"Greek Tragedy"

Market Commentary – July 2015

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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. decreased at an annual rate of 0.2% in the first quarter of 2015. This is lower than the advance estimate of +0.2% growth, but higher than the second estimate of a -0.7% decline. In mid-June, the Federal Open Market Committee (FOMC) quietly lowered its estimate of 2015 GDP to a range of 1.8%-2.0% (vs. 2.3%-2.7% in March). It sees GDP growing by 2.4%-2.7% in 2016, 2.1%-2.5% in 2017, and 2.0%-2.3% beyond that. In other words, tepid growth is here to stay, according to Fed projections. Remember that these estimates are for "real" GDP, which factors out inflation and thus represents true economic growth.

As the FOMC left its benchmark federal funds rate at a rock-bottom range of 0% to 0.25% on June 17, market participants are still wondering: 1) when the FOMC will begin raising interest rates, 2) the pace of rate hikes, and 3) when the FOMC will reduce the size of its $4.5 trillion balance sheet. In a press conference on June 17, Federal Reserve Chair Janet Yellen stated that the FOMC "continues to judge that the first increase in the federal funds rate will be appropriate when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term." The FOMC projects unemployment, which was 5.5% in May, at 5.0%-5.2% over the long run. It sees inflation at 0.6%-0.8% in 2015 and 1.6%-1.9% in 2016. Interestingly, the events unfolding with Greece's default on its debt may give the Fed an excuse to postpone monetary policy tightening into the future.

Earlier today, Greece failed to pay the 1.6 billion euros it owed to the International Monetary Fund (IMF) and thus became the first developed economy to default on loans from the IMF. In recent weeks, Greece has engaged in a nasty debate with its European partners to try to negotiate the terms on its onerous debt. It appears that talks have broken down and Greece has defaulted. This is not to say that a deal will not be worked out in the days ahead. After all, a basic tenet of negotiating a bitter dispute is for each side to push their cause to the limit in order to prove to their respective constituents that those negotiating on their behalf have their best interests at heart. This happens with negotiations between management and unions, for example. Americans cannot live in a glass house and throw stones at the Greeks. The U.S. struggles with its fiscal policy, too, running huge deficits which have led to $18.3 trillion in national debt. Is the Greek fiscal tragedy a taste of a pending American fiscal tragedy?

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 $124.54, which implies a price-to-earnings (P/E) ratio of 16.6 with the S&P 500 at 2,063. The earnings yield (E/P) of 6.04% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.34%.

The S&P 500 is hovering above its 200-day moving average at 2,054, which is acting as support. If this support level fails, downside targets include 2,040 (March 2015 low), 1,990 (January 2015 low), and 1,850 (October 2014 low). A drop to 1,850 from the high of 2,131 would represent a healthy 13% pullback. This would not be the end of the world and would inject much-needed fear to rid investors of their complacent malaise. Our worst-case objective for the S&P 500 continues to be the 1,500 area.

We welcome a pullback as an opportunity to incrementally buy stocks at lower prices. The stock market is not trading at bubble valuations (unlike the bond market), which should provide a reasonable floor on stock prices. Investors have been spoiled in recent years by the lack of a significant correction. The key is to keep emotion out of the investment process and gradually buy into weakness.