SASSER
INVESTMENT MANAGEMENT, INC

Disciplined Value Investing

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Q2 2019 Commentary: The Fed's got our back…

Don't fight the Fed. Is that all there is to it? The experience of the past nine months would argue yes, that is the case. That bromide is tossed around whenever the Federal Reserve seems intent on moving interest rates in a particular direction. If rates are going down, buy stocks. Be cautious if rates are rising. In the Fall, the Federal Reserve signaled its intention to raise interest rates over the course of the coming year and the stock market sold down sharply. By January, faced with concerns about economic growth, the Fed indicated it might reverse course on its interest rate intentions. Since that time, the stock market has recovered from its losses and moved to all-time highs. The stock and bond market extended very good first quarter performance in the second quarter. The S&P 500 gained 4.30% and posted its best first half of the year since 1997. The Bloomberg Barclays U.S. Aggregate Bond Index rose 3.08%, primarily due to the 30-year U.S. Treasury yield falling from 2.41% to 2.00% during the quarter.

The new high for the S&P 500 came after marking time since its last high almost 18 months ago. The catalyst then was the new tax law that lowered many tax rates passed in late 2017. Remember, the stock market anticipates what is to come and prices stocks in anticipation of strong earnings and earnings growth to come. Gains in 2017 came in anticipation of 2018 earnings and the expectations were met.

When we consider an appropriate level in the stock market, the focus must be on earnings which is the economic part of the equation. In general, as earnings go, so goes the stock market and a strong economy should translate into strong earnings growth. The second part of market valuation is sentiment and how much investors are willing to pay for earnings. That level is most often expressed as a multiple of earnings or the price to earnings ratio (P/E). When investors are confident about the future, they are willing to pay higher prices for stocks. Bull markets typically end when confidence becomes so great and prices paid for stocks are at such a high valuation that results do not meet expectations. This most famously occurred at the height of the dot.com bubble when a survey of investors revealed that they expected to realize annual returns well in excess of 20% even though the long-term average was in the neighborhood of 10%.

Currently, we are nowhere near market bubble levels, nor is investor sentiment overly confident. Even though the economic expansion became the longest on record in July, investors remain skeptical. Their skepticism stems from uncertainty. Economic uncertainty in the form of slowing global economies, trade and tariff uncertainty, and political uncertainty are all raising investor angst. Whether its domestic turmoil or increasingly contentious foreign policy, all these factors raise uncertainty and lower the amount investors are willing to pay for stocks. One of my colleagues describes current investor sentiment as a fear of heights. However, just because we are at new highs, it does not mean we need to fear a major sell-off. Modest volatility is to be expected and the stock market valuation has moved higher, but it is still within a reasonable historic range.

Coming full circle, however, let's not fight the Fed…nor the Bank of Japan…nor the European Central Bank…nor the People's Bank of China. Lower interest rates have driven nice stock market returns in the first half of the year. The global effort to jumpstart the world economy will lead to better growth later in the year and continued good results for our portfolio of stocks.