"Don't Fight The Central Banks…For Now"

Market Commentary – November 2014

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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 2014. This is lower than the 4.6% reading for 2014 Q2. The 3.5% Q3 GDP reading was generated by the following components: consumer spending +1.22 percentage points, investment +0.17 percentage point, net exports +1.32 percentage points, and government spending +0.83 percentage point. Consumer spending, which historically makes up about 70% of GDP, was respectable in Q3, although it could have been stronger. Investment was weighed down by a drop in inventories and weak residential spending. Net exports jumped higher, but it is questionable how sustainable this is, especially with the stronger dollar in recent weeks (a strong dollar encourages imports and discourages exports). Government spending spiked, but future spending will be constrained by stretched fiscal budgets. Overall, the Q3 reading was decent, but it was perhaps a bit less robust than the headline may suggest.

As expected, the Federal Open Market Committee (FOMC) ended its controversial "quantitative easing" or "QE" program with its announcement on October 29. While the Fed is no longer buying additional bonds, it does plan to reinvest principal payments from its existing debt holdings as they mature. As a result, the size of the Fed's $4.5 trillion balance sheet should stay relatively constant. When the Fed eventually stops reinvesting, other bond buyers will need to fill the Fed's big shoes (likely resulting in lower bond prices and higher yields). In terms of the federal funds rate, the FOMC stuck with its language of keeping it at a rock-bottom range of 0%-0.25% "for a considerable time". The next scheduled FOMC announcement regarding monetary policy is December 17.

In a recent TV interview, Warren Buffett cleverly stated, "interest rates to stocks are like gravity to physical objects." Of course, weak gravity allows objects to float up toward outer space, while strong gravity pulls objects back toward Earth. In the financial world, low interest rates allow asset prices (including stock prices) to float higher, while high interest rates weigh on asset prices. Investors jump at any news of central banks perpetuating the current nirvana of low interest rates. For example, the October 8th release of minutes from the FOMC's September policy meeting caused the Dow Jones Industrial Average to spike 275 points on hopes that particular concerns could cause the FOMC to keep interest rates lower for longer. Days later, global stock markets became volatile and were near collapse when central bankers lured investors from the edge of the cliff with more promises of low rates. On October 31, the Bank of Japan jolted global markets with a surprise, unprecedented asset purchase stimulus, causing the Japanese stock market to skyrocket 5% and major stock markets to rally worldwide.

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 $129.42, which implies a price-to-earnings (P/E) ratio of 15.6 with the S&P 500 at 2018. The earnings yield (E/P) of 6.41% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.34%. While sovereign debt markets are in bubbles, stock prices are not.

Major stock markets were on the verge of a 1987-style crash in mid-October when central bankers came to the rescue yet again. The S&P 500 bottomed at an intraday low of 1820 on October 15, before bouncing back by an amazing 10.8% over the next two weeks. With the S&P 500 now sitting at a new high, investor sentiment is soaring. According to the American Association of Individual Investors weekly survey of investor sentiment reported on October 30, nearly 50% of investors were bullish for the second week in a row (well-above the historical average of 39%). The recent rally has been led by riskier stocks. We prefer to maintain our margin of safety by sticking with stocks that have attractive valuations, strong balance sheets, low betas, and high dividends.