# "Selective About Valuations"

## Market Commentary – November 2013

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**The advance estimate of Gross Domestic Product (GDP) for 2013 Q3 was not released at the end of October due to the government shutdown.** According to the U.S. Bureau of Economic Analysis, it is scheduled for release on November 7. In a recent article titled "The Snail Economy", *Barron's* argues that an aging population and sluggish productivity growth will result in annual U.S. economic growth of only 2% over the next 20 years. This compares with average annual GDP growth of 3.5% between 1948 and 2000, which *Barron's* referred to as the Golden Age of economic growth. Fiscal problems in the U.S. government do not help matters. Moreover, the trend of an aging population is also present in Asia (including Japan, Hong Kong, China, and Singapore) and Europe. Low growth may be our reality.

**The Federal Reserve is still not convinced the U.S. economy can grow without its ultra-accommodative monetary policy.** On October 30, the Federal Open Market Committee (FOMC) announced the continuation of its $85 billion "quantitative easing" (QE) monthly bond purchase program. According to the FOMC press release, "taking into account the extent of federal fiscal retrenchment over the past year, the Committee sees the improvement in economic activity and labor market conditions since it began its asset purchase program as consistent with growing underlying strength in the broader economy. However, the Committee decided to await more evidence that progress will be sustained before adjusting the pace of its purchases." The FOMC also commented that "fiscal policy is restraining economic growth." It is unclear when the Fed will have enough data to tell it to pull back on QE, but such an event is inevitable. The next announcement on monetary policy is scheduled for December 18.

**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 $117.37, which implies a price-to-earnings (P/E) ratio of 15.0 with the S&P 500 at 1757. The earnings yield (E/P) of 6.68% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.53%. It is interesting to note that with the removal of 2013 Q3 and the addition of 2014 Q3 to the next 12 months, EPS has jumped up from $114.86 to $117.37. Still, stock prices have risen at a faster rate than earnings, resulting in P/E expanding from 14.6 last month. Stocks have become less attractively priced.

**The dip in early October proved to be enough for the S&P 500 to launch to new highs by the end of the month.** The hoopla surrounding the fiscal debate in Congress caused investor anxiety to spike, but the corresponding drop in the stock market ended up being similar to corrections in June and August (modest, only carrying slightly below the 50-day moving average). Support levels exist around 1725 (September high), 1694 (50-day moving average), and 1650 (October low). Meanwhile, the 200-day moving average, currently at 1621, is steadily marching higher. Since the S&P 500 is at a new high, there is no technical resistance above. We are slightly bearish because the rate of stock market ascent cannot continue at this pace, especially since it is faster than earnings growth.

**While updating our "universe" of stocks spanning all sectors and industries, we have made some interesting observations about stock valuations.** There is a cohort of popular stocks trading at bubble prices, especially those rising on strong sales data (rather than strong earnings). Valuations of these stocks are irrational. There is another group of stocks that is very pricey, with P/E ratios between 20 and 30. While such valuations are not as stratospheric as the bubble group, they are expensive. These companies tend to be growing, and investors are paying dearly for this growth. Beware of these two groups! We are focused on stocks with attractive valuations, strong balance sheets, and excellent free cash flow. These stocks also tend to pay healthy dividends (although we are fine with companies that choose to reinvest their profits in their operations or to buy back stock). By positioning a portfolio with solid companies, we are boosting the portfolio's margin of safety.