"The Last Laugh"

Market Commentary – August 2015

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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 2.3% in the second quarter of 2015. The Bureau of Economic Analysis provided its annual revision of the last three years, and Q1 GDP now shows growth of +0.6% rather than a -0.2% decline. Q2 GDP was a nice rebound from Q1. Looking at the components of Q2 GDP, consumer spending contributed +1.99 percentage points to GDP (decent). What is disappointing, however, is that investment only contributed +0.06 percentage point. This reading is not abnormally skewed by changes in inventory, either. In other words, businesses are hesitating to invest. Net exports added +0.13 percentage point and government spending added +0.14 percentage point, both modest. In summary, consumers are spending moderately; businesses, not so much.

The Federal Open Market Committee (FOMC) left its benchmark federal funds rate at a rock-bottom range of 0% to 0.25% on July 29, but signs are pointing to a hike this year. In the meeting minutes from the June 16-17 FOMC meeting, which were released on July 8, the Fed cited "uncertainty about whether Greece and its official creditors would reach an agreement and about the likely pace of economic growth abroad, particularly in China and other emerging market economies." This suggested a delay in rate hikes. On July 15, in the prepared text of her semiannual testimony to Congress, Fed Chair Janet Yellen stated, "If the economy evolves as we expect, economic conditions likely would make it appropriate at some point this year to raise the federal funds rate target, thereby beginning to normalize the stance of monetary policy." Expect the next FOMC monetary policy announcement on September 17.

Having recently updated our "universe" of stocks spanning all sectors and industries, we have a fresh sense of valuations in the market. Our process involves analysis on more than 1,800 stocks with a combined market capitalization of more than $27 trillion. While programmed spreadsheet formulas calculate various metrics, we carefully input certain data by hand for each stock to ensure accuracy. We found an alarming number of bubbly-priced stocks, especially in health care and technology. Not all companies are like this, however, and there are some interesting opportunities. In an attempt to build a margin of safety in our portfolios, our universe of 103 stocks that "made the cut" emphasize reasonable valuations, low betas, and balance sheets with low debt. These firms tend to pay nice dividends, as well. These are also the companies that, right now, are out of favor.

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 $127.79, which implies a price-to-earnings (P/E) ratio of 16.5 with the S&P 500 at 2,104. The earnings yield (E/P) of 6.07% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.21%.

Breadth is narrowing in this market, which is interpreted by market technicians as underlying weakness. Not including dividends, the market cap-weighted S&P 500 is up +2.2% year-to-date while the equally-weighted S&P 500 is up +0.6%. A handful of the large companies are leading the S&P 500, especially those that are also in the Nasdaq 100 (up +8.3% YTD). In comparison, the Dow Jones Industrial Average is down -0.7%. There is also a major divergence between value and growth. The mid-cap S&P 400 growth index is up +8.3%, while the equivalent value index is down -1.6%. The small-cap S&P 600 growth index is up +7.9%, while the equivalent value index is down -2.8%. Investors are piling into companies that exhibit growth. There will come a time, perhaps soon, when such investors will wish they had watched valuations more. Those who pay the most attention to valuations should ultimately have the last laugh, although we cannot say for sure when that will be. Until then, we remain patient.