"Mr. Market Forgot How To Worry"

Market Commentary – September 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. grew at an annual rate of 4.2% in the second quarter of 2014. Not only is this reading higher than the advance estimate of 4.0%, the components of the increase reveal slightly stronger economic growth than previously reported. Inventories, which are a subset of investment, accounted for +1.39 percentage points of GDP in the second estimate, compared with +1.66 percentage points in the advance estimate. Inventories are volatile and not sustainable, so it is impressive to see that overall GDP nudged higher by additional 0.2% while inventories were 0.27% lower. Still, this does not change the trend that overall economic growth in the United States is mediocre.

Minutes from the July policy meeting of the Federal Open Market Committee (FOMC) revealed a debate about the timing of higher interest rates. According to the minutes, "some participants viewed the actual and expected progress toward the [Fed's] goals as sufficient to call for a relatively prompt move toward reducing policy accommodation." In other words, interest rates should be raised soon. On the other hand, the minutes revealed that "most participants indicated that any change in their expectations for the appropriate timing of the first increase in the federal funds rate would depend on further information on the trajectories of economic activity, the labor market, and inflation." These Fed officials are concerned with the economy's first quarter contraction (looking for evidence this was temporary), unrest in the Middle East and Ukraine, weakness in the U.S. housing sector, and slow growth in household income. The next FOMC decision on monetary policy is scheduled for September 17.

"Mr. Market", the fictional character created by legendary value investor Benjamin Graham to describe market movements, is on a euphoric high. (For a refresher on how Mr. Market works, please review the January 2012 market commentary.) One measure of how Mr. Market is feeling is the weekly American Association of Individual Investors (AAII) Sentiment Survey. AAII announced on August 28 that this week's survey participants were 51.9% bullish, 28.8% neutral, and 19.2% bearish, compared with historical averages of 39.0%, 30.5%, and 30.5%, respectively. AAII reported that optimism exceeded 50% for the first time since December 2013, and for just the fourth time since February 2011. In other words, such extreme bullishness is rare. Remember that investors are typically bullish *after* they have bought (hoping their stocks will rise in price). However, it is actually bears that make stock prices rise going forward, because bears represent future buyers (either covering shorts or going long).

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 $127.75, which implies a price-to-earnings (P/E) ratio of 15.7 with the S&P 500 at 2003. The earnings yield (E/P) of 6.38% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.34%. Note that the E/P slipped lower from last month as the rise in stocks outpaced the rise in earnings. At the same time, the Treasury yield also declined, as the price of those bonds was bid higher. Low interest rates are making stocks more attractive than they would be otherwise.

The correction in August was short-lived, as buyers rushed in to propel the S&P 500 to an all-time high. The S&P 500 made it down to 1905 (a mere -4.3% correction), before rocketing higher. The most bullish thing the stock market can do is rise, however, we are very skeptical about this rally. The last time the S&P 500 corrected by more than 10% was April-June of 2012 (-10.9%), and the last 20% correction was July-October of 2011 (-20.8%). If we compare the majority of market participants to a "herd", it would be prudent to remember that the herd is always right in the trend and wrong in the reversal. September and October are dicey months for stocks. When this market eventually turns south, it will do so violently. Our balanced approach allows us to enjoy the upside while planning for the downside.