"Beware Of Greed"
Market Commentary – March 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 2.2% in the fourth quarter of 2014. Ironically, the drop from the Q4 advance estimate of 2.6% was not as bad as it seems. Here is a summary of the percentage points each component contributed to GDP (Q4 advance/second estimates): consumer spending (+2.87/+2.83), investment (+1.20/+0.84), net exports (-1.02/-1.15), and government spending (-0.40/-0.32). Consumer spending was robust in both estimates, which is favorable. The biggest change was the drop in investment, but a deeper dive into this number reveals hidden strength. Inventory generation, which is not sustainable, generated only +0.12 percentage point in the second estimate, compared with +0.82 percentage point in the advance estimate. Fixed investment picked up a significant portion of this drop, illustrating a degree of underlying strength. All of this happened with the backdrop of a strong dollar, which is pummeling net exports, and weak government spending.

In her testimony last week before the Senate Banking Committee, Federal Reserve Chair Janet Yellen walked the fine line of acknowledging that interest rates will eventually rise without committing the Fed to any particular timeline. "Before raising rates, we will want to feel confident that the recovery will continue and that inflation is moving up over time," she said. "There are also, of course, risks of waiting too long to remove accommodation. We have a highly accommodative policy that's been in place for some time. We have to be looking forward." Yellen added that the Fed "will at some point begin considering an increase in the target range for the federal funds rate on a meeting-by-meeting basis." The next Federal Open Market Committee decision on monetary policy is scheduled for March 18. While a change in the federal funds rate is not expected at that meeting, economists generally expect the first increase by mid to late-2015.

The U.S. Federal Reserve's anticipated raising of interest rates is an anomaly in the world, as other global central banks continue to lower their respective interest rates. This weekend, China's central bank cut interest rates for the second time in four months in an attempt to boost economic growth. Across the globe, central banks are in a race toward zero interest rates (and in some cases, interest rates have actually turned negative). With interest rates on U.S. Treasuries "juicy" when compared to other developed areas of the world, demand for the U.S. dollar has been soaring since July 2014. While the collapse in the price of oil from near $100 per barrel to near $50 per barrel has definitely been influenced by supply-and-demand factors, the strong U.S. dollar has helped push commodity prices even lower. Just like with any medication, there are side effects of the central banks' accommodative monetary policy.

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 $118.32, which implies a price-to-earnings (P/E) ratio of 17.8 with the S&P 500 at 2,105. The earnings yield (E/P) of 5.62% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.00%. Earnings estimates continue to get slashed, especially in the energy sector. The only reason overall valuations are still attractive is because of the ultra-low interest rate environment. The valuation story with individual stocks is much trickier. Setting aside the bubble valuations present in the social media and biotech industries, there are many blue chip companies trading at rich valuations. Good deals are tough to find.

Rather than break below its 200-day moving average, the S&P 500 raced higher…once again. The influence of the global central banks cannot be overstated. At some point, however, the central banks will run out of bullets and global stock markets will need to stand on their own. There will be a reckoning day. The best alignment for a portfolio continues to be balanced, which enables an investor to participate in some upside while also protecting some downside. Beware of greed.