"Complacent"

Market Commentary – November 2017

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written October 31, 2017 – www.banyan-asset.com

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 3.0% in the third quarter of 2017. Following a 3.1% reading in 2017 Q2, these are the first two consecutive quarters with GDP above 3% since 2014 Q2 and Q3. The components of the 2017 Q3 GDP number are: consumer spending +1.62 percentage points, investment +0.98 percentage point, net exports +0.41 percentage point, and government spending -0.02 percentage point. The sum of these numbers equals 2.99%. Digging into the investment number, +0.73 percentage point was due to building inventories (which is volatile and not sustainable). Plus, the consumer spending value was mediocre. Overall, the headline reading of 3.0% grabbed more attention than the details warranted.

President Trump is expected to announce on Thursday, November 2 his nomination for Chairman of the Federal Reserve. This is a major decision and potentially a market-moving event. Speculation is that current Fed Governor Jerome "Jay" Powell is a favorite, although it is possible that current chair Janet Yellen or someone else could be nominated. If Powell is nominated, it would be viewed as a vote in favor of current Fed policy. As a governor, Powell has consistently supported Chairs Bernanke and Yellen. The stock market has enjoyed accommodative monetary policy and has celebrated a slow return to "normal" with a strong rally. The next Federal Open Market Committee announcement on monetary policy is scheduled for Wednesday, November 1, when we will likely hear about how the Fed started to reduce its $4.5 trillion balance sheet in October.

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 $140.14, which implies a price-to-earnings (P/E) ratio of 18.4 with the S&P 500 at 2,575. The earnings yield (E/P) of 5.44% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.38%. The yield curve has been flattening, given the following Treasury yields: 1-month 0.99%, 1-year 1.43%, 5-year 2.01%, 10-year 2.38%, 20-year 2.66%, and 30-year 2.88%. A critical key to the rising stock market has been long-term interest rates staying at depressed levels, even as the Fed has been raising short-term rates. An inverted yield curve (short-term interest rates higher than long-term) would cause concern. Moreover, higher long-term interest rates would be negative for stock valuations. Time will tell how this unfolds.

Financial market participants have become complacent and the markets are ripe to be jolted. Through October 31, the S&P 500 has gone 248 trading days without falling more than 3% below its record high. *The Wall Street Journal* reported this as "its longest such streak ever". The rise of passive investing and Exchange Traded Funds could be part of the explanation for the low volatility. However, it seems foolish for investors to seemingly forget that the stock market can be a dangerous place…and it can turn that way on a dime. Human nature causes us to become risk-loving in the realm of gains and risk-averse in the realm of losses. A chart that has risen in price at an aggressive rate tends to make investors want to buy (vice versa for a declining price chart). At Banyan Asset Management, we tend to think the opposite.

Portfolio management is about planning for the future, not predicting it. A useful tool in planning for the future is balancing a portfolio between stocks and cash. If the market rises, great – the stocks would likely profit. If the market drops, that is fine as well – there is cash on hand to buy quality stocks on sale. When utilizing this approach, however, it helps for the investor to also be an optimist. A pessimist would complain about having cash while stocks rise and owning stocks when they fall. However, to be 100% invested in a rising market and 100% cash in a declining market implies clairvoyance. This is not realistic. Instead, an optimist is grateful to own some stocks in a rising tide and is also pleased to have cash if stocks turn south. Having a balance keeps us nimble and enables us to help defend against the unexpected.