"Index And Fund Investors Beware"

Market Commentary – July 2018

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The third 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 2.0% in the first quarter of 2018. This is lower than the advance estimate of 2.3% and the second estimate of 2.2%. On June 13, the Federal Open Market Committee (FOMC) released its revised economic projections. It sees GDP growth of 2.8% in 2018, 2.4% in 2019, 2.0% in 2020, and 1.8% in the "longer run" (beyond 2020). The forecast for 2018 was bumped up from 2.7%, while the other projections remained the same. Some economists are becoming concerned about a recession in 2020. They cite the convergence of the diminishing effects of lower taxes, higher interest rates, and a shrinking Federal Reserve balance sheet. Former Fed chairman Ben Bernanke recently stated "in 2020, Wile E. Coyote is going to go off the cliff and is going to look down." Economic cycles are *cyclical* by nature – they do not last forever.

As expected, on June 13, the FOMC raised its target range for the federal funds rate to 1.75% to 2.0%. By the end of 2018, the FOMC now sees a federal funds rate of 2.4%, up from its projection of 2.1% in March. This implies yet two more 25 basis point hikes to a range of 2.25% to 2.5%. Moreover, the FOMC nudged up its federal funds rate projection for 2019 from 2.9% to 3.1%. It left its 2020 and longer run forecasts alone at 3.4% and 2.9%, respectively. Adding to the drama, the European Central Bank released plans in June to shut down its $2.9 trillion bond-buying program by the end of 2018 and added the possibility of raising its interest rates in the second half of 2019. The global central bank party of monetary stimulus is coming to an end. The next FOMC decision on monetary policy is scheduled for August 1.

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 $161.75, which implies a price-to-earnings (P/E) ratio of 16.8 with the S&P 500 at 2,718. The earnings yield (E/P) of 5.95% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.85%. The yield curve is in danger of inverting, as evidenced by the following Treasury yields: 1-month 1.77%, 1-year 2.33%, 5-year 2.73%, 10-year 2.85%, and 30-year 2.98%. With short-term interest rates on the rise, long-term interest rates should be following suit; they are not. Investors need to watch this potential flag for a future recession.

The S&P 500 is grinding back and forth in a trading range, although there is a slight upward bias. In June, the S&P 500 closed as high as 2,787, which exactly matched the closing high from March and confirmed this price level as resistance. There is also resistance from the all-time high in January (2,872). In terms of support below, the S&P 500 has formed incrementally higher lows since March. Support levels exist at the 200-day moving average (2,669) and around the lows from February, March, and May (2,600). A break below the 200-day moving average would be ominous, but the piercing of 2,600 would likely be accompanied by a violent downdraft to significantly lower levels.

Investors are allocating money to the S&P 500 in a lopsided manner, with a full 26% of the S&P 500 in the information technology sector. Technology is only one of 11 sectors! This is a heavy overweight and represents a bubble that is getting worse. To exemplify this bubble, pages 2 and 3 of *Barron's* (premium advertising space) were for an Exchange Traded Fund (ETF) representing the "communication services" sector. S&P officially calls this sector "telecommunications" and includes traditional companies like AT&T, Verizon, and CenturyLink. The advertisement shows the ETF's major holdings as 23% Google, 21% Facebook, and 5% Netflix, before getting to AT&T as a 5% holding. Think about it – 49% of the ETF is in three richly priced non-telecom stocks. It is surprising that the ETF company did not figure out how to spin Amazon into the fund! This bubble will eventually burst, and when it does, the indexes will get crushed. We are, however, becoming increasingly convinced that instead of taking down all boats, the "forgotten" value stocks would prosper. Index and fund investors beware…