“The Secret”
Market Commentary – December 2019

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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 2.1% in the third quarter of 2019. This is higher than the 2.0% reading for 2019 Q2. Economic growth was solid during the five quarters spanning from 2017 Q3 through 2018 Q3, averaging 3.1% per quarter. At the beginning of October 2018, Federal Reserve Chair Jerome Powell said, referring to the Fed’s benchmark federal funds rate, “we’re a long way from neutral at this point, probably.” The stock market collapsed over the following three months and economic growth slowed with it, as 2018 Q4 GDP grew at a tepid 1.1%. Realizing his error, Fed Chair Powell reversed course on monetary policy and reignited a cycle of rate cuts. GDP bounced back to 3.1% in 2019 Q1, before cooling to 2.0% in 2019 Q2 and 2.1% in 2019 Q3. Since it is well known that monetary policy operates with a lag, the slowdown in 2019 was likely due in part to the Fed raising rates too high in 2018. In the months ahead, lower interest rates should help boost economic growth.

With the benchmark federal funds rate in a range of 1.50% to 1.75% following three 0.25% cuts in 2019, financial markets are wondering what is next for this key rate. Fed Chair Powell has hinted in recent weeks that the Fed has no plans to cut or raise the federal funds rate going forward. Futures markets seem to agree, predicting that the federal funds rate will only be 0.25% lower by October 2020. The Federal Reserve has a statutory mandate to maximize employment and price stability. Their job, ironically, is not to drive economic growth. With unemployment hovering around the lowest level in 50 years and inflation running below the Fed’s 2% objective, current monetary policy seems appropriate. The inverted yield curve situation has been fixed, too. The next FOMC decision on monetary policy is scheduled for December 11.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are bullish on the market. The Standard & Poor’s forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $170.85, which implies a price-to-earnings (P/E) ratio of 18.4 with the S&P 500 at 3,141. The earnings yield (E/P) of 5.44% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.78%. The spread between these two rates has compressed to 3.66% (the larger the spread, the more attractive stocks are). While this spread is down from 4.32% on September 30, 2019, it is also much higher than 2.68% from October 31, 2018.

The S&P 500 continued to march higher, forming yet another all-time high of 3,153 in November. Rest assured that stock prices have not forgotten how to decline. A significant pullback will eventually happen, seemingly without notice. In the meantime, we are in a favorable time of year with December and January. Support should exist around 3,100 (support from a minor November pullback), 3,026 (July 2019 high and 50-day moving average), and 2,927 (200-day moving average).

The secret to making money in the stock market is to not lose too badly. At first blush, this may seem obvious, but a dive into the numbers illustrates what this means. Assume a stock starts at $100 per share and declines 10% to $90. For that $90 stock to trade back to $100, it needs to gain $10 (on a $90 investment, which is an 11% increase). Therefore, a 10% loss creates the need for an 11% gain to break even. If a stock loses 25% (goes from $100 to $75), it must gain 33% to break even (gain $25 from $75). If a stock loses 50%, it must gain 100% to break even. If a stock loses 90%, it must gain a whopping 900% to break even. Note how the math goes exponentially against the investor in the realm of steep losses.

Cash is a critical tool to help a portfolio from losing too badly in a market decline (and more importantly, profiting from the eventual rebound). With the stock market uptrend in recent years, it is easy to forget the importance of cash. A black swan event can happen when you least expect it. Stocks are significantly riskier today than they were a year ago when the market was in a cascading daily freefall. We continue to enjoy the upside potential in stocks, but we are mindful that reward does not come without risk.