"No Stock Market Bubble"

Market Commentary – January 2015

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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 5.0% in the third quarter of 2014. The news for Q3 keeps getting better, remembering that the advance estimate was 3.5% and the second estimate was 3.9%. This also compares favorably to the Q2 GDP reading of 4.6%. The components of the Q3 third estimate show even more strength in all the right places. Consumer spending now seemingly contributed +2.21 percentage points to GDP (vs. +1.51 in the second estimate and +1.22 in the advance estimate). Investment contributed a robust +1.18 percentage points (vs. +0.85 and +0.17). Moreover, the building of inventories was essentially flat (-0.03 percentage point), so the investment reading was driven by true investment. Net exports and government spending did not change significantly from the second estimate, which is desirable (these two categories are not the preferred generators of sustainable economic growth). Perhaps economic growth is becoming robust…finally.

The Federal Reserve will likely credit its accommodative monetary policy with the sudden firming of economic growth, but they must be careful to not stay at the party too long. As part of its monetary policy announcement on December 17, the Federal Open Market Committee (FOMC) updated the survey of its 17 participants regarding the future of the federal funds interest rate (currently at the rock-bottom range from 0% to 0.25%). Of the 17 FOMC participants, 15 believe the first increase in the federal funds rate should occur during 2015, while only two prefer this during 2016. The group collectively sees the federal funds rate at 1.1% by the end of 2015 and 2.5% by the end of 2016. For comparison purposes, the federal funds rate was 5.25% in mid-2007. The next FOMC announcement on monetary policy is scheduled for January 28.

While there is a massive bubble in the global sovereign debt market, the U.S. stock market overall is not in a bubble. When considering the components of a corporate income statement, earnings appear to be stable. Corporate revenue growth has been swimming against a current of anemic global economic growth, but the U.S. is the relative shining star. "Cost of Goods Sold" would only balloon if inflation heats up. Even when interest rates and commodity prices normalize, out-of-control inflation is not on the horizon. "Sales, General, and Administrative" expenses will be controlled as long as slack in the labor market and productivity contain wage inflation. Unemployment is 5.8% as of November; below the peak of 10.0% in October 2010, but well-above the trough of 4.4% in May 2007. If interest rates skyrocket, interest expense will eventually rise. However, corporations that sold long-term debt at low interest rates will not face the music until those bonds mature years from now and they need to refinance. In summary, earnings overall are not at bubble levels right now. When the sovereign debt bubble eventually bursts, downward pressure on stock prices should result in outstanding opportunities to buy cheap stocks.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $126.79, which implies a price-to-earnings (P/E) ratio of 16.2 with the S&P 500 at 2059. The earnings yield (E/P) of 6.16% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.17%. Earnings estimates have come down over the past month, especially due to energy companies dealing with low-priced oil.

The stock market started to correct in the first half of December, and once again, central bankers swooped in to the rescue. The S&P 500 dropped from 2075 on December 5 to 1973 on December 16. The moment the FOMC released its monetary policy comments on December 17, the S&P 500 shot up to 2091 by December 29. Investors love hearing that any hike in interest rates may be delayed. There will come a reckoning day for financial markets when they adjust to more normal policies. That process will likely be painful in the short-run. The key will be to stay logical and profit from others' emotions.