“Boomerang Stock Market”

Market Commentary – March 2019

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The initial 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 2.6% in the fourth quarter of 2018. This is down from 3.4% in 2018 Q3. The components of the 2018 Q4 GDP number are: consumer spending +1.92 percentage points, investment +0.82 percentage point, net exports -0.22 percentage point, and government spending +0.07 percentage point. The sum of these numbers equals 2.59%. While growth has seemingly slowed a bit since 2018 Q2's reading of 4.2%, the Q4 result was decent overall. Consumer spending drove 74% of Q4 GDP, which is roughly in line with historical patterns. Nonresidential fixed investment made up essentially all the investment contribution to GDP. The only soft spot continued to be residential investment (i.e., housing), weighing on Q4 GDP by -0.14 percentage point. Residential investment has had a mildly negative contribution to GDP for four consecutive quarters.

Minutes of the January 29-30 Federal Open Market Committee (FOMC) meeting, released on February 20, reveal how sensitive the Fed was to the volatile financial markets in December. As reported in the minutes: “Financial markets were quite volatile over the intermeeting period”, citing “a weaker outlook and greater uncertainties for foreign economies (particularly for Europe and China), perceptions of greater policy risks, and the partial shutdown of the federal government.” The Fed added, “Against this backdrop, market participants appeared to interpret FOMC communications…as not fully appreciating the tightening of financial conditions and the associated downside risks to the U.S. economic outlook.” As we correctly expected, the Fed did indeed blink at stock market weakness. The next FOMC announcement on monetary policy is scheduled for March 20.

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 $166.36, which implies a price-to-earnings (P/E) ratio of 16.7 with the S&P 500 at 2,784. The earnings yield (E/P) of 5.97% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.71%. Earnings estimates continue to come down while stock prices have been rising. Without a doubt, the relative value remaining is not as juicy as it was in the depths of the December plunge, but it is still attractive on an absolute basis.

The extreme stock market weakness seen in December has reversed and boomeranged back up. While the decline took about three weeks and the subsequent rally has taken about nine weeks, the S&P 500 is back at the highs of November and December. The S&P 500 faces significant technical headwinds moving forward. The 2,800 level should provide some resistance overhead, due to the highs in November and December. Looking even higher, resistance should exist around 2,870 (January 2018 high) and 2,930 (all-time closing high in September 2018). On the other hand, major support should exist near the following levels: 2,750 (200-day moving average), 2,630 (November closing low and 50-day moving average), and 2,350 (December closing low).

Recent strength in the stock market has been surprising, but we are not complaining. The 2008 playbook is working out well once again. Portfolio management is less about predicting the future and more about planning for it. When the stock market drops, there is no way of knowing how low it will go. What we do know, however, is that stock prices are significantly lower than they were (such as in December 2018). Likewise, there is no way to know that the market would boomerang higher as quickly as it has. Thinking back to 2008, the opposite happened. The stock market would undergo a vicious round of selling, rally up a bit, and then tank to an even lower level. This could have played out again after the December 2018 decline, and it *still* may happen in 2019. In the meantime, we can be satisfied that we did not panic in December and put more cash to work (depending on a specific client's objectives and risk profile, of course). We cannot overemphasize the importance of our old friends, “balanced” and “incremental”.