"Weaker Than It Looks"

Market Commentary – November 2015

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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 1.5% in the third quarter of 2015. On the heels of growth of 0.6% in Q1 and 3.9% in Q2, Q3 showed a resumption of the choppy economic growth we have learned to accept as the new normal. Investment spending reigned in growth this time, cutting 0.97 percentage point from GDP (the worst showing since 2011 Q1). Digging deeper into this investment reading, however, reveals a more benevolent cause for the decline. Inventory changes reduced GDP by 1.44 percentage points. In other words, businesses chose to consume and not replenish inventories. This pattern tends to reverse itself in future quarters, rather than be the canary in the coal mine indicating something worse than our tepid economy.

On October 28, the Federal Open Market Committee (FOMC) chose to leave its benchmark federal funds rate unchanged at a rock-bottom range of 0% to 0.25%. In its statement, the FOMC wrote "In determining whether it will be appropriate to raise the target range at its next meeting, the (FOMC) will assess progress…toward its objectives of maximum employment and 2 percent inflation." They add that this assessment will include a variety of factors, including "readings on financial and international developments". The fate of interest rates may rest with the stock market. If the stock market is wobbly come December 16, the FOMC may leave rates alone until 2016. However, if stocks hang on to or build upon their October gains, a hike may be in the cards.

While the October rally in stock prices was impressive on the surface, a deeper look gives hints of the same problem plaguing stocks earlier in the year: bad breadth. Fewer stocks are enjoying rising prices, which indicates that the stock market is not healthy. An analysis of the major index returns (without dividends) for 2015 year-to-date tells the story: +9.7% Nasdaq 100 (largest 100 Nasdaq companies); +6.7% Nasdaq Composite; +3.7% S&P 600 Small Cap Growth; +3.2% S&P 400 Mid Cap Growth; +2.0% S&P 100 Mega Cap; +1.0% S&P 500 Large Cap (market cap weighted); -0.9% Dow Jones Industrial Average; -1.7% S&P 500 Equal Weighted; -3.6% Russell 2000 (small and mid cap companies, combining growth and value); -4.5% S&P 400 Mid Cap Value; -5.4% S&P 600 Small Cap Value; -6.1% Dow Jones Utility Average; -11.1% Dow Jones Transportation Average. Here are the patterns that stand out: 1) the largest technology companies are racing to new highs; 2) technology stocks in general are doing relatively well; 3) investors are bidding up the price of growth stocks in our growth-starved world; 4) the smaller the company, the bigger the spread between growth and value; 5) Dow theorists are alarmed that the Industrial, Utility, and Transportation averages are negative for the year.

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 $122.67, which implies a price-to-earnings (P/E) ratio of 17.0 with the S&P 500 at 2,079. The earnings yield (E/P) of 5.90% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.15%. The combination of higher stock prices and an EPS estimate $2.50 lower than last month is a double-whammy for valuations.

Risk of "the plunge" has been temporarily set aside, thanks to the readiness of the European central bank to add more quantitative easing if needed and the Chinese central bank lowering interest rates for the sixth time since November 2014. The Fed can take some credit, too, for kicking its interest rate can down the road. This does not mean we can fall asleep at the wheel. The S&P 500 faces significant resistance between its current level and 2,130, the triple top from May, June, and July of 2015. Looking below, support exists at 2,000 (old resistance in September) and 1,870 (lows of the late summer swoon). Most likely, the stock market is back in a malaise that has characterized the majority of stocks for 2015. We refuse to overpay for growth just because it is popular.