"No Alternative?"

Market Commentary – August 2016

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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 1.2% in the second quarter of 2016. The headline number is a continuation of the sluggish economic growth plaguing the U.S. economy. Since this recovery began in mid-2009, only 7 out of 28 quarters have seen GDP grow by at least 3.0%: 2009 Q4 (3.9%), 2010 Q2 (3.9%), 2011 Q4 (4.6%), 2013 Q3 (3.1%), 2013 Q4 (4.0%), 2014 Q2 (4.0%), and 2014 Q3 (5.0%). To illustrate how anemic this recovery has been, we can compare it to two other recent major economic expansions using U.S. Bureau of Economic Analysis data: quarterly GDP growth was at least 3.0% in 19 out of 24 quarters from 1994 to 1999, and 22 out of 28 quarters from 1983 to 1989. The causes of the weak recovery since 2009 are debatable, but high U.S. corporate taxes relative to the rest of the world, the burden of $19 trillion in U.S. government debt, excessive regulation, and "affordable healthcare" laws that have made healthcare anything but affordable are topics to consider. What we do know is that something is not quite right with this "recovery".

On July 27, the Federal Open Market Committee (FOMC) decided to keep its benchmark federal funds rate between 0.25% and 0.50%. Their monetary policy press release revealed strength with consumers and weakness on the part of businesses. "Household spending has been growing strongly but business fixed investment has been soft." The Fed has observed gains in jobs, but the gains have not been strong enough to stoke inflation. (The key on this front would be a shortage of workers for available jobs causing wage inflation, in addition to the propensity for people with cash to spend.) The FOMC continues to be on hold, and with the election coming up in November, the probability of seeing a rate hike before then is slim. The next decision on monetary policy is scheduled for September 21.

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 $124.97, which implies a price-to-earnings (P/E) ratio of 17.4 with the S&P 500 at 2,174. The earnings yield (E/P) of 5.75% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.46%. That being said, stocks are not nearly as attractive as they were a few years ago. The last time the 10-year Treasury yield was at 1.49% was in August 2012. At the time, the E/P on the S&P 500 was 7.86%, for a yield spread of 6.37% (7.86% minus 1.49%). This spread is now 4.29% because stock valuations are much higher.

The strength of the post-Brexit panic reversal in stock prices has been surprising. Since touching an intraday low of 1,992 on June 27, the S&P 500 has rallied 9.1%. Most surprisingly, market participants took this opportunity to drive the S&P 500 through resistance around 2,100, a level that had been a ceiling since late 2014. A pullback to test old resistance as support would be in order, but we must respect an index that is pushing to new all-time highs. Interestingly, the strength has not extended to all indexes. The Russell 2000, a measure of small and mid-cap stocks, is still 5.8% below its 2015 high. The Dow Jones Transportation Average is 15.7% below its 2015 high. The tide is not raising all boats.

The only way you can justify current stock prices is if interest rates stay at these rock-bottom levels. Central banks worldwide have forced money back into risk assets, including the stock market. Ten-year sovereign bonds are currently yielding -0.18% in Japan, -0.12% in Germany, +0.10% in France, +0.69% in the U.K., and +1.17% in Italy. Negative interest rates each year for 10 years in Japan and Germany? This is a massive bubble that will eventually burst with disastrous consequences for stocks and real estate. Unfortunately, we cannot identify when this will happen. Absent a crystal ball, we must rely our portfolio management discipline and our fundamental and technical analysis tools. When stocks get ahead of their earnings power, we prefer to sell. One of the worst things investors can do is buy (or refuse to sell) a risky asset because of the perception that there is "no alternative".