July 25, 2015

Q2 2015 Commentary: Beneath the surface

There were a number of concerns for the financial markets in the second quarter that did not amount to much in terms of market price. Between the financial "crisis" in Greece, economic and stock market concerns in China, and interest rate uncertainty in the US, there was much to talk about. However, the hand wringing did not translate into stock market volatility. Ultimately, the stock market nudged higher with the S&P 500 rising 0.3% in the quarter. Stocks have spent much of the first half of the year in positive territory, but have been regularly retreating to where we started on January 1st. Interest rates drifted higher in the spring with the expectation of the Fed raising interest rates. Rising interest rates results in lower bond prices and the Barclay's US Aggregate Bond index fell by 1.7% accordingly.

We have enjoyed two years of steadily rising US stock prices with very little volatility. During this period, the rise in earnings has not kept pace with the rise in stock prices resulting in a higher price to earnings ratio for the stock market as a whole. In other words, the stock market has become more expensive. The S&P 500 now trades at eighteen times this year's earnings estimate, which is above the historic average. The six year rise in market valuation is concerning because it cannot go on forever and, in general, means that it becomes harder to find attractively priced stocks. To justify higher prices we will eventually need earnings to grow.

Earnings in the first half of the year have been a mixed bag and these results go a long way toward explaining this year's stock market action. In the first quarter, the consensus earnings estimate for the S&P 500 fell significantly and by the time earnings were reported in April the S&P 500 companies were expected to report earnings that declined four percent versus the prior year's first quarter. However, first quarter earnings beat expectations by a considerable amount and actually ended up rising slightly. This unexpected performance has supported stock prices at current levels. Similarly in the second quarter, the S&P 500 companies' earnings were expected to decline by 4.5%. Of the companies that have reported thus far, earnings have declined by 2.2% according to Factset Research; better than expected but not great either.

There is cause for optimism, however, once we dig into the numbers. The energy sector is a gigantic drag on earnings with a whopping 54% estimated decline in the 2nd quarter. If the energy sector earnings are excluded, earnings grow 4.1%. As we pointed out in an earlier letter, the strong dollar negatively impacts earnings for companies with large international sales. Again according to Factset Research, S&P 500 companies (ex-energy) that do a majority of their business in the US are on track for 8.3% growth. Once we strip out energy companies, US companies are doing better than appears on the surface.

Given, the modest earnings growth we have experienced thus far in 2015, it is understandable that stocks have struggled to move higher. Flat earnings growth translates into a flat stock market. We must be patient while earnings catch up to stock prices. The economy remains well positioned to continue its six year expansion. Employment is up and the Fed will continue its accommodative policies. On balance, we remain positive about the portfolio and see no compelling reason to assume a defensive posture.