"Lack Of Volatility"

Market Commentary – September 2016

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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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 1.1% in the second quarter of 2016. This is lower than the advance estimate of 1.2%. The components of the 2016 Q2 GDP reading are as follows: consumer spending +2.94 percentage points, investment -1.67 percentage points, net exports +0.10 percentage point, and government spending -0.27 percentage point. (Note that the sum of these numbers equals 1.1%.) Consumer spending gave its strongest showing since 2014 Q4. Investment is not quite as weak as it appears. Drops in inventory drove 75% of the overall investment decline. Inventory values are notoriously volatile from quarter to quarter. Of more interest was the 30 basis point decline in residential investment (i.e., housing), the largest drop since 2010 Q3. Was this an anomaly or a sign of tougher times ahead for housing? Net exports and government spending were non-issues. Overall, the economy is struggling to gain traction.

The Federal Reserve is carefully dropping hints that it intends to slowly raise its benchmark federal funds rate over time. In the minutes from its July meeting, the FOMC reported that several members wanted to wait until they were more confident inflation would rise to the Fed's 2% objective, while others believed the U.S. is close to a fully recovered job market and rates should increase soon. In recent days, Fed Chair Janet Yellen said "In light of the continued solid performance of the labor market and our outlook for economic activity and inflation, I believe the case for an increase in the federal funds rate has strengthened in recent months." The next decision on monetary policy is scheduled for September 21.

The yield curve is flattening, which is a cautious signal on the economy. In mid-2012, the 5-year U.S. Treasury note yielded as low as 0.54%; it is now 1.18%. In contrast, the 10-year U.S. Treasury yielded 1.39% versus 1.57% today. The 30-year U.S. Treasury bond yielded 2.45% versus 2.23% today. Note that since interest rates "bottomed" in mid-2012, the 5-year Treasury is well above that lowest yield. The 30-year Treasury is below the mid-2012 yield. The 10-year Treasury is in between. This is an easy way to observe that the yield curve has flattened. In other words, short term interest rates have risen while long term interest rates have fallen. While the yield curve has not yet inverted (a situation where short term rates are actually higher than long term rates), it is on its way to doing so. Some economists view inverted yield curves as an indicator of upcoming recessions.

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 $124.34, which implies a price-to-earnings (P/E) ratio of 17.5 with the S&P 500 at 2,171. The earnings yield (E/P) of 5.73% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.57%. Still, we maintain that the attractiveness of stocks is purely relative to the extremely low interest rate environment.

Stocks overall have treaded water over the past month, but the most interest-rate sensitive stocks have tended to pull back. Buyers have continued to crawl out of the woodwork in the post-Brexit world, propping up the stock market. At some point, this will ease and the stock market will correct. Since 2,100 acted as resistance for the S&P 500, a pullback to that level would be considered "normal". It would take quite a bit for stocks to break below the 200 day-moving average at 2,054.

The lack of volatility with stock prices hovering near all-time highs is concerning. Investors have a knack for buying high and selling low. Many people see new high prices and feel compelled to rush in before prices move even higher. The problem is that a correction is imminent, and those people just bought from others who wisely sold into strength. We prefer to buy into weakness, which always seems to creep up…especially in September and October.