"Exciting Opportunities"

Market Commentary – June 2019

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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 3.1% in the first quarter of 2019. This is lower than the advance estimate of 3.2%, but still higher than 2.2% in 2018 Q4. Consumer spending was light and inventory build-up drove a considerable amount of economic growth in 2019 Q1. Taking a step back, however, the U.S. economy is in favorable shape. Unemployment dropped to 3.6% in April, the lowest rate since December 1969. Inflation has been tame, with the Consumer Price Index rising 2.0% between May 2018 and April 2019.

On May 1, the Federal Open Market Committee (FOMC) announced its latest stance on monetary policy. It left the benchmark federal funds rate in a range of 2.25% to 2.50%. Moreover, the Fed's balance sheet will be reduced by $35 billion per month going forward (undoing the cumulative effects of quantitative easing). Fed funds futures are still projecting one 0.25% cut in the federal funds rate by November 2019, with a second 0.25% cut by April 2020. Fed officials quoted recently in the media have denied that rate cuts are in the cards, which has weighed on stock prices.

The yield curve has inverted, which some investors interpret as warning of a recession. The following were U.S. Treasury yields as of May 30: 3-month 2.38%, 1-year 2.29%, 5-year 2.03%, 10-year 2.22%, and 30-year 2.65%. Remember that bond prices and yields move in opposite directions. Long-term bond yields are being pushed lower due to high demand. On the short end of the yield curve, Fed policy has pushed those rates higher. Assuming long-term interest rates stay at current levels, a lower federal funds rate would help steepen the yield curve (a more "normal" scenario). Then again, perhaps all of this is a side effect of the massive experiment in easy monetary policy by global central banks over the past decade.

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 $169.93, which implies a price-to-earnings (P/E) ratio of 16.4 with the S&P 500 at 2,789. The earnings yield (E/P) of 6.09% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.19%. Note that the spread between the two yields has risen to 3.90%, back toward the higher end of the range of 2.68% from October 2018 and 4.17% from January 2019. The higher spread makes stocks relatively more attractive.

The S&P 500 petered out around 2,945, forming a new level of resistance above. The index is currently finding some support around the 200-day moving average (2,776) and the upper end of the 2,640 to 2,790 trading range in October/November 2018. Should this level fail, other support levels include 2,740 (March 2019 low) and 2,640 (lower end of trading range from October/November 2018). It is possible, however, that a new trading range may be forming between 2,780 and 2,945.

Our updated stock market research has yielded some exciting new companies to own. Indeed, we adjusted many client portfolios in May, selling a few stocks that were removed from our universe and buying some fresh new ones. In general, we increased our exposure to stocks as they have pulled back in price. Our overall portfolio, which includes all client portfolios combined, has a P/E of 12.7, beta of 0.78, and dividend yield of 4.4%. Moreover, our stocks tend to have strong balance sheets, as well (with only a few exceptions having strategic leverage). Compare this to the S&P 500, which has a P/E of 16.4, beta of 1.0, and dividend yield of 2.0%. Cheap valuation, low volatility, and high income are desirable portfolio characteristics to us. Meanwhile, money has continued to gravitate toward technology stocks trading at rich valuations, leaving behind the boring ones we prefer to own. Index funds and passive Exchange Traded Funds (ETFs) are perpetuating the situation (big companies get bigger). At some point, however, the straw will break the camel's back and investors will realize which stocks are truly the better value.