“Market Melt-Up”

Market Commentary – February 2018

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The advance 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 2.6% in the fourth quarter of 2017. This follows a 3.2% reading in 2017 Q3. The components of the 2017 Q4 GDP number are: consumer spending +2.58 percentage points, investment +0.60 percentage point, net exports -1.13 percentage points, and government spending +0.50 percentage point. The sum of these numbers equals 2.55%. The headline number is actually stronger than it appears. Investment would have been +1.27 percentage points without being weighed down by inventories. Plus, net exports is notoriously volatile due to fluctuations in the strength of the U.S. dollar, so the decline on that front is not a concern. Economic growth is finally looking decent.

In the last announcement on monetary policy under the leadership of Fed Chair Janet Yellen, the Federal Open Market Committee (FOMC) decided on January 31 to leave its benchmark federal funds rate at a range of 1.25% to 1.5%. According to the FOMC statement, “the labor market has continued to strengthen and…economic activity has been rising at a solid rate.” The statement adds that “gains in employment, household spending, and business fixed investment have been solid, and the unemployment rate has stayed low”. It is widely expected that the FOMC will raise interest rates by another 25 basis points on March 21, which is its next scheduled announcement on monetary policy. This will also be the first FOMC meeting led by incoming Fed Chair Jay Powell.

Global debt has skyrocketed over the past 20 years, which increases risk to the global financial system. The Institute of International Finance analyzes global debt as the sum of financial corporate debt, non-financial corporate debt, government debt, and household debt. An important metric is total debt as a percentage of global GDP (total debt to GDP = financial + non-financial + government + household):

- 1997: 217% total debt to GDP = 53% + 64% + 58% + 42%
- 2007: 278% total debt to GDP = 86% + 77% + 58% + 57%
- 2017: 318% total debt to GDP = 80% + 92% + 87% + 59%

Financial sector debt shot up from 1997 to 2007 (53% to 86%), just in time for the 2008-2009 financial crisis. From 2007 to 2017, that debt was seemingly transferred to governments (58% to 87%). If financial corporations could get bailed out by governments, who would bail out governments? The endgame may ultimately be government debt defaults, which would be catastrophic to global financial markets. Meanwhile, non-financial corporations and households are leveraging, too. “Financial Armageddon” is not necessarily imminent, as these are 20-year trends; but, it would be wise to keep these trends in mind.

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 $152.11, which implies a price-to-earnings (P/E) ratio of 18.6 with the S&P 500 at 2,824. The earnings yield (E/P) of 5.39% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.72%. The jump in earnings is logically caused by analyst estimates incorporating tax savings from the drop in the U.S. corporate tax rate from 35% to 21%. Note how the spread between the earnings yield and 10-year Treasury is still compressing. In turn, it seems that stock investors started to take notice by selling at the end of January.

Stock prices have run up too far, too fast. Bullishness is rampant. Investors have become spoiled to think that stocks only rise and are no longer volatile. Did they forget about 2008-2009? The greed investors are feeling now is the mirror image of the fear they felt in 2008-2009. A harsh correction is in order. After the correction, however, we will be looking for clues as to whether a critical turning point has taken place. Then again, stocks may continue to motor higher. If they do, we would become increasingly cautious.