“Valuation Barbell”

Market Commentary – January 2016

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The third 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 2.0% in the third quarter of 2015. This compares with the advance estimate of 1.5% and second estimate of 2.1%. On December 16, 2015, the Federal Open Market Committee (FOMC) revised its September forecast for economic growth. The FOMC now projects GDP growth of 2.4% in 2016, 2.2% in 2017, 2.0% in 2018, and 2.0% in the “longer run” (beyond 2018). The September projections were 2.3%, 2.2%, 2.0%, and 2.0%, respectively. Unemployment is expected to hover around 5% and inflation is seen around 2%. If the Fed’s projections come true, the days of robust GDP growth are over for the foreseeable future. This presents a major problem for stocks – a lack of GDP growth suggests a lack of sales growth.

As telegraphed in advance, the FOMC ended a 7-year run of the federal funds rate being at a record-low range of 0% to 0.25% by raising it to 0.5% on December 16. This marks the highest level for the rate since December 2008. The FOMC is gingerly addressing the pace of future rate hikes by projecting the federal funds rate at 1.4% by the end of 2016, 2.4% by 2017, 3.3% by 2018, and 3.5% in the longer run. Recall that Fed Chairman Alan Greenspan led a series of small hikes from 1.0% to 5.25% between 2004 and 2006. It is interesting that the FOMC sees a “normal” federal funds rate at 3.5%, which is much lower than last cycle’s peak of 5.25%. Perhaps the FOMC is communicating some structural changes in the economy, such as the retirement of the baby boomers or something else.

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 $125.54, which implies a price-to-earnings (P/E) ratio of 16.3 with the S&P 500 at 2,044. The earnings yield (E/P) of 6.14% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.27%. Valuations of individual stocks in the S&P 500 are like a barbell. There are a literally a handful of mega-cap growth stocks that are very expensive and popular, thus leading the S&P 500 higher. On the other end of the spectrum, there are a considerable number of stocks that are great values, having been kicked to the curb because their growth is anemic. Ideally, we want growing profits; moreover, it is better for earnings to be driven by revenue growth than cost-cutting. You can only cut costs “so much”. Right now, however, Wall Street is treasuring revenue growth more than valuations. We disagree.

Crowning the head of this bi-polar Mr. Market is the energy sector. Earnings of energy companies have been decimated with the collapse of the price of oil, leading some to argue on a P/E basis that these stocks are expensive. It is important with any commodity-based company to consider “normalized” commodity prices. When prices are too high, don’t get overly optimistic; when prices are too low, cut them some slack. To call energy companies expensive now implies the belief that the price of oil will stay low for many, many years to come. That does not seem likely. We are in the camp that energy stocks are inexpensive, but beware: 2016 could see some bankruptcies within the energy space due to leverage. For companies that had the discipline to keep their balance sheets clean and not be tempted to take on low interest rate debt, they will gain market share and profits and soar when the cycle turns up.

The trading range of 2015 is still in place as the S&P 500 chops between 2,000 and 2,100. Interestingly, we have not found this sideways market to be favorable for selling covered calls (due to the valuation barbell). We have built positions in cheap, unpopular stocks. These are stocks we want to own. Covered calls are an excellent tool for selling a stock that gets too far ahead of reality. Since our management style has mainly avoided the popular bubbly stocks that led the market in 2015, we do not have much to sell. If a stock is attractive, we do not want to limit our potential upside by selling a call. In the meantime, we are enjoying our average dividend yield of 3.9% (vs. 2.1% for the S&P 500).