"On The Brink"

Market Commentary – May 2018

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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 2.3% in the first quarter of 2018. This is compares with growth of 2.9% in 2017 Q4. The components of the 2018 Q1 GDP number are: consumer spending +0.73 percentage point, investment +1.19 percentage points, net exports +0.20 percentage point, and government spending +0.20 percentage point. The sum of these numbers equals 2.32%. While the consumer spending number was disappointing, investment was robust. Breaking down the investment number, non-residential fixed investment was up a solid +0.76 percentage point. Remember from last month that the Federal Open Market Committee (FOMC) seems convinced that the rate of economic growth has peaked.

Minutes from the FOMC meeting on March 20 and 21 affirmed the Fed's plans to continue raising short-term interest rates gradually. It seems that the real debate is at what point the Fed should deliberately restrict growth. The federal funds rate, currently in a target range of 1.5% to 1.75%, is seen by the FOMC at 2.1% by the end of 2018, 2.9% in 2019, 3.4% in 2020, and 2.9% beyond. In addition to hiking interest rates, the Fed is also trimming its bloated balance sheet each month. Note how the stock market seems to have run into a brick wall thus far in 2018. Warren Buffett famously likened interest rates to gravity in the physical world. Higher interest rates, like strong gravity, bring asset prices back down to earth. The next FOMC decision on monetary policy is scheduled for May 2.

The annual update of our universe of stocks revealed many stocks, considered too expensive for several years, which are starting to become attractive again. We analyzed a total of 1,954 companies one at a time, with a cumulative market capitalization of $34.5 trillion. Our process allowed us to identify "our universe", which is comprised of stocks we believe have the best risk/reward prospects (based on a combination of low valuation, low beta, low debt to market cap, and, usually, high dividend yield). A total of 85 stocks made the cut and have the following market capitalization ranges: $33 million to $500 million (16 stocks), $500 million to $2 billion (17 stocks), $2 billion to $10 billion (22 stocks), $10 billion to $100 billion (21 stocks), and >$100 billion (9 stocks). Most of the opportunities are in the small and micro-cap space, while the larger companies have been heavily picked over. In the coming months, we will perform in-depth fundamental research on the companies in our universe with attractive technical chart patterns to determine which ones we should buy.

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 $157.64, which implies a price-to-earnings (P/E) ratio of 16.8 with the S&P 500 at 2,648. The earnings yield (E/P) of 5.95% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.94%. The spread between the two yields has remained in a range of about 2.7% to 3.2% since October 2017, thanks to improved corporate earnings and lower stock prices. The stock market has finally cooled off.

The S&P 500 is on the brink of breaking out, which we believe will be to the downside. The S&P 500 chart has formed a "right-angled triangle" pattern. Support below exists around 2,600 (lows in February and March and also the 200-day moving average). Rallies since January 2018 have failed at increasingly lower levels: 2,873 on 1/26; 2,787 on 3/9; 2,709 on 4/18; and 2,670 on 4/27. Coiled springs house potential energy, which is suddenly converted into kinetic energy when the spring releases. This technical stock chart pattern behaves similarly: a violent breakout is likely (although not guaranteed). Considering the psychology of how rallies have been failing at lower levels, investors are becoming quicker to take profits. If support is broken, a significant move lower would be in order. We maintain that lower prices should be embraced, not feared, due to the opportunities they would bring…for investors with cash.