“Intelligent Investing”

Market Commentary – June 2014

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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. declined at an annual rate of 1.0% in the first quarter of 2014. This is a sharp drop from the advance estimate of 0.1% growth in 2014 Q1 announced last month and growth of 2.6% in 2013 Q4. The biggest drag on Q1 GDP was declining inventories, which accounted for 1.62 percentage points of the fall in GDP. The drawdown in inventory implies that sales were fulfilled more with existing product rather than new production, which many economists attribute to the abnormally cold and snowy winter. The good news is that inventory levels will likely be replenished, which should juice economic growth in Q2 and possibly the rest of this year.

Minutes from the Federal Open Market Committee (FOMC) meeting held on April 29 and 30 reveal a disagreement among FOMC members whether slack in the labor market (including unemployed and underutilized workers) will keep inflationary pressures under control. Fed Chair Janet Yellen believes that inflation will be tame, especially with unemployment in April at 6.3%. Some Fed officials are more cautious, however, and want to be less accommodative sooner. Back in February 2014, Esther George, President and CEO of the Federal Reserve Bank of Kansas City and a member of the FOMC, spoke to the Forum Club of Southwest Florida. During her fascinating speech, she commented that fiscal headwinds are easing and labor markets are improving, which boosts consumer confidence. She is looking for business investment to kick in if the economy is to strengthen further. Interestingly, she said that unwinding the unprecedented accommodative monetary policy will be a “turbulent process”, admitting that we are in uncharted waters regarding economic policy. The next FOMC announcement on monetary policy is scheduled for June 18.

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 $124.56, which implies a price-to-earnings (P/E) ratio of 15.4 with the S&P 500 at 1924. The earnings yield (E/P) of 6.48% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.46%.

Following the breakout to new all-time highs in May, the S&P 500 may consolidate a bit before pushing higher. By definition, there is no technical resistance with an all-time high. Old resistance around 1880 on the S&P 500 should become future support. Below 1880, there are several strong layers of support, including the April low at 1815 and the 200-day moving average near 1800.

Once again, the process of updating our “universe” of stocks spanning all sectors and industries is revealing opportunities…and pitfalls. The cohort of popular stocks trading at bubble prices is still present, although some of these stocks have corrected sharply in recent months. The most alarming observation was the number of high quality companies priced for perfection (for example, a blue chip company trading with a P/E ratio between 20 and 30). At the same time, there are still many stocks with attractive valuations, strong balance sheets, solid dividends, and low betas. These stocks are out there, although they are harder to find these days. We have been selling some of our positions that have gotten ahead of reality, with the hope of redeploying capital into stocks with a higher margin of safety.

While the upside in stock prices has been enjoyable, it is important to remember the words of legendary value investor Benjamin Graham. In his famous book The Intelligent Investor, Graham wrote: “The intelligent investor recognizes that stocks become more risky, not less, as their prices rise and less risky, not more, as their prices fall. By refusing to pay too much for an investment, you minimize the chances that your wealth will ever disappear or suddenly be destroyed.”