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Market Comment Summer 2018

The US Stock market continues to wrestle with the conflicting news flow. Uncertainties surrounding trade, interest rates and economic growth in Europe are being offset by a favorable economic backdrop in the US as witnessed by strong corporate profit growth. This tug of war has resulted in modest gains for domestic equities, but a more challenging outlook for fixed income securities and international stocks. While volatility has picked up considerably from a year ago, markets continue to gradually climb this "Wall of Worry". The level of risk is rising, however, and any sign of turmoil in economic conditions could send investors scurrying to the sidelines. Stay tuned…

FUNDAMENTAL & ECONOMIC INDICATORS

For the year to date through 6/30/2018 the S&P 500 ETF (IVV) returned 2.51%. Earnings for all S&P 500 companies are expected to increase 20% from last year to $159 (up from $153). The closing price for IVV on June 30, 2018 was 2718.37. The Price/Earnings ratio (P/E), based on 2018 earnings is currently 17.09. Since 1988 the range for the P/E on IVV has been 17.34-22.36. This range includes very high P/E ranges from 1998-2002 during the tech boom. Since 2009 the P/E range has been 15X to 19.39X. Next year 2019 earnings are expected to grow only 10% to $175. Based on next year's earnings the current market P/E is a very reasonable 15/5x. These Statistics tell us the market is not overvalued.

The Smallcap S&P index, IJR, has significantly outperformed the large cap stocks in the S&P 500 returning 9.28%. This is due to small caps not being involved in international trade disputes. Generally, small companies are domestically oriented so they have not had to deal with the fallout from the tariffs. IJR earnings are expected to grow 34.5% in 2018 and 19.3% in 2019.

On 7/9/18 the 10 year Treasury yields 2.8. The 2 year Treasury yields 2.47. The difference between these is .33 or 33 basis points and is called the yield spread. When the 2 year yields more than the 10 year the spread is negative. This is called an inverted yield curve and has an excellent record of forecasting recessions. We are dangerously close to this point and clearly the market has noticed. Whether investors are taking cover in the safety of treasuries due to the trade tensions or just taking advantage of higher rates, the demand for treasuries has increased. While there are many possible explanations for why interest rates are behaving this way, we prefer to avoid the "this time it's different" chorus and focus on the facts. The last time the curve inverted was December 2005. One year later, the market peaked. 2 years later we were in a recession.

The Leading Index for the US for May 2018 is 1.51. It is reported monthly and includes activity measures such as housing permits, unemployment claims, manufacturing and non-manufacturing (service) and the spread between 10 year treasuries and 3 month treasuries.

From January 1982 to the present when the leading index dips below 1 we have gone into recession shortly thereafter. July 1989 LEI was .73. One year later the recession began in July 1990 lasting 8 months ending in March 1991. on July 16, 1990 we also entered a bear market that ended on 10/11/1990 bringing the market down 19.92%. As usual, the market troughed 6 months in advance of the end of the recession. In October 2000 LEI was 1.09. We entered a bear market on 3/24/2000 and a recession started in March 2001. The market declined 49.1% and bottomed on 10/9/2002 after the recession had ended in November of 2001 which is the only time since 1960 this has ever happened. Usually the market turns down prior to a recession and turns up prior to the recession ending.

In June 2007 LEI was at .71. A bear market began on 10/9/2007 and by Dec 2007 we were in a recession. The bear market ended on March 9, 2009 followed by the end of the recession in June 2009. The stock market is a reliable leading indicator and usually turns down prior to a recession and turns up prior to the recession end.

One last fundamental data point is the earnings yield of the market which is Earnings divided by Price or E/P minus the yield on the 10-year treasury. At every market peak since 1969 this number has been negative ranging from -1.1 to -4.0. The E/P for the S&P 500 today is 159/2718=5.85. The yield on the 10-year treasury is 3%. The difference between the earnings yield and the 10 yr treasury is 2.85%. If the yield on the 10-year treasury rose to 4% next year the S&P would have to rise to 4375 With EPS of 175 for the E/P-10 year spread to be 0. This suggests a recession is not on the horizon.

We have bought ourselves some time and delayed the inevitable end of this business cycle with tax cuts and lessened regulation.

TECHNICAL INDICATORS

A 2 year chart of the S&P 500 shows support at 2677. This means prices have bounced off this level multiple times but have not fallen through it. The 50 day Moving Average is 2931. If you add up the closing prices for the S&P 500 over the past 50 days and divide it by 50 that is your 50-day moving average. If the 50 MA drops to 2677 and falls below that is a bearish signal called the golden cross. This is when I usually start to get interested in adding to positions. Buy when everyone is bearish.

The % of stocks trading over the 200 day MA is 61.8 up from a low in May in the low 50's. The euphoria we experienced at the beginning of the year when prices were up every day in January saw 82% of stocks trading above their 200 day MA. The range from 2010 until now has been a low of 11% on August 10, 2011 to a high of 93% on May 22, 2013. 61% of stocks trading above their 200 day MA is neither too weak nor too strong. And it shows in the YTD S&P 500 performance with a total return of only 2.5% through 6/30.

The American Association of Individual Investors (AAII) reports survey responses on how bullish or bearish investors are. We look at 8 week moving averages and how long an elevated or depressed Bullish/Bearish reading lasts. Last week on July 5 Bullish sentiment had dropped to 28%. Neutral sentiment was 33% and Bearish sentiment was 39%. Right now, Bullish sentiment is at 43% above the long-term average of 38%. Neutral sentiment is at 28% below the long-term average of 31% and Bearish sentiment is at 29% slightly below the long-term average of 30%. These are very different numbers from last week's readings which tells you that emotions can change significantly regarding how investors perceive the future performance of the market in just a week.

To smooth out the week to week gyrations we look at the 8-week moving average and the number of readings that are unusually high or low for Bullish or Bearish. The 8-week bullish moving average is 37% which is about average. At the beginning of the year there were 7 weeks of elevated bullish readings from 45% to 60% bullish. This tells us that investors are overly confident. We had 2 weeks only of very low bullish readings on 6/28 and 7/5 of 28% but it was short lived and this weeks reading jumped back up to 43%. Looked at over longer periods of time sentiment right here is showing a very jittery investor jumping from despair to confidence. We have not seen a long enough period of high bullishness again like January to be worried about a major pullback.

The Michigan Consumer Sentiment survey is the final sentiment indicator that works like a contrary indicator. When sentiment has peaked during a business cycle the market will usually perform poorly Over the next year. When sentiment has bottomed during a downturn the market performs well over the next 12 months.

So, all these indicators we look at are currently telling us to be vigilant and watch the reports as they are published for significant changes in direction. Some indicators tell us the economy is doing great and others are telling us to be cautious. The yield curve and the leading economic indicators are 2 we focus on the most right now. If we notice any big changes in outlook we will let you know.

We have positioned your portfolios to withstand whatever is coming considering your time horizon, risk tolerance and specific goals and needs. If at any time you are uncomfortable or just want to talk about your financial position please do not hesitate to call us.