"Salivating"

Market Commentary – September 2015

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The second estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 3.7% in the second quarter of 2015. This is much higher than the advance estimate of 2.3%. Each of the components of GDP were a bit higher in the second estimate, but the biggest jump was in investment (from +0.06 percentage point in the advance estimate to +0.88 percentage point). Digging into the investment figure, inventory creation generated +0.22 percentage point of GDP (not abnormally high). The other components of investment were all modest. It is as if the major components of GDP were all "penalized" somehow in the advance estimate, and that penalty was resolved in the second estimate. In any case, given the magnitude of the change from the advance to second estimates, the measurement process of GDP is less precise than we would like.

All eyes are on the Federal Open Market Committee (FOMC) decision on monetary policy scheduled for September 17. Economists and investors have been listening to comments from Federal Reserve Bank presidents and trying to interpret whether a rate hike is on for September. Within the FOMC, officials are torn on the topic, as revealed in the minutes from the Fed's July 28-29 meeting: "Most judged that the conditions for policy firming had not yet been achieved, but they noted that conditions were approaching that point." A problem for the Fed is that many variables are outside of its control, especially when it comes to global economic uncertainty. In August, China shocked the global economy by devaluing its currency. It is believed that China did this to make its goods relatively cheaper abroad with hopes of boosting their exports (and thus their economy). Some worry that this could trigger a currency war. In any case, one must believe that the FOMC is watching these other factors carefully.

A chart of the S&P 500 versus the Fed balance sheet since 2009 shows an amazing correlation, indicating that quantitative easing (QE) has pumped up stock prices. QE inflated the Fed's balance sheet with the purchase of Treasury and mortgage-backed securities in an attempt to artificially lower those interest rates. In August 2008, before QE began, the Fed balance sheet stood around $900 billion. It is now $4.5 trillion. Interestingly, the S&P 500 has risen nearly in lockstep with the three periods of QE. During periods of breaks from QE, the S&P 500 has chopped sideways. The third round of QE ended on October 29, 2014, when the S&P 500 closed at 1,982. The index is sitting near those levels nearly 10 months later. Fortunately, the Fed is able to be in this for the long haul, so they can keep their balance sheet inflated for years to come. What remains to be seen is how much corporate earnings have been inflated by monetary policy. In the long run, earnings power drives stock prices.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are bearish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $126.57, which implies a price-to-earnings (P/E) ratio of 15.6 with the S&P 500 at 1,972. The earnings yield (E/P) of 6.42% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.20%.

Stock indexes fell off of a small cliff in August, officially confirming the weakness we have been detecting in the stock market for many months. The S&P 500 fell from 2,102 on August 17 and closed at 1,868 six trading days later. A "dead cat bounce" took the index back up to 1,989 on Friday, before settling at 1,972 today. We may see a "V-shaped" bounce in stocks, similar to October 2014. However, we believe there is a 50% probability of a swift 1987-like plunge in stocks from these depressed levels before the end of October 2015. Should this happen, though, the Fed will likely have to ice rate hikes and implement a fourth round of QE, which should help the market recover fairly quickly. We have held off from buying the August dip because of this possible scenario, which has us salivating.