"Zigging When Others Zag"

Market Commentary – March 2018

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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 2.5% in the fourth quarter of 2017. While this is 0.1% lower than the advance estimate of 2.6%, the four major components of GDP between the advance and second estimates were surprisingly similar. Minutes from the Federal Open Market Committee (FOMC) meeting from January 30 and 31 revealed that Federal Reserve officials believed economic growth was accelerating at a pace faster than originally thought at its December 2017 meeting. Of course, tax cuts were passed by Congress after the FOMC's December 2017 meeting, which will likely boost economic growth.

As Jerome Powell started his new job as chairman of the Federal Reserve on Monday, February 5th, financial markets responded with fireworks of volatility not seen since early 2016. It is generally believed that Chairman Powell will continue on the path of steadily removing accommodative monetary policy. This may mean three or four 25 basis point hikes in the federal funds rate in 2018 (currently in a range of 1.25% to 1.5%) and shrinking the Fed's $4.5 trillion balance sheet to $2.5-$3.0 trillion in a few years. Financial market participants are seemingly spooked about whether the economy will overheat, which would in turn cause the Fed to become even more restrictive and could possibly trigger a U.S. recession. The next FOMC announcement on monetary policy is scheduled for March 21.

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 $156.22, which implies a price-to-earnings (P/E) ratio of 17.4 with the S&P 500 at 2,714. The earnings yield (E/P) of 5.76% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.87%. With the Fed raising short-term interest rates and the federal government borrowing to finance spending and tax cuts, investors in longer-term Treasuries are now demanding higher interest rates. Higher interest rates make stocks less attractive.

Major stock market indexes in the U.S. finally had their long overdue "10% correction" in February. The S&P 500 peaked at 2,873 on January 26th and plummeted to an intraday low of 2,533 on February 9th (down -11.8% in only 10 market days). If investors were wondering whether volatility was dead, this drastic move caused them to stop wondering. It is always amazing to observe that no matter how steady a rise in asset prices, the eventual collapse seems to occur three times as quickly. The bounce off of the low of 2,533 stopped at 2,780 and the stock market has turned back south without forming a higher high (which is called a "failed rally"). Market technicians will closely watch for support around 2,550 due to the closing low in February and the 200-day moving average. If this level is materially breached on a closing basis, significant technical damage would be done and a much deeper decline would be in store. On the other hand, taking out the highs of 2,780 in the short-run and 2,873 longer-term would excite the bulls. Of course, there is always the possibility of a trading range where the market fluctuates back and forth.

The breadth problem from 2017 has gotten worse in 2018, which has us concerned about market risk. An analysis of the major index returns (without dividends) from 1/1/2017 through 2/28/2018 is a perfect example of "herd mentality" among investors: +40.9% Nasdaq 100 (largest 100 Nasdaq companies); +35.1% Nasdaq Composite; +26.7% Dow Jones Industrial; +21.2% S&P 500 Large Cap (market cap weighted); +18.6% S&P 400 Mid Cap Growth; +16.3% S&P 500 Large Cap (equal weighted); +13.2% S&P 600 Small Cap Growth; +6.6% S&P 600 Small Cap Value; +5.8% S&P 400 Mid Cap Value; +1.4% Dow Jones Utility. The following patterns stand out: 1) the largest technology companies are racing to new highs; 2) large-cap stocks are outperforming small and mid-cap stocks; 3) investors are piling into growth stocks and shunning value stocks. The February correction did not "scare" speculators enough to reverse these patterns. When the majority of investors prefer zagging, we prefer to zig.