"The Big Experiment"

Market Commentary – October 2016

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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 1.4% in the second quarter of 2016. This is higher than both the advance estimate of 1.2% and the second estimate of 1.1%. With its announcement on monetary policy on September 21, the Federal Open Market Committee (FOMC) revised its June 2016 economic forecasts. The FOMC now projects GDP growth of 1.8% in 2016, 2.0% in 2017 and 2018, 1.8% in 2019, and 1.8% in the "longer run" (beyond 2019). June projections were 2.0% across the board. It is fascinating that the "longer run" growth forecast now begins with a "one". Sluggish economic growth of recent years appears here to stay; but why?

The Federal Reserve left its benchmark federal funds rate in a target range of 0.25% to 0.50% on September 21, but signaled that it still expects to raise it before year-end. According to its press release, "The Committee judges that the case for an increase in the federal funds rate has strengthened but decided, for the time being, to wait for further evidence of continued progress toward its objectives." (The Fed's statutory mandate is to maximize employment while maintaining low inflation.) In June 2016, the Fed projected its federal funds rate at 0.9% in 2016, 1.6% in 2017, 2.4% in 2018, and 3.0% in the longer run. In September 2016, it revised its projections to 0.6% in 2016, 1.1% in 2017, 1.9% in 2018, 2.6% in 2019, and 2.9% in the longer run. There are two remaining FOMC announcements on monetary policy scheduled for 2016: November 2 and December 14. While the Fed is supposed to be "non-political", with the election occurring on November 8, all eyes will be on December 14 for the next interest rate hike. Remember that higher interest rates are bearish for stock, bond, and real estate prices.

Macroeconomics often feels like a big experiment. Equally smart economists intelligently argue reasons to do and not to do particular policies, and there is no better example of this than the FOMC itself. Of the ten voting members of the FOMC, seven voted in favor of leaving the federal funds rate at its current range of 0.25% to 0.50% and three voted to raise the target range to 0.50% to 0.75%. One of the dissenting votes was cast by Esther George, President and CEO of the Federal Reserve Bank of Kansas City. Ms. George had spoken to the Forum Club of Southwest Florida in February 2014. At the time, she commented that unwinding the unprecedented accommodative monetary policy will be a "turbulent process", and she admitted that we are in uncharted waters regarding economic policy. She also mentioned during her February 2014 presentation that she was in favor of raising rates as soon as possible, as there will likely be unintended consequences by leaving them abnormally low for too long.

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 $127.92, which implies a price-to-earnings (P/E) ratio of 17.0 with the S&P 500 at 2,168. The earnings yield (E/P) of 5.90% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.61%. Low interest rates are attracting money into riskier asset classes as investors search for yield. As a result, the prices of these assets are bid higher than they would be in a more normal interest rate environment.

The S&P 500 tried to correct in September, but bounced from 2,125 after only a 2.8% pullback. There is considerable support around 2,100 from previous resistance and the 200-day moving average at 2,059. It seems that recent big down days in the stock market have been caused by speculation that interest rates are heading higher, only to be offset by other days where such concerns were alleviated. The U.S. election on November 8, which includes the important vote for our country's next president, is sure to occupy headlines in the weeks ahead. But it is the central banks, in the U.S. and worldwide, that truly have the attention of the financial markets. This is where we should be focused.