"Bubbly"

Market Commentary – September 2018

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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 4.2% in the second quarter of 2018. This is up from the advance estimate of 4.1%. The Federal Reserve has a statutory mandate to "foster maximum employment and price stability". Unemployment in July was only 3.9%, which is likely representative of (or close to) full employment. People who want work are generally able to find it. Inflation, as measured by the Consumer Price Index (CPI), was 2.9% for the 12 months ending in July 2018. Excluding the volatile food and energy segments, CPI was 2.4%. The Fed is trying to target inflation at 2%. It seems that inflation may be starting to ignite. High inflation would cause the Fed to tighten monetary policy in an attempt to slow the economy and squelch inflation. Might this be our future?

The Fed is at a crossroads, as they weigh making monetary policy less accommodative with the risk that they overshoot their goals and possibly help cause the next recession. In a pre-scheduled monetary policy announcement on August 1, the Federal Open Market Committee (FOMC) decided to leave its benchmark federal funds rate in a range of 1.75% to 2.0%. The Fed expects two more 25 basis point hikes before the end of 2018 (there are only three more meetings). In terms of its balance sheet due to the legacy effects of quantitative easing, the Fed has already lowered its assets by nearly $200 billion over the past year to $4.3 trillion. Effective July 2018, assets are being erased at a rate of $40 billion per month. Any way you slice it, the Fed is becoming less accommodative and more restrictive. Higher interest rates cause businesses to pause on corporate spending, which could trickle through the economy and trigger a recession. The next FOMC decision on monetary policy is scheduled for September 26.

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 $167.49, which implies a price-to-earnings (P/E) ratio of 17.3 with the S&P 500 at 2,901. The earnings yield (E/P) of 5.77% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.85%. Even though the stock market has risen in recent weeks, valuation had not become richer since earnings have increased proportionally.

The S&P 500 was able to break through major resistance at 2,870, so technically there is no resistance overhead…for now. From a practical perspective, the index will take a temporary rest at some point. It cannot continue to go straight up. Areas of support should be around 2,870 (old resistance becomes new support), 2,730 from the 200-day moving average, 2,700 from the June lows, and 2,600 from the lows in February, March, and May.

The parabolic performance of a handful of large cap technology stocks and some other non-tech "growth" stocks looks and smells like a bubble. As we have done in some previous market commentaries, an analysis of the major index returns (without dividends) from 1/1/2018 to 8/31/2018 tells the story: +22.8% S&P 600 Small Cap Growth; +19.7% Nasdaq 100 (largest 100 Nasdaq companies); +17.5% Nasdaq Composite; +15.3% S&P 500 Large Cap Growth; +12.1% S&P 600 Small Cap Value; +9.3% S&P 400 Mid Cap Growth; +5.7% S&P 400 Mid Cap Value; +5.0% Dow Jones Industrial; +1.4% S&P 500 Large Cap Value. Growth is trouncing value. It is almost as if valuations no longer matter. Bubbles are fun while they are inflating, but they can burst at any time. Do investors know what they are getting into? The situation is a lot riskier than it appears on the surface.

There are opportunities in certain value stocks that are being ignored by market forces at the moment. We bought some of these companies in recent weeks. Cheap valuations, strong balance sheets, high dividends, and low betas are attractive to us. We also have cash to take advantage of a possible contagion resulting from the popping of the bubble. Investors do not plan to fail, but they often fail to plan.