April 25, 2015

Q1 2015 Commentary: Ripples on the pond

The current US economic environment is eerily similar to this time last year. Severe winter weather (though apparently not quite a polar vortex) in many parts of the mid-west and eastern regions of the country seems to have caused a significant slowdown in economic activity. The March employment report showed only 126,000 jobs created, which was about half of what was expected. In addition, the number of jobs created in the previous two months was revised lower by 69,000. This lull in job creation set off alarms that the US economy might be in trouble. However, like last year we see little reason why the economy will not pick up as the weather improves. The recipe for economic growth that has driven the economy for years now, remains firmly in place. Inflation is low, monetary policy is loose and the risk of the Fed changing its policy anytime soon has dropped significantly.

During the quarter, concerns about economic growth and low inflation pushed the ten year US Treasury yield down to 1.93% from 2.17% at the beginning of the year. Estimates of first quarter economic growth have been revised significantly lower. In January, the consensus estimate of first quarter growth was 3.0%. By the end of the quarter, the expectation was for 1.0% growth. The Federal Reserve has been given little impetus to raise interest rates and most Fed watchers have pushed the timeframe for rates to rise from June to much later in the year. Furthermore, monetary policy remains very accommodative, almost without exception, in countries around the globe. Belief that interest rates will remain in place through government policies around the world, provides powerful support for stock prices. We do not see a reason to fight the Fed and remain positive about the stock market.

We do have some concerns. There is little doubt that the Federal Reserve's interest rate policy has supported stock prices since 2009. With interest rates at such low levels, investors are seeking someplace to earn decent returns. That place has been the stock market. Following the great recession and subsequent bear market, many shell shocked investors swore off the stock market. Since then, investors have been slowly coming back to stocks. At some point, however, one can have too much of a good thing. As more money is directed toward stocks, the market valuation has expanded. The Value Line Investment Survey of 1700 stocks was trading at just 10x earnings in 2009. Since then, the market multiple has expanded to 19x earnings. As the price to earnings ratio expands, we become increasingly uncomfortable. Investors have become emboldened by returns over the past two years and are slowly turning from fearful to greedy. The potential for prices to rise to dangerous levels has increased. We are not there yet, but we are on guard against it.

For a contrarian investor, extremes create opportunity. Any time major events have a large impact on the stock market, opportunity is created for the contrarian investor. The collapse in oil prices will create opportunity in energy stocks. Extreme interest rate policies are likely to create distortions in market prices that can turn advantageous for the opportunistic investor. Market volatility has been very low for an extended period, but that seems to be changing. The change would be welcome and very positive toward our outlook for future returns.