"Momentum Reversal"

Market Commentary – April 2018

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The third 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 2.9% in the fourth quarter of 2017. This is higher than the advance estimate of 2.6% and the second estimate of 2.5%, and it also highlights how much variance there is in the GDP measurement process. On March 21, the Federal Open Market Committee (FOMC) released its revised economic projections. It sees GDP growth of 2.7% in 2018, 2.4% in 2019, 2.0% in 2020, and 1.8% in the "longer run" (beyond 2020). Forecasts for 2018 and 2019 were bumped up from 2.5% and 2.1% respectfully, while the 2020 and "longer run" projections were left the same. In the eyes of the FOMC, economic growth right now is as good as it gets.

In the first monetary policy meeting led by new Fed chairman Jerome Powell, the FOMC raised its target range for the federal funds rate to 1.5% to 1.75%. By the end of 2018, the FOMC projects a federal funds rate of 2.1%, which implies two more 25 basis point hikes to a range of 2.0% to 2.25%. The FOMC sees the federal funds rate at 2.9% in 2019, 3.4% in 2020, and 2.9% in the longer run. According to the Quarterly Report on Federal Reserve Balance Sheet Developments released in March, the Fed's balance sheet now stands at $4.39 trillion (down $68 billion from October 2017 and down $65 billion from March 2017). The monthly reduction in the cumulative effects of quantitative easing is slowly taking place. With higher interest rates and a shrinking balance sheet, the Fed is gently restricting monetary policy. Investors must remember that they are now swimming against the current. The next FOMC decision on monetary policy is scheduled for May 2.

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 $156.12, which implies a price-to-earnings (P/E) ratio of 16.9 with the S&P 500 at 2,641. The earnings yield (E/P) of 5.91% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.74%. The 30-year U.S. Treasury bond is yielding 2.97%, down from 3.22% in February. Curiously, long-term Treasury yields have hit a ceiling as the Fed has been raising short-term interest rates. The yield curve is in danger of inverting, which is often interpreted as a warning sign for a recession.

The S&P 500 is currently in a trading range, but it is in danger of crashing through the support floor. Resistance on the trading range is marked by all-time high of 2,873 and more recent peaks around 2,780, and important support exists around 2,600 (lows in February and March and also the 200-day moving average). While the trading range may continue, every time the index is near support, one must evaluate the risk of support being broken. The S&P 500 has not materially broken below the 200-day moving average since early 2016, so this would be a significant technical event should it happen now. Major support does not exist until around 2,100, which would imply about a 27% correction from the all-time high. Such a move would be painful, but ultimately healthy. It would also yield incredible buying opportunities.

Just as the rising tide has not raised all stocks during the past 15 months, a falling tide does not necessarily need to sink all stocks. Market participants have been crowding into certain hot stocks, propelling particular indexes higher. Momentum strategies are dangerous in the investment world, as they can also work in the opposite direction. We may be witnessing this unfold at this moment. The Dow Jones Industrial Average is up 22.0% from 1/1/2017 to 3/31/2018, but is down -2.5% in 2018 year-to-date (YTD). On the other hand, the S&P 600 Small Cap Value index, which was up only 7.9% from 1/1/2017 to 3/31/2018, is down only -1.8% in 2018 YTD. Small-cap stocks are starting to outperform mid-cap and large-cap stocks on a relative basis, although growth is still outperforming value…for now. Generally speaking, we did a round of buying in the weakness of early February. If support breaks in the coming weeks, we have cash available to do more rounds of buying: incremental and balanced.