"Perception Vs. Reality"
Market Commentary – January 2017

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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. grew at an annual rate of 3.5% in the third quarter of 2016. This is higher than the advance estimate of 2.9% and the second estimate of 3.2%. With its announcement on monetary policy on December 14, the Federal Open Market Committee (FOMC) revised its September 2016 economic forecasts. The FOMC now projects GDP growth of 2.1% in 2017, 2.0% in 2018, 1.9% in 2019, and 1.8% in the "longer run" (beyond 2019). The December projections are bumped up by 0.1% point for 2017 and 2019, compared with September. The Fed still does not see an end to sluggish economic growth. From 2017 through the longer run, unemployment is expected to fluctuate between 4.5% and 4.8% (a range representing peak employment), while inflation is projected to stay between 1.5% and 2.0%. The Fed is meeting its statutory mandate of fostering "maximum employment and price stability", but it has not been able to excite GDP growth.

The FOMC raised its benchmark federal funds rate on December 14 and it telegraphed an expectation of three more rate hikes in 2017. The federal funds rate is now set for a target range of 0.50% to 0.75%, up from a range of 0.25% to 0.50%. Moreover, the Fed continues to reinvest proceeds from maturing Treasury securities and principal payments from agency debt and mortgage-backed securities, so it has yet to unravel the cumulative effects of quantitative easing. The Fed expects the federal funds rate to be 1.4% by the end of 2017, 2.1% by the end of 2018, 2.9% by the end of 2019, and 3.0% in the longer run. The 2017 projection implies three 0.25% rate hikes in 2017. While the overall level of the federal funds rate remains low, it is clear that the Fed intends to become less accommodating in the months ahead.

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 $130.93, which implies a price-to-earnings (P/E) ratio of 17.1 with the S&P 500 at 2,239. The earnings yield (E/P) of 5.85% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.45% (note the narrowing gap, though).

After hitting an all-time high in December and encountering a bit of year-end profit taking in the final days of the month, the S&P 500 is looking healthy. Continued consolidation in January would be favorable. Strong support should exist for the S&P 500 around 2,185, which was old resistance. Other levels of support include the 50 day moving average (2,195) and the 200 day moving average (2,136). The all-time intraday high for the S&P 500 stands at 2,277. After such a steep advance in stock prices, we sold a couple of stocks and opened covered call positions expiring in May. If the market continues to roar higher, we will gladly be called out of these stocks. However, if the market chooses to consolidate instead, which would be a healthy outcome, our portfolios would benefit from the covered call income. In the meantime, our average dividend yield is a robust 3.2%.

It is common knowledge that the stock market attempts to anticipate future events. Since people trade with their best information, the market represents investors' cumulative hopes and fears for the future. Sometimes, however, markets get it wrong and wild price swings result. Following the November election, the stock market has jumped significantly higher. Is this move up justified? Will GDP growth finally snap out of its rut with the fiscal policy of the Trump administration? To what extent will this translate into higher corporate earnings? While it is possible that the stock market is correctly anticipating higher earnings (because of higher economic growth, lower taxes, etc.), it is also possible that stocks have gotten ahead of reality. It is too soon to know. All of this is happening, of course, with the backdrop of the Fed's monetary policy becoming less accommodative. As we proceed into 2017, we should be mindful that stocks trade based on perception, which may or may not become reality. Professional investors understand that thoughts of greed must be replaced with a degree of fear.