"This Time It's Not Different"
Market Commentary – August 2017

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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The advance 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 2.6% in the second quarter of 2017. This higher than 1.4% in 2017 Q1 and 2.1% in 2016 Q4. The components of the 2017 Q2 GDP number are: consumer spending +1.93 percentage points, investment +0.34 percentage point, net exports +0.18 percentage point, and government spending +0.12 percentage point. The sum of these numbers equals 2.57%. Consumer spending contributed 75% of GDP, which is slightly higher than its typical 70% contribution. The investment reading was disappointing, weighed down by -0.27 percentage point for residential investment (i.e., housing) – the worst contribution by housing since 2010 Q3. We believe, as does President Trump, that lower taxes and simplified regulations would jolt the economy. Unfortunately, the dysfunctional Congress makes these possibilities less likely.

The Federal Open Market Committee (FOMC) intends for monetary policy to slowly become less accommodative without becoming too restrictive. On the side of "less accommodation", the FOMC's monetary policy announcement on July 26 revealed the Fed's desire to start reducing the size of its $4.5 trillion balance sheet "relatively soon". Perhaps this will occur in its next monetary policy announcement scheduled for September 20? On the other hand, Federal Reserve Chair Janet Yellen indicated to Congress in her mid-July testimony that the "neutral" rate on the federal funds rate is lower than many may think. Financial markets already do not seem to believe the current FOMC long-run forecast for the federal funds rate of 3.0% given that the 30-year U.S. Treasury bond is yieldingly only 2.9%. With the FOMC deciding on July 26 to leave its benchmark federal funds rate at a range of 1.0% to 1.25%, the pace of rate hikes has been relaxed. Logically, it makes sense for the Fed to reduce its debt before interest rates get too high.

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 $137.21, which implies a price-to-earnings (P/E) ratio of 18.0 with the S&P 500 at 2,470. The earnings yield (E/P) of 5.55% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.29%. Low interest rates are the main reason current stock valuations can be justified. If the 10-year Treasury was at 3.0%, stock prices would feel significant pressure. The situation would be even worse with a 10-year Treasury at 4.0%.

While the S&P 500 and Dow Jones Industrial Average are in uptrends, the overall stock market is significantly weaker than one may be led to believe. As we have pointed out in recent months, a great way to highlight the underlying weakness is to observe the following index returns year-to-date as of 7/31/17 (without dividends): +20.9% Nasdaq 100, +17.9% Nasdaq Composite, +10.8% Dow Jones Industrial, +10.3% S&P 500 Large Cap, +8.7% S&P 400 Mid Cap Growth, +5.2% S&P 600 Small Cap Growth, +3.2% S&P 400 Mid Cap Value, +0.7% S&P 600 Small Cap Value. The spread between the Nasdaq 100 and S&P 600 Small Cap Value was 21.7% on 5/31/17, narrowed to 16.0% on 6/30/17, and has widened to 20.2% as of 7/31/17. The "hot" stocks have become very expensive, while the beaten-down stocks have been left behind. High volatility in the hot stocks in recent days hints that a change may come sooner rather than later.

An important axiom of investing comes from stock investor Sir John Templeton (1912-2008), who famously said: "The four most expensive words in the English language are, 'This time it's different.'" There will eventually be an unexpected, painful ending to the bubbles in growth investing, passive index/ETF investing, and complacency. Investors responsible for inflating these bubbles are chasing returns. There is no way for anyone to know when this situation will unravel, but it will probably do so when many least expect it. With our balance of stocks and cash, we are humbly prepared to try to profit when it does.