October 25, 2016

Q3 2016 Commentary: Calm but no storm…

The S&P 500 marched forward in the third quarter under relatively benign conditions. Most of the gains were achieved in the first weeks of July. Stocks then entered an extended calm period before ending the quarter 3.9% higher. The Summer is generally considered a slow time for financial markets. "Sell in May and go away" is a long-standing Wall Street axiom. However, in the past two years we experienced major market corrections during this time. Many expected similar upheaval this year considering the stridency of the presidential election and speculation over interest rate policy. It was not to be. Prior to September 9th, the S&P 500 went 44 days in which it did not move more than one percent. Meanwhile, the market volatility index, VIX, fell to its lowest level in two years during this extraordinary period of tranquility.

The bond market managed to rise 0.5% in the quarter and was buffeted by speculation that the Fed would raise interest rates at the September FOMC meeting. Having held interest rate policy steady in September, any Fed rate hike is off the table until its December meeting as it is customary not to change monetary policy around the time of national elections. However, a consensus is forming that rates will be raised by the end of the year. The Fed still maintains that any rate hike will be "data driven" and there will be plenty of data released between now and December such that no rate decision is certain. A quarter point rate hike, if implemented, is manageable as it will only confirm that the economy is on solid footing

We have no doubt that volatility will increase, but not so much to create undue concern. The election is almost behind us and is having little impact on financial markets at this point. Between now and the end of the year, we believe expectations for corporate earnings will exert the greatest influence on stocks. As we have mentioned previously, earnings growth has stalled since 2015 and given the level of stock prices relative to earnings, we are inclined to believe it will take a resumption in earnings growth to take markets higher. It is the middle of quarterly earnings reporting season and results are encouraging. FactSet Research reports the S&P 500 companies are on track for quarterly year over year revenue growth for the first time since 2014. Earnings growth is expected to resume in the fourth quarter following a third quarter that looks to be essentially flat. For reasons we can't identify specifically, there is currently a high degree of unease among investors. We do not feel this trepidation is warranted and believe no major market correction is imminent. Global fiscal and monetary stimulus, corporate earnings growth and rising employment instill confidence in our current position.

At the end of the day, our investment philosophy and decision making are not determined by the economy, or politics or market trading patterns. At its core, we are making a judgement on the quality of a business and the price at which the market allows us to purchase it. We believe in being patient and waiting for the time when a good business can be bought at a once in a generation price. We must not be unduly influenced by the ever-present factors that can distract us from this mission. It is a common refrain to hear that the market is too rich, or too volatile or too risky to act now. Interest rates, oil prices, terrorism, warfare etc. are cited as reasons to take to the sidelines. However, we don't invest in markets, or countries, or industries. We invest in companies for the long term. At any particular time, there are many companies trading at low valuations or thirty percent or more off their recent high prices. The best of these companies are candidates for the portfolio. For these stocks, there is no reason to wait. The price is right.