"Financial Gravity"

Market Commentary – May 2016

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The advance 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 0.5% in the first quarter of 2016. This is the worst reading since 2014 Q1, when GDP lost -0.9%. The components of the 2016 Q1 GDP number are not impressive. Consumer spending accounted for 1.27 percentage points, which was dragged down by losses of -0.60 percentage point for investment and -0.34 percentage point for net exports. Government spending contributed 0.20 percentage point. The details of the investment figure are usually telling, and 2016 Q1 is no different. Nonresidential fixed investment and inventories weighed on GDP by -0.76 percentage point and -0.33 percentage point, respectively. The only bright spot was that residential fixed investment, which includes the housing sector, contributed 0.49 percentage point, the strongest showing since 2012 Q4. At the risk of sounding like a broken record, low growth continues to plague the U.S. economy.

On April 27, the Federal Open Market Committee (FOMC) decided to keep its benchmark federal funds rate between 0.25% and 0.50%. They see a mixed bag of economic factors, as reported in their monetary policy press release. "Labor market conditions have improved further even as growth in economic activity appears to have slowed. Growth in household spending has moderated, although households' real income has risen at a solid rate and consumer sentiment remains high. Since the beginning of the year, the housing sector has improved further but business fixed investment and net exports have been soft." Futures markets continue to forecast federal funds rates through 2018 near the same levels as reported in our April 2016 market commentary, within a couple of basis points. The next FOMC announcement on monetary policy is scheduled for June 15.

When considering the effect of accommodative monetary policy since the 2008 financial crisis, the CEO of National Presto Industries, Maryjo Cohen, shared some insight in her company's 2015 annual report. "Although it should be apparent by now that holding interest rates at near zero has retarded growth, it appears that the Federal Reserve officials continue to think that the low rates are supporting the economy." She added that "Low interest rates discourage loans. There is little incentive to risk principal when interest rates are ultra-low." This is quite an astute economic observation from the CEO of a company with a market capitalization of only $600 million. It is fascinating that despite all of the monetary stimulus from central banks worldwide, global economic growth has been relatively weak.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $122.40, which implies a price-to-earnings (P/E) ratio of 16.9 with the S&P 500 at 2,065. The earnings yield (E/P) of 5.93% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.82%. Warren Buffett uses an excellent analogy to describe the relationship between interest rates and asset prices, and he shared this again in an interview on CNBC on April 29. "Interest rates act on asset values like gravity works on physical matter. If you had zero interest rates and you knew you were going to have them forever, stocks should sell at, you know, 100 times earnings or 200 times earnings." Not surprisingly, Maryjo Cohen also linked low interest rates to high stock prices in her company's 2015 annual report.

Resistance in the S&P 500 has kicked in, keeping a lid on stock prices for now. The S&P 500 reached as high as 2,111 in April before pulling back to 2,065. The 50-day moving average crossed above the 200-day moving average on April 25, which some technicians will regard as bullish. However, the massive resistance in the low 2,100 area is undeniable to those same technicians. Perhaps the trading range will continue. In the meantime, our individual stock portfolios have been enjoying the return to popularity of value stocks. Low valuations, strong balance sheets, and high dividends sound great to us!