"Buyers Beware"

Market Commentary – December 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 3.3% in the third quarter of 2017. This compares with the advance estimate of 3.0%. This is decent economic growth, without a doubt, but it is not as stellar as the news headlines would lead you to believe. The components of the revised 2017 Q3 GDP number are: consumer spending +1.60 percentage points, investment +1.20 percentage points, net exports +0.43 percentage point, and government spending +0.07 percentage point. The sum of these numbers equals 3.30%. The investment number includes +0.80 percentage point related to building inventories, which is not sustainable. To put this in perspective, from 2003 through 2016, the annual value for inventories has had a mean of +0.02% and a median of -0.01%. In other words, the building of inventories is not a sustainable driver of long-term economic growth. If you subtract 0.80 percentage point from 2017 Q3 GDP, you get only 2.5%...not bad, but not great either.

The Federal Reserve is on track to make monetary policy less accommodative over time. Indications are that the Federal Open Market Committee (FOMC) will raise its benchmark federal funds rate by 0.25% on December 13. Future measures of inflation, relative to a target of 2%, will drive additional rate hikes. The Fed is also in the process of slowly reducing the size of its balance sheet. As expected, current Fed Governor Jerome "Jay" Powell was nominated by President Trump to replace Janet Yellen as Chair of the Federal Reserve (subject to Senate confirmation). This is an indication the Fed will likely continue in the same direction with its monetary policy, although perhaps with a bias toward less regulation.

All eyes are on Congress, which is working to reduce taxes in the largest tax reform effort since 1986. It is clear that stock market participants generally like the idea of lower and simpler taxes, and they are bidding stocks higher in anticipation. The question is how much lower taxes will boost corporate earnings. First, there would theoretically be a direct positive effect on profits since less money would be paid in taxes. Second, a multiplier effect would hopefully help spur economic growth, which may drive revenue growth (and hence even more profits). Differing political views can spin the debate as to how this will all shake out, but we believe that lower taxes will be beneficial. Time will help quantify the true benefit.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $140.35, which implies a price-to-earnings (P/E) ratio of 18.9 with the S&P 500 at 2,648. The earnings yield (E/P) of 5.30% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.42%. According to Banyan Asset Management month-end records, this is the first time the spread between the two rates has dropped below 3.0% since the end of March 2010. For comparison purposes, this spread reached a peak of 7.29% at the end of September 2011 (earnings yield of 9.21% versus 10-year Treasury of 1.92%). Not coincidentally, the title of our October 2011 market commentary was "A Time To Plant" – was it ever! Clearly, much attractiveness has evaporated from equity valuations since then.

There are eerie signs of bubbles popping up, and bitcoin may prove to be the canary in the coal mine. The price of bitcoin has gone parabolic, rising from less than $500 in May 2016 to over $11,000 in November 2017. Hot money is being thrown at various asset classes, especially in the technology space. Valuations are being disregarded for the sake of growth. As stock prices have risen, we have generally become more defensive in our portfolios. We now have covered calls on four stocks maturing between February and April 2018. We are also being careful with our cash positions, which we view as being short the market. Capital has started to revert back to the "unpopular" stocks that tend to make up the core of our portfolios, but the imbalances have by no means completely unwound. Market melt-ups, fueled by speculative capital and short covering, are not likely sustainable: buyers beware.