November 2, 2015

Q3 2015 Commentary: Ripples on the pond

For the first time since the summer of 2011, the stock market experienced a 10% correction from its most recent high price. Four years is an exceptional period of time without a major market disruption. Despite rallying in September, the S&P 500 fell by 6.4% in the quarter. We view the quarter's stock market activity as a return to a more normal pattern of volatility in which five or ten percent corrections are more frequent. In 2011 US debt was downgraded and Congress was threatening to close down the government. Well, Congress is still threatening a shut down over debt limits, but this time around it was fears of slow global economic growth and rising interest rate concerns that sent markets down. However, following the pattern we have seen for the past four years, market weakness has been followed by a swift recovery.

We are comfortable with current market levels. Stock market measures are moderate and not at any sort of extreme levels. Market valuation is in the vast gray area in which stocks are roughly fairly valued and trading within a comfortable valuation range. Price to earnings based on estimates for the next 12 months on the S&P 500 is not cheap, but neither is it particularly expensive at 16x. With interest rates still low and Asian and European financial authorities committed to very loose monetary policy, we believe staying invested is the best strategy. As demonstrated in September and October, a market retreat is likely to be shallow and short-lived. Economic weakness will be met with further monetary stimulus and pro-growth government action. Diverging from long term portfolio asset allocations is not justified by today's favorable investment environment.

The current investment environment reminds us of a Rorschach test. Like a Rorschach test, each observer of the stock market can see just about anything they want to see. Stocks can look expensive by one measure, but cheap if you exclude certain sectors. Low oil prices are hurting the energy sector, but helping the transportation and travel industries. The labor market may look like it is improving since unemployment is threatening to go under 5%, however the labor participation rate, a measure of the labor force relative to the population is very low indicating plenty of slack in the workforce. It seems inevitable that no matter what the latest news brings, either positive or negative, we will continue to muddle along in the moderate growth environment which we have experienced for the many years now. The economy will not be as good as the most recent strong report may indicate, nor will it be as bad as the next poor economic release might suggest.

We are moving cautiously toward new investment opportunities. As contrarians we are intrigued by the energy sector. It has been more than a year since oil prices started falling yet it appears we are still a long way from a recovery in oil prices. Despite the number of working wells being cut by more than half, inventories are still high. Oil in storage in October was at the highest level in 85 years. Until supply begins to fall into balance with demand we will sit patiently. The largest of the S&P 500 growth companies have performed well thus far in 2015 and have supported the index level. However, many of the components of the S&P 500 have not fared so well. Smaller companies, in general are looking more attractive than they have in some time. Individual stock performance is really a mixed bag with no specific industries looking particularly cheap. Opportunities are on a stock by stock basis and we are encouraged by what we are finding.