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Q1 2016 Commentary: Follow the earnings…

Markets completed a round trip during the first three months of the year. The S&P 500 finished the quarter higher by 1.3% but not before getting off to the worst start to a year in stock market history. By February 11th the S&P 500 had fallen by 10.5%. More importantly the mood of the market continues to swing rapidly between pessimism and optimism. Investor sentiment veered toward pessimism over concern for poor economic growth in the US and fears of global economic recession. However, the mood rapidly changed for the better following a rebound in job growth and the Federal Reserve's signal that it would raise interest rates more slowly than previously planned in 2016. The number of rate hikes planned this year has been reduced from four to two. The response in the stock and bond markets has been uniformly positive and the catalyst for the recovery by the end of the quarter.

Much as we have maintained for the past six years and reiterated over the past six months, economic growth will continue to be moderate. There will be some months in which the economy pauses and others when growth appears to be accelerating. However, when reviewing the most recent numbers, it is apparent the economy is doing just fine. If financial markets get hung up on specific data points, all the better for our portfolios. It is incumbent upon us to have the discipline to take what the market gives us and use volatility to our advantage. We were buying in February near market lows and were able to initiate positions in companies at attractive prices.

With our focus on bottom up stock selection, we are much more concerned with the outlook for corporate earnings than macroeconomic trends. Last year's earnings for the S&P 500 companies did not exceed the previous year's. An earnings recession is generally defined by lower year over year earnings for at least two consecutive quarters. The S&P 500 companies are now reporting what will be their fourth consecutive quarter in which aggregate S&P 500 operating earnings are lower than the previous year's total. Granted much of the decline can be attributed to the disaster going on in the energy and commodity sectors. However, if we exclude the energy sector's results, earnings in the first quarter are still expected to be down 4%. Stagnant earnings growth reflects the slowdown in international markets, particularly China and Europe, and the impact of the strong dollar on currency translation and the higher cost of US goods abroad.

As the market worked its way higher since February, the price/earnings ratio of the stock market has expanded to its approximate historic average. For the market to move higher, either earnings or the price/earnings ratio must grow. With somewhat elevated PE ratios, we expect it to take earnings growth to take stocks higher. It hardly seems a coincidence that the stock market has struggled to move higher for more than a year while earnings growth has stalled. However, as we look toward next year the prospects for earnings growth improves. Oil prices are stabilizing and the energy sector losses will subside. Global economic growth will pick up as the enduring stimulative government policies around the world gain traction. Finally, the headwinds over the strong dollar will abate as the dollar is already weakened versus world currencies over the past five months. In politics they say to follow the money. We would suggest that stock market investors follow the earnings. In the next year we will follow the earnings and the stock market higher.