"Divergence"
Market Commentary – September 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 3.0% in the second quarter of 2017. This is higher than the advance estimate of 2.6% and is the highest since 2015 Q1. The components of the 2017 Q2 GDP number are: consumer spending +2.28 percentage points, investment +0.60 percentage point, net exports +0.21 percentage point, and government spending -0.05 percentage point. The sum of these numbers equals 3.04%. The investment reading is more encouraging than originally thought. Nonresidential investment, which includes business investment, added 0.85 percentage point to GDP in 2017 Q2, which is on top of 0.86 percentage point in 2017 Q1. These are the highest values since 2014 Q3. It appears that businesses are spending under President Trump's leadership, at least thus far. It will be interesting to see how sustainable this spending is going forward.

According to minutes from the Federal Open Market Committee (FOMC) meeting on July 25-26, Fed officials were split about the future of interest rate hikes and were more in agreement that the balance sheet should start to be reduced soon. The minutes revealed that Fed officials "reaffirmed their view that a gradual approach to removing policy accommodation was likely to remain appropriate to promote the Committee's objectives of maximum employment and 2 percent inflation." In terms of the federal funds interest rate, most Fed officials believed that economic projections are on track and inflation will hover around the Fed's target of 2 percent. "However, some participants expressed concern about the recent decline in inflation", arguing that "the Committee could afford to be patient…in deciding when to increase the federal funds rate further." As for reducing its balance sheet, participants generally agreed that it was appropriate for this plan to begin "relatively soon". The next FOMC decision on monetary policy is scheduled to be announced on September 20.

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 $136.81, which implies a price-to-earnings (P/E) ratio of 18.0 with the S&P 500 at 2,458. The earnings yield (E/P) of 5.57% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.14%. While the Federal Reserve has been raising short-term interest rates, longer-term interest rates have remained stubbornly low. For example, the 30-year U.S. Treasury bond yields 2.75%, down from 3.19% in March 2017. With long-term bond yields low, riskier assets, like stocks, are relatively more attractive.

Amazingly, the divergence observed among various market indexes continues to grow as the year progresses. Similar to recent months, consider the following index returns year-to-date as of 8/30/17 (without dividends): +22.0% Nasdaq 100, +18.3% Nasdaq Composite, +10.8% Dow Jones Industrial, +9.8% S&P 500 Large Cap, +6.3% S&P 400 Mid Gap Growth, +1.7% S&P 600 Small Gap Growth, +0.2% S&P 400 Mid Cap Value, and -3.2% S&P 600 Small Cap Value. The spread between the Nasdaq 100 and S&P 600 Small Cap Value is now more than 25%! A handful of stocks, especially large cap technology, are powering some of these indexes. As well, large cap is more popular than mid cap, and mid cap is more in favor than small cap. Finally, the growth style is trouncing the value style…for now.

It is not known for how long this divergence will continue, and it is also not known how large the divergence may grow. However, our belief is that the indexes referenced above will eventually converge. It seems that the rush into certain "hot" stocks, whether it is by hedge fund managers, mutual fund managers, index funds, ETFs, or other market participants, is overdone. We observe this situation as a sign of caution for what may lie ahead, and our general approach is to be careful committing capital in this environment. One of the most important tools in our investing toolbox is a balance between stocks and cash. If our stocks come back into favor, this is ideal; and if the market corrects, the reasons for carrying cash will be evident.