"Bad Breadth"

Market Commentary – October 2014

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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 4.6% in the second quarter of 2014. This reading is higher than the advance estimate of 4.0% and the second estimate of 4.2%. While inventory creation generated +1.42 percentage points of GDP (unsustainable), nonresidential investment (i.e. business spending) drove +1.18 percentage points of GDP. Business spending is viewed as a robust way to generate economic growth: businesses do well, which encourages their employees to spend money personally, which in turn drives even more economic growth across a variety of sectors. Meanwhile, the Federal Reserve has grown increasingly cautious on its outlook for GDP. In its revised forecast in September, the Fed now expects 2014 GDP in a range from 2.0%-2.2% (down from 2.8%-3.0% in March and 2.1%-2.3% in June) and 2015 GDP from 2.6%-3.0% (down from 3.0%-3.2% in June). In the "longer run" (beyond 2017), the Fed expects GDP to grow annually by only 2.0%-2.3%. Slow economic growth, which implies slow corporate sales growth, is here for a while.

While the Federal Open Market Committee (FOMC) is giving more clarity about the end of "quantitative easing" or "QE", the future of interest rates is less clear. On September 17, the FOMC cut its $25 billion QE program by another $10 billion to $15 billion (following $10 billion cuts in December, January, March, April, June, and July). FOMC Chair Janet Yellen stated that as long as the incoming data agree, the FOMC "will end this program at our next meeting". For the first time, the FOMC also released a new statement called "Policy Normalization Principles and Plans", which announced the intent of raising the federal funds rate from the current range of 0%-0.25% and reducing the size of the Fed's bloated balance sheet. No specifics regarding timing and pace of policy were revealed. Chair Yellen is consistent in stating that future changes to monetary policy will be driven by economic data. The next scheduled FOMC announcement regarding monetary policy is October 29.

The stock market as a whole is much weaker than one may initially believe. In 2014 year-to-date, the Russell 2000 (2,000 small and mid-cap companies) is down -5.3% (without dividends). In other words, 2,000 stocks, on average, are down -5.3% in 2014. In contrast, the Dow Jones Industrial Average (30 large companies) is up +4.6% (with dividends). The S&P 500 is up +8.4% (with dividends). Large cap stocks have done better than their smaller counterparts, but something is driving the S&P to outpace the more traditional DJIA. The Nasdaq 100 is up +12.7% (without dividends). The largest companies in the Nasdaq 100 (technology, biotech, and others) are essentially driving the S&P 500. Our observation is that these stocks are generally trading at very high valuations. We do not own, nor do we want to own, these stocks. Narrow breadth in a rising stock market means that only a few stocks are leading the charge higher. This is unhealthy for the uptrend's future.

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 $131.79, which implies a price-to-earnings (P/E) ratio of 15.0 with the S&P 500 at 1972. The earnings yield (E/P) of 6.68% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.51%. The E/P has risen as stocks pulled back and earnings have improved, but this was countered with a rise in the Treasury yield.

The S&P 500 has still not exhibited a correction in a long time, but that can change quickly. Stock market participants have become spoiled by the absence of real downside volatility. The situation of bad breadth adds to our concern. Investors are shunning a large number of stocks in favor of a few popular ones. The valuations of these stocks are questionable, so that ice is thin. It makes more sense to us to own stocks with cheap valuations, strong balance sheets, low betas, and high dividends. While such stocks have fallen out of favor in recent weeks, we believe they have better risk-adjusted potential.