"Frothy"

Market Commentary – July 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 1.4% in the first quarter of 2017. This is higher than the advance estimate of 0.7% and the second estimate of 1.2%, but lower than the 2016 Q4 reading of 2.1%. On June 14, the Federal Open Market Committee (FOMC) released its revised economic projections. It sees GDP growth of 2.2% in 2017, 2.1% in 2018, 1.9% in 2019, and 1.8% in the "longer run" (beyond 2019). Only the 2017 value was increased by 0.1% when compared with March's forecasts, while the other numbers remained the same. From 2017 through the longer run, the Fed expects unemployment to fluctuate between 4.2% and 4.6% and inflation to remain around 2.0%. President Trump is confident that his policies will stimulate GDP growth above 3%, but the Fed is not convinced.

The Federal Reserve is slowly giving more clarity about the future of its monetary policy decisions. The Federal Open Market Committee (FOMC) voted unanimously to raise its benchmark federal funds rate by 0.25% to a range of 1.0% to 1.25% in its announcement on June 14. It also revealed more details about its plans to start slowly shrinking its $4.5 trillion portfolio of bonds later this year by allowing various securities to mature. After ramping up over a period of about 12 months, the Fed expects $50 billion per month in securities to roll off of its balance sheet. The Fed "anticipates reducing the quantity of reserve balances, over time, to a level appreciably below that seen in recent years but larger than before the financial crisis". (For comparison purposes, the Fed's balance sheet was about $900 billion before the 2008 financial crisis.) The Fed also reserves the right to reverse this policy should the economy need more help down the road. The next decision on monetary policy is scheduled to be announced on July 26.

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 $133.10, which implies a price-to-earnings (P/E) ratio of 18.2 with the S&P 500 at 2,423. The earnings yield (E/P) of 5.49% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.30%. The future direction of the stock market rests heavily on the direction of interest rates. We know that the Fed is raising its federal funds rate, which is a very short term rate. Interestingly, long term rates have stayed depressed. In other words, the yield curve is flattening. Investors seem content to receive paltry returns on long-term bond investments…for now, that is. Stocks are more attractive than they would be if interest rates were higher.

After hitting a peak of 2,453.82 on June 19, the S&P 500 has gently pulled back as some of the froth has started to come off of the overly-popular technology stocks. Looking lower, significant support levels exist for the S&P 500 at 2,360 and 2,330, and the 200-day moving average is currently 2,294 and rising. A pullback to any of these levels would be considered "normal". It is also reasonable to expect the spread between the Nasdaq 100 and the S&P 600 Small Cap Value to narrow. (It was 12.6% on 3/31/17, hit 21.7% on 5/31/17, and currently sits at a frothy 16.0%.) The question in our mind is whether the reversion to the mean will cause out of favor stocks to rise much more than the indexes or whether weakness in the hottest stocks will trigger selling across the board. If the former scenario comes true, our portfolios will enjoy stocks that have become strongly in favor again. If the latter scenario evolves, we will be grateful for our elevated cash position and there will be some amazing opportunities for that cash.

Many investors have been lulled into a cozy slumber and have forgotten how violently painful the stock market can become so quickly. From financial articles to interviews of market participants, there is a complacency plaguing the stock market. As the calendar ticks toward October, we cannot help but think that 2017 is the 30-year anniversary of the crash of 1987. The stock indexes showed a similar froth in January to September of 1987, before the violent correction in October erased that and more. Should an encore happen in 2017 (it may, it may not), it would become instantly obvious why we maintain cash.