"April Fools"
Market Commentary – April 2015

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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 2.2% in the fourth quarter of 2014. This is lower than the advance estimate of 2.6% and identical to the second estimate. At its March meeting, the Federal Open Market Committee (FOMC) updated its December economic projections. They now see 2015 GDP growth at 2.3%-2.7% (vs. 2.6%-3.0% in December), 2016 GDP at 2.3%-2.7% (vs. 2.5%-3.0%), 2017 GDP at 2.0%-2.4% (vs. 2.3%-2.5%), and "longer run" GDP at 2.0%-2.3% (vs. 2.0%-2.3%). Aside from the fact that it downgraded its economic outlook, it is interesting to observe that the FOMC projects today's rate of economic growth to continue in the foreseeable future.

In its monetary policy announcement on March 18, the FOMC dropped its assurance to be "patient" before raising interest rates. "An increase in the target range for the federal funds rate remains unlikely at the April FOMC meeting," the FOMC wrote. It added that it will raise rates "when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2% objective over the medium term." Despite dropping the word "patient", financial markets interpreted the FOMC announcement and downgrade of the U.S. economy as a hint that the federal funds rate will not be increased until later in 2015 (i.e., not at the June FOMC meeting). The S&P 500 rallied more than 1% within moments of receiving this news. Investors love postponing the inevitable.

It is amazing how the bubble in sovereign debt is essentially going unnoticed by many financial market participants. At the Forum Club of Southwest Florida luncheon on March 6, the featured speaker was Charles Morrison, President of Asset Management at Fidelity Investments. When asked about potential risks in the current stock market, Mr. Morrison paused and said, "There are no clouds that we can see in the near future." He did not identify the possible presence of a sovereign debt bubble. Ironically, he explained how yields on certain German government bonds are negative, which he said is "essentially the German government taxing you to fund their debt." Maybe we are missing something, but to us, this is most certainly indicative of a bubble.

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 $118.55, which implies a price-to-earnings (P/E) ratio of 17.4 with the S&P 500 at 2,068. The earnings yield (E/P) of 5.73% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.93%. This difference is at the heart of the Fed's magic of lowering interest rates. It forces investors to take more risk than they may have otherwise taken to try to earn a decent return.

The S&P 500 has been volatile in recent weeks, but it is still above the 200-day moving average (currently 2,012). At the end of November 2014, the S&P 500 index closed at 2,068, the same level as today. The index has essentially treaded water for four months. Market breadth has deteriorated, indicating that only a handful of stocks are driving the index. This is unhealthy. On the downside, we are looking at 2,040 and 2,000 as important areas of support. A push below 2,000 could trigger a momentum swing down to the October low near 1,850. Longer-term, we see downside risk to the 1,500 area. On the upside, a rally through 2,120 would be a new high and thus resume the questionable uptrend.

Our management style has been out of favor in recent months, which is a flashback to 2007 and what turned out to be a major market peak. NASDAQ stocks, especially in tech and biotech, have been a popular destination for hot money. Even the stodgy Dow Jones Industrial Average has seen capital rush to its most expensive components. We are staying true to our process, which keeps us objective. Perhaps market participants are about to get fooled.