"Adjusting"

Market Commentary – November 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 3.5% in the third quarter of 2018. This is down from 4.2% in 2018 Q2. The components of the 2018 Q3 GDP number are: consumer spending +2.69 percentage points, investment +2.03 percentage points, net exports -1.78 percentage points, and government spending +0.56 percentage point. The sum of these numbers equals 3.50%. Digging deeper, this GDP number is more mixed than it may appear. On the favorable side, consumer spending was robust. On the unfavorable side, net exports were negative as the strong U.S. dollar make it more expensive for foreigners to buy our goods (more on this later). However, the biggest surprise is hidden within the investment number. Inventories, which are notoriously volatile, accounted for +2.07 percentage points, which is more than all of the investment number itself. Business spending was weak, and this build-up of inventories will weigh on future production as inventory is eventually drawn down.

The Federal Reserve is at the front-and-center stage as interest rates are the primary driving force of financial markets right now. Minutes from the September 25-26 Federal Open Market Committee (FOMC) meeting revealed a Fed focused on continued interest rate hikes in an attempt to keep a lid on economic growth. They are seeking the sweet spot for interest rates that will neither drive nor slow economic growth. After eight 25 basis point increases since December 2015, the FOMC sees one more 25 basis point hike in 2018, three more in 2019, and one final increase in 2020. The next FOMC decision on monetary policy is scheduled for November 8.

Why are interest rates so important? In terms of investments, high interest rates draw money out of the stock market and into the bond market (thus pushing stock prices lower). In terms of corporate earnings, there is the obvious effect that higher interest rates weigh on corporate income statements as interest expense increases. Additionally, if interest rates are high in the U.S. relative to other parts of the world, then money will be attracted to the U.S. to earn those higher interest rates. This causes demand for the U.S. dollar. A strong U.S. dollar weighs on the earnings of U.S.-based international companies, because earnings from foreign subsidiaries (which are denominated in foreign currencies) are not worth as much when translated back into U.S. dollars. A consequence of a strong U.S. dollar, however, is that the prices of commodities, like oil, fall. Lower commodity prices, in turn, means lower inflation, and lower inflation encourages lower interest rates. Self-correcting mechanisms like these drive economic cycles.

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 $171.10, which implies a price-to-earnings (P/E) ratio of 15.7 with the S&P 500 at 2,683. The earnings yield (E/P) of 6.38% represents attractive value relative to the 10-year U.S. Treasury note yield of 3.11%. Note that the spread between the E/P and 10-Year Treasury has *expanded* from 2.68 percentage points last month to 3.27 percentage points today. The recent stock market decline has helped rebalance stock valuations with interest rates.

The S&P 500 sliced through numerous support levels in October, although it failed to break below 2,580 (the lows from February and April 2018). Looking lower, the next major support area is 2,430 (June to August 2017 support/resistance area). Keep in mind that as long as corporate earnings hold up, stocks will find fundamental support as valuations become too attractive. Meanwhile, the gap between growth and value stocks has begun to contract. For example, one month ago, the difference between year-to-date returns for the S&P 500 Growth vs. S&P 500 Value was 14.9%; now, that difference has shrunk to 9.2%. Growth stocks, especially in the technology-rich Nasdaq Composite index, have been hammered – much more so than value stocks (as expected). Overall, we view this stock market correction as an adjustment to higher interest rates. Time will tell if this turns into something more ominous.