



Market Comment Fall 2018

As we enter the 4th quarter of 2018, the U.S. economy finds itself on the cusp of its 10th consecutive year of economic expansion. A remarkable record considering the depths of despair we experienced during the 2008 financial crisis. While the stock market is still positive on the year, some fundamental changes are beginning to creep into the picture and these developments are likely to impact the investment landscape as we move forward.

On balance, the backdrop is about what one might expect this late in a bull market. Tightening labor markets and whiffs of higher inflation accompanied by a rise in interest rates are all to be expected at this point in the economic cycle. On the one hand, these are all positive developments; more people are working, wages are rising and the ultra-low interest rates that have been in place since the financial crisis are finally starting to return to more “normal” levels. But this also means that company profit margins may come under pressure. Higher interest rates and higher wages can also result in higher costs of goods and services. The unemployment rate of 3.7% is the lowest since 1969 and should be celebrated, but it also suggests that much of the improvement in the labor markets is now behind us. These same factors, which were viewed positively as recently as one year ago, are now being perceived in a different and less favorable light. The investment glass once viewed as half full is now in danger of being seen as half empty.

Still, some of these concerns may be overblown. While all of the aforementioned developments bear watching, the fact of the matter is the economy remains strong and corporate profits continue to grow. We do not appear to be on the cusp of significantly higher interest rates or inflation and fears that the Federal Reserve seems ready to abandon its gradual and measured approach to monetary policy also seem unjustified. Yes, trade tensions with China still exist, midterm election outcomes are still to be determined, energy prices have been moving higher and geopolitical issues pop up with increasing regularity. But with the stock market coming off a relatively strong year in 2017, a pullback in prices accompanied by a healthy dose of nervousness might actually be a positive development for investors with a longer term time horizon.

While history may not always repeat itself, it often rhymes. We therefore find it useful to sift through historical data and see what can be deciphered from previous cycles. In the paragraphs that follow, we take a deeper dive into the data to look for clues as to where we currently are in the economic expansion and what this likely means for stock prices and interest rates as we go forward.

FUNDAMENTAL & ECONOMIC INDICATORS

For the year to date through 9/30/2018 the S&P 500 ETF (IVV) returned 8.99%. Earnings for all S&P 500 companies are expected to increase 20% from last year to \$160 (up from \$158). The closing price for IVV on Sep 30, 2018 was 2907.20. The Price/Earnings ratio (P/E), based on 2018 earnings is currently 18.16. The S&P 500 fell 6.9% from its high on Sep 20 and closed last Friday Oct 11 at 2767. The forward

P/E for 2019 EPS based on this new close is 15.72. Since 1988 the range for the P/E on the S&P 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 \$176. Based on next year's earnings the current market P/E is a very reasonable 15.72x which is reasonable but not cheap.

To estimate fair value for the S&P 500, or any security, we divide next year's earnings by a number called the discount rate; next year EPS \$176/ discount rate = fair value

A component of discount rate calculation is the 3 month T-Bill. The 3 Month T-Bill was near zero for some time which meant the denominator was smaller than usual resulting in a higher fair value result. Investors could not earn anything in bonds and turned to stocks for attractive dividends as a substitute for bond interest. Higher fair values result in higher Price/Earning.

As short term rates have been rising due to the Federal Reserve increasing the Fed Funds rate, the discount rate, denominator, continues to get bigger resulting in lower fair values. Lower fair values result in lower P/Es.

On 10/16/18 the 10 year Treasury yields 3.1%. The 3 month T-Bill yields 2.30%. The difference between these is .80% or 80 basis points and is called the yield spread. When the 3 month T-Bill 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 moving in that direction. What is postponing an inverted yield curve is that when the 3 Month T-Bill moves up the 10 Yr Bond follows. They don't move in lock step or at the same time but the entire curve from 3 Month T Bills to 30 year treasury bonds has been moving up in a parallel fashion. So far so good. The market will adjust to these higher rates with lurches down from time to time. The last time the curve inverted was December 2005. One year later, the market peaked. 2 years later we were in a recession.

How many times will they raise interest rates? The average number of rate increases is nine; we have had seven so far. Over the long term 1958-2018 the real yield (nominal yield minus inflation) on the 10 year treasury has averaged 2.36%. With inflation at the Fed's target of 2% that implies the 10 yr. treasury should be yielding 4.36% not today's 3.1%.

There is one more increase this December of 25 basis points (.0025) and 3 to 4 more in 2019 of 25 bps. If all these happen then rates should rise by 1.25% which would bring us to the long term average: $3.1\% + 1.25\% = 4.35\%$. These rate hikes will only happen if the economy continues to do well. And the move there will not be as neat and orderly as it looks on this sheet of paper. The market will have more lurches downward toward normal.

The Leading Index for the US for August 2018 came in at 1.31 down from May's reading of 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. LEI peaked in October 2014 at 2.0 and has been slowly trending downward since then. We don't get concerned until LEI is near 1.0 and we are a far way from that right now.

The Institute for Supply Management (ISM) publishes manufacturing and non manufacturing indices. For September the manufacturing index came in at 59.8. Over 50 is expansion and under 50 is contraction. Non Manufacturing came in at 61.6 up from 58.5 in August. Both of these readings are very strong.

Household debt service payments as a percentage of disposable income remains at very low levels. Just before the recession began with the housing boom debt service payments took up 13% of disposable income. Before the dot com bust debt service payments were 12.38% of disposable income. The most recent reading is 9.8% meaning that less than 10% of disposable income is required for debt service. This is important because the consumer is 70% of the economy.

TECHNICAL & SENTIMENT INDICATORS

A 2 year chart of the S&P 500 shows support at 2705. The all time high was on Sep 20 at 2944. Today Oct 16 we closed at 2804 as of 6:23pm. The 50 day Moving Average is 2884. 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 2743 and falls below that is a bearish signal called the golden cross. This could happen with one bad day. This is when I usually start to get interested in adding to positions. Buy when everyone is bearish.

The percent of stocks trading over the 200 day MA has dropped from a high of 62.5% on July 9 to a low of 33.5% on Oct 11. Today 41% of stocks closed above their 200 Day Moving Average which is low. 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. 41% of stocks trading above their 200 day MA is a weak reading. Bear markets don't start when the majority of stocks are already trading below their 200 day MA. This is a bullish signal.

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 10/10/2018 Bullish sentiment had dropped to 30.6% down 15% from the prior week's reading of 45.7%. Neutral sentiment was 33% and Bearish sentiment was 35 up 10% from last week's reading of 25.2% which is low. The Bullish long-term average is 38%. Neutral long-term average is 31% and Bearish long-term average is 30%. The weekly numbers vary widely and tell you that emotions can change significantly regarding how investors perceive the future performance of the market in just a week. Right now investors have moved from feeling confident to despair. 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. September consumer sentiment came in at 100.1 up from August 96.2. 95 would be considered normal sentiment. Prior to the dot com bubble in 2000 consumer sentiment peaked at

110. Consumer sentiment was around 95 when 2007 recession came. Readings much higher than 100 only happened in the mid-60s and late 90s. Otherwise sentiment peaks around 100. Sentiment is important because it can be an indicator of consumer spending. This is a worrisome indicator.

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.