"Have A Plan"

Market Commentary – February 2017

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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 1.9% in the fourth quarter of 2016. This is lower than the Q3 reading of 3.5%. The components of the Q4 GDP number are: consumer spending +1.70 percentage points, investment +1.67 percentage points, net exports -1.70 percentage points, and government spending +0.21 percentage point. The sum of these numbers equals 1.88%. At a glance, the investment component appears encouraging, but a look underneath the hood reveals something else. Inventories, which are volatile and not sustainable, accounted for 1.00 percentage point of the overall 1.67 percentage point investment reading. Net exports was a drag on GDP, as the U.S. exported less and imported more. This makes sense because the U.S. dollar index (measured against a basket of global currencies) rose from around 95 to about 100 in Q4 (a large move for the dollar); a stronger dollar causes exports to fall and imports to rise. Fortunately, net exports is not a consistent driver of economic growth over time. Consumer spending and investment are critical, and neither is looking hot these days.

The Federal Open Market Committee (FOMC) is scheduled to make its next scheduled announcement regarding monetary policy on February 1. The federal funds rate is currently set for a target range of 0.50% to 0.75%. Fed funds futures see the federal funds rate at 1.0% by October 2017, 1.25% by April 2018, 1.50% by November 2018, and 1.75% by July 2019. While the financial markets expect the Fed to become less accommodating, we should note that a federal funds rate of 1.75% is not restrictive. As for the legacy of quantitative easing (also known as "QE"), which includes a bloated balance sheet of about $4.5 trillion in various Treasury, agency, mortgage-backed debt, and other securities, investments continue to be rolled over at maturity. In other words, as dollars are made liquid from these bonds maturing, the Fed reinvests that money in new bonds. At some point, this will need to stop.

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 $131.13, which implies a price-to-earnings (P/E) ratio of 17.4 with the S&P 500 at 2,279. The earnings yield (E/P) of 5.75% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.45%. Still, it should be noted that the difference between the two numbers (3.30%) is the lowest since April 2010. Remember that higher stock valuations are reasonable with low interest rates. As interest rates move higher, though, headwinds are created for stock prices. Earnings growth is the most robust way to justify higher stock prices.

Interestingly, the stocks driving the S&P 500 seemingly changed at the start of 2017. In 2016, and especially since the U.S. election in November, high valuation technology stocks were generally shunned for more boring value stocks. We viewed this as healthy and rational. While the S&P 500 hit another all-time closing high in January (2,298), it is a bit troubling that it did so being led by stocks with frothy valuations. The Nasdaq 100 index, which tends to include the largest technology companies, rose a stunning 5.2% in January. Hot money seems to be chasing these stocks once again; we respectfully pass.

It is worth a refresher on the strategic role of cash in a portfolio. We view cash as a conservative way to short the stock market. The point of cash is not to earn pennies of interest, although the Fed's rate hikes are alleviating this condition somewhat. There are three benefits of cash. First, cash is not subject to stock market risk (obvious benefit). Second, after stocks decline significantly, investors with cash do not have to sell a cheap stock before buying another cheap stock (somewhat obvious benefit). Third, investors with cash have a psychological advantage over those who are fully invested and are able to scoop up tremendous deals from those who are panicking (subtle benefit). A balance between stocks and cash should be embraced as an intelligent way to navigate market movements in either direction. Whether stocks go up or down, balanced portfolios have a plan.