"Buy Quality, Avoid Hype"

Market Commentary – May 2017

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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 0.7% in the first quarter of 2017. This is lower than the 2016 Q4 reading of 2.1% and the worst since 2014 Q1's drop of -1.2%. The components of the 2017 Q1 GDP number are: consumer spending +0.23 percentage point, investment +0.69 percentage point, net exports +0.07 percentage point, and government spending -0.30 percentage point. The sum of these numbers equals 0.69%. The contribution from consumer spending was the lowest since 2009 Q4, and the drop from 2016 Q4's +2.40 percentage point contribution is dramatic. Making matters worse, the collapse affected both goods and services. Investment was not quite as weak as it appears, with inventories (notoriously volatile) weighing on the result by -0.93 percentage point. Overall, the economy has been exhibiting the same characteristics since this shaky recovery began in 2009.

The Federal Reserve finally gave a few clues about reducing the size of its bloated $4.5 trillion balance sheet in the minutes from the Federal Open Market Committee (FOMC) meeting on March 14-15. The Fed inflated its balance sheet from around $900 billion in August 2008 to $4.5 trillion today with its quantitative easing ("QE") programs during and after the 2008-2009 financial crisis. While the balance sheet stopped growing in late 2014 (the end of QE), the FOMC has continued to reinvest proceeds of maturing securities, effectively keeping the balance sheet around $4.5 trillion. In its most recent minutes, the Fed revealed that "most participants…judged that a change to the committee's reinvestment policy would likely be appropriate later this year", adding that "reducing the size of the balance sheet should be conducted in a passive and predictable manner." The next FOMC decision on monetary policy is scheduled to be announced on May 3.

Passive investing is creating market inefficiencies (i.e., opportunities) for true active managers. A trend in recent years has been investors flocking to the indexes and shunning active management. Many popular indexes select stocks based on market capitalization and do not discriminate based on valuation, balance sheet strength, or many other important factors. Therefore, indexes by definition include both "quality" and "hyped" stocks, and capital that should logically go toward quality stocks is instead siphoned by hyped ones. True active managers (not "closet indexers"), who establish parameters to separate quality from hype, can position their portfolios toward what they believe are quality stocks and avoid the hype. Eventually, the opportunities presented by the quality stocks will be too sweet for Mr. Market to resist, and investors will sell the hype and buy the stocks they should have been buying all along. Index investors will be left holding the bag, with portfolios tainted by formerly popular stocks that have been brought back to reality. The pendulum of popularity will ultimately swing back from passive to active investing.

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 $134.32, which implies a price-to-earnings (P/E) ratio of 17.8 with the S&P 500 at 2,384. The earnings yield (E/P) of 5.63% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.28%, with the caveat that stocks are attractive only because interest rates are so low.

The pattern of a small handful of large technology companies outperforming the rest of the market became even more pronounced in April. The following are key index returns year-to-date as of 3/31/17 and 4/30/17 (without dividends): Nasdaq 100 +11.8%, +14.8%; S&P 400 Mid Cap Value +2.2%, +2.1%; S&P 600 Small Cap Value -0.8%, -0.3%. Passive index investing is magnifying the situation since larger market capitalizations attract even more capital away from the smaller "quality" names that truly deserve the investment capital. We see opportunity, but it may take months or even years for the market to recognize the same opportunities. Patience is required.