. Chinese trade talks, Brexit, government shutdowns, Fed rate hikes, inverted yield curves or Trump's tweets all seem to be culprits in this conspiracy to drive down the stock market.

Since none of these issues have any significant impact on the underlying **U.S. economy**, why do they cause so many declines in the stock market?

To answer that question, investors have to go back to Economics 101—in the long-term, the U.S. stock market always reflects the trend and direction of the underlying U.S. economy. Right now, the U.S. economy is currently on pace for its fastest growth since 2015. Historically, stock market corrections, fueled by political, foreign policy or governmental issues, usually last only a month or two, and, when it dawns on investors these issues do not impact the underlying economy, the market recovers quickly. These correction recoveries are usually V-shaped—fast and high.

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Now for some good news. Investors can take comfort in the fact that the current correction in the equities has left the stock market undervalued. According to FactSet, the current 12-month forward price to earnings ratio for the S&P 500 Index is currently at 15.4 times annual earnings. This P/E ratio is now well below the 5-year long-term average of 16.4. At the sector level, the Consumer Discretionary sector has the highest forward P/E ratio of 19.8, while the Financials sector has the lowest forward P/E ratio of 11.1, per FactSet.

For the time being, investors can only consider forward P/E ratios, because the traditional backward looking, trailing P/E doesn't include the effects of several months of tax cut legislation that didn't go into effect until earlier this year.

With the S&P 500 index so undervalued, investors need to adhere to the advice their grandmother gave them as a child: buy low and sell high. The reason to invest now is the consensus forecast for the S&P 500 Index will increase in price 17.1% over the next 12-months, according to consensus estimates compiled by FactSet of 11,125 analyst's ratings for S&P 500 companies.

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