"Feels Like 1999"

Market Commentary – June 2017

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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 1.2% in the first quarter of 2017. This is higher than the advance estimate of 0.7%, but lower than the 2016 Q4 reading of 2.1%. The four major components of GDP (consumer spending, investment, net exports, and government spending) were each a little higher in the second estimate than the advance estimate, but the story is still the same: consumer spending plummeted in 2017 Q1, offset somewhat by acceptable strength in investment. While we remain optimistic that the economic policies of the Trump administration will help boost economic growth, especially decreased regulation and tax cuts, the noise out of Washington D.C. makes it unclear to what extent meaningful changes can make it through the political process.

The Federal Reserve is walking a tightrope of tweaking its monetary policy while being careful to not rile financial markets. The Federal Open Market Committee (FOMC) left its benchmark federal funds rate at a range of 0.75% to 1.0% in its announcement on May 3. However, the minutes from that meeting, released a few weeks later, showed that Fed officials believe it will "soon be appropriate" to raise short-term interest rates once again. Perhaps a June rate hike is in the cards? As for undoing the effects of quantitative easing, the Fed did not officially change its position on reinvesting principal from maturing securities. However, the minutes did reveal that the Fed is looking to gradually allow increasing amounts of securities to mature without reinvestment. The next FOMC decision on monetary policy is scheduled to be announced on June 14.

In the long run, true active managers should ultimately be able to profit at the expense of "closet indexers". As mentioned in the May market commentary, a trend in recent years has been investors flocking to the indexes and shunning active management. Seeing this trend, many active managers, especially those running large mutual funds, position their investments to somewhat mirror the indexes (call these managers "closet indexers"). They do this because they cannot take a chance on losing assets under management due to dramatically "underperforming" the indexes. The closet indexing phenomenon is adding fuel to the momentum hyped stocks that keep motoring higher without careful consideration of their quality. When the pendulum eventually swings from passive to active investing, closet indexing active managers will need to come out of their shells and buy the stocks they should have been buying all along. This will add momentum to the popularity of quality stocks, while the formerly hyped stocks languish.

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 $133.83, which implies a price-to-earnings (P/E) ratio of 18.0 with the S&P 500 at 2,412. The earnings yield (E/P) of 5.55% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.20%, with the key word being *relative*.

Capital is being attracted to a handful of large cap tech stocks, which is starting to feel like 1999. A great way to illustrate the story is to observe the following index returns year-to-date as of 3/31/17 and 5/31/17 (without dividends): Nasdaq 100 +11.8%, +19.0%; S&P 400 Mid Cap Value +2.2%, +0.3%; S&P 600 Small Cap Value -0.8%, -2.7%. Notice how the spread between the Nasdaq 100 and the S&P 600 Small Cap Value index has widened from 12.6% on 3/31/17 to a whopping 21.7% on 5/31/17! It is impossible to know how wide this spread will become or for how long this divergence will continue. This market environment feels very similar to 1999, when Wall Street rewarded technology stocks with nosebleed valuations. There is an arrogance with market participants who are riding the hot stocks higher, and frustration from those who are not. Emotion is a liability, not an asset, for investors. When the reversal eventually comes (and it will come), it will likely be sudden and very violent. Investors need to be honest with themselves today about their true investment objectives and risk profile.