New Albany
Investment Management

May 13, 2019

That's Life

"That's life (that's life) that's what people say, You're riding high in April
Shot down in May
But I know I'm gonna change that tune,
When I'm back on top, back on top in June."
(Frank Sinatra)

Who would have thought the lyrics of a song by Frank Sinatra could describe today's market environment? The first stanza of the famous song, *'That's Life'*, speaks of the roller coaster ride of life, which is not unlike the market behavior we have been experiencing over the last 14 months. Volatility has been the mantra, as we have seen five reversals, three tops, and two +/- 23% swings since January 2018. And as I write this letter today, the market is once again back on its heels, experiencing the worst down day since January 3rd. Will the market find its footing or is 'that (just) life'?

Why is the Market so Volatile? Fiscal Policy, Politics, Fed Policy, International trade, to name a few, are indeed factors that impact growth and the financial markets, but they alone are not the cause of volatility. Rather it is the current low level of growth that creates the volatility**. Slowing growth amplifies the vulnerability or potential for negative growth, where a small change can suddenly 'tip the scales', so to speak, and cause a quick and brutal change in the confidence and direction of the markets**. Slowing growth is symptomatic of the late stages of an economic cycle and it fosters a manic type environment of extreme highs and lows as the data oscillates from strong to weak to strong again. Even the Fed has displayed very volatile behavior, moving from a firm tightening path to easing in just thirty days. Investors are indeed riding a roller coaster, experiencing the full "G" force of the *'fear of missing out'* on the runs up and '*panic of getting out'* on the wicked declines. Both directions leave a sick feeling in the stomach.

Roller Coaster Data: Hot and Cold

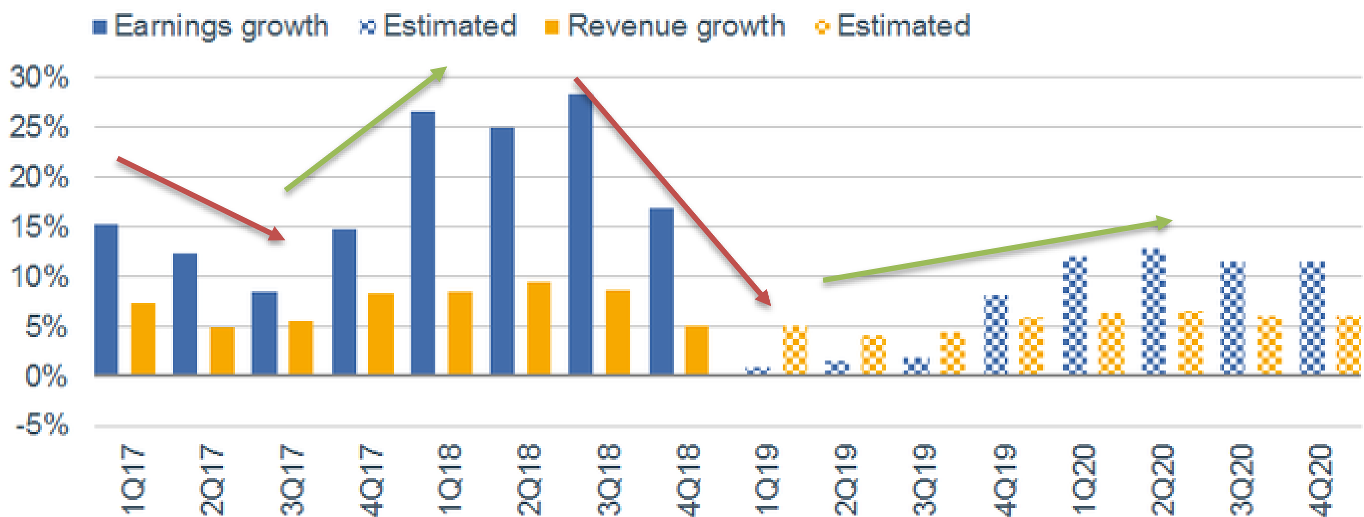
- **Unemployment Rate drops to 3.6% lowest in 30yrs, however both the labor pool and participation rate declined.**
- **Inflation Rate falls back below Fed's target of 2%, however wage growth rising to 3.2%.**
- **1st Qtr GDP 3.2% (higher than expected), however components of growth outside of government spending and inventories are weak.**
- **1st Qtr Earnings growth stronger than forecasted, however actual earnings growth was only 0.9%.**
- **China - US trade deal was all but assured; now closure is very uncertain.**
- **Nasdaq and US S&P 500 indices made new highs, however only 22% of the S&P 500 stocks actually made new highs (This is a distant memory now!).**

You probably saw some of these headlines over the past month, and on the surface, they look good; however, the underlying detail is telling a much more muted if not uncertain picture. There are pockets of real strength and pockets of real weakness. It is this dichotomy of forces which creates a challenging but not impossible market environment.

So what is an investor to do? It is easy to focus only on one side of the data (strong or weak) and get swept away in either direction, but doing so can be detrimental to any portfolio. Therefore, it is essential to continually evaluate the fundamentals, keep the big picture in focus and make sure the risk position is well diversified and balanced.

With that in mind, let's look at a few of the fundamentals. The following indicators and charts offer some perspective of where we are today:

The Roller Coaster of Earnings Growth and the markets: The stock market is always forward looking, so expectations of future earnings growth is critical to the direction and magnitude of change in the stock market. As expectations change, so goes the market. Case in point, the rapid market sell off in the 4th quarter can be linked to the dramatic drop in forecasted earnings growth in the 1st qtr. Likewise, the huge rally in the 1st qtr this year can be link to expectations (hope) of earnings growth recovering by 2020. The chart below shows actual earnings and revenue growth by quarter of the S&P 500 from 2017 - 2018 and the forecast for 2019 - 2020. With growth barely positive for 2019, any negative change in expectations would be a big disappointment for the market. This explains the market's vulnerability to bad news, and why it is now reacting so poorly to the deteriorating US - China trade news. Again, low growth amplifies the market reactions.



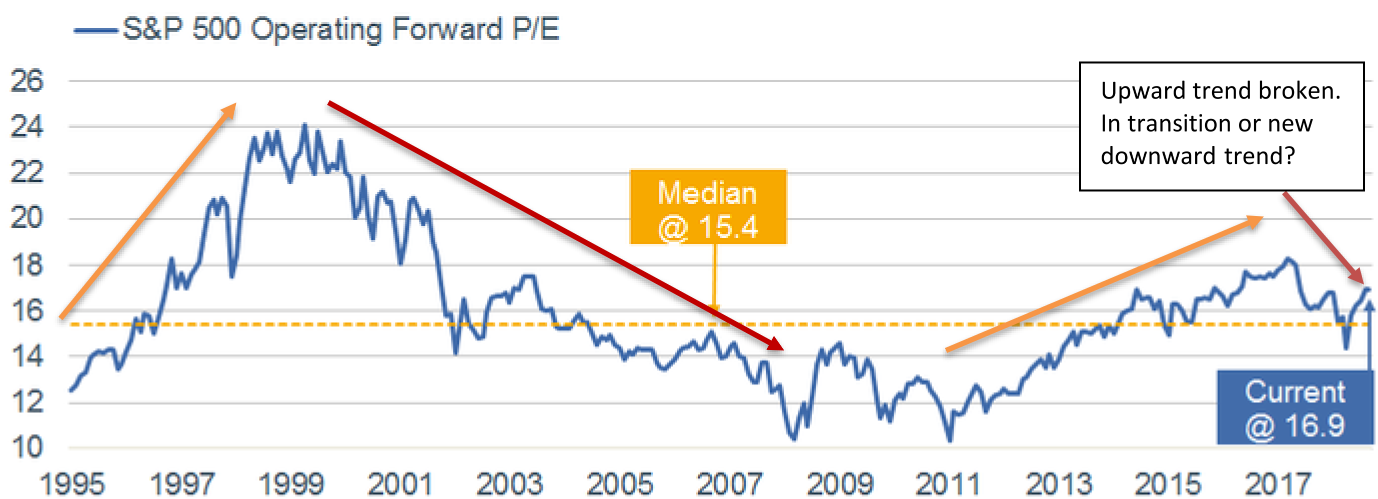
Source: Charles Schwab/ Refinitv

Valuation: Though valuation alone does not cause a market to change direction, once a change occurs, it can <u>influence the magnitude of change</u>. A common valuation measure is the Forward Price/Earnings Ratio (P/E) which uses forecasted future earnings as the denominator. The ratio will rise when stock prices rise faster than expected earnings growth. This year, the P/E has risen from a low of 14 to nearly 17, and well above its historical average of 15.4. (see chart on next page) This means **the huge rally in stocks this year has far outpaced the expected rise in earnings in 2020 and leaves the market vulnerable to disappointment.**

Trend of the P/E Ratio may give hints of health in the market: The direction and trend of the P/E ratio gives a good picture of market health. When it is rising, it generally corresponds to an expanding economy and bullish period and when it is falling, the economy is stalling and earnings growth is declining.

The chart below shows the P/E since 1995. There are periods when the P/E ratio trends in one direction, and then there are periods where it is quite choppy, signaling a major transition in stock performance is underway. Notice the two periods of rising P/E ratios (1995-2000 and 2011-2017). These were periods of exceptional market strength. And then notice the downward trending period known as the 'Lost Decade" (2000 – 2010) when stocks struggled significantly (owning the S&P during this 10yr period, resulted in a ZERO return). The next period, 2009-2011, was very choppy, and the market was transitioning into the great bull run through 2017. Since late 2017, it appears upward trend has been broken as the P/E ratio has fallen from about 19 to as low as 14 (December 24th) and then recovered to 16.9 this year. What does this tell us? Two things. One, the market could well again be in transition again meaning more volatility and perhaps lower prices. Two, the current level of 16.9, while not at an extreme, it is elevated enough such that earnings growth likely needs to turn more positive to justify current P/E multiple expansion from these levels.

P/E Back Above Historical Median



Source: Charles Schwab, FactSet, as of May 3, 2019.

Big Picture Valuation View: The Buffet Indicator is a measurement of Gross National Product (GDP) to Total Stock Market Capitalization (TMC) (*see chart on next page*). It is used in a broad way to **assess the amount the stock market is over or under valued** relative to its historical average. According to Warren Buffett, this ratio is "*probably the best single measure of where valuations stand at any given moment.*" It must be emphasized this is a long term, big picture measurement and not a timing indicator.

The chart below shows TMC (blue line) to US GDP (Green line) since 1970. As you can see there were very long periods of undervaluation (1970-1998) and over valuation 2014- present).

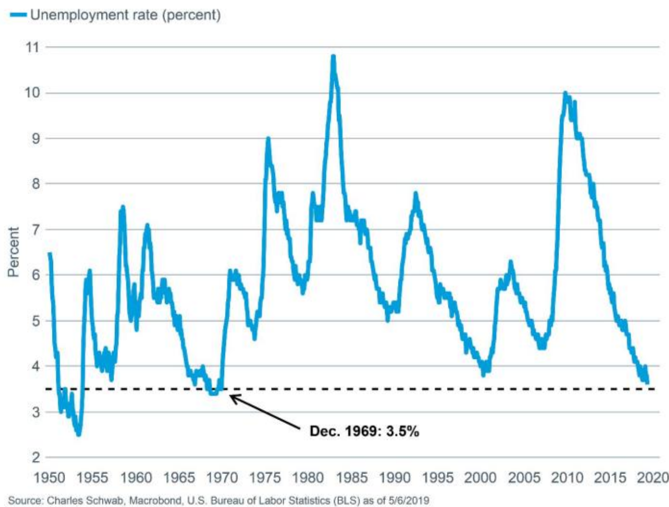
Chart source: Gurufocus

The Buffett Indicator has varied within a very wide range of 25%-146% (see chart below). The lowest point was about 35% in the deep recession of 1982, and then had another dip during the dot com burst in 2000, and then again during the financial crisis in 2008. Since then, it bounced back during the long bull market from 2009 until 2018. It hit an all-time high on of 149% on 1/17/2018 when the market first peaked, and today it currently stands at 144%. At this level, the Buffett Indicator is saying the stock market is significantly overvalued, double its historical average of 75%, and is likely to experience a negative -2% return annualized over the next 8 yrs.

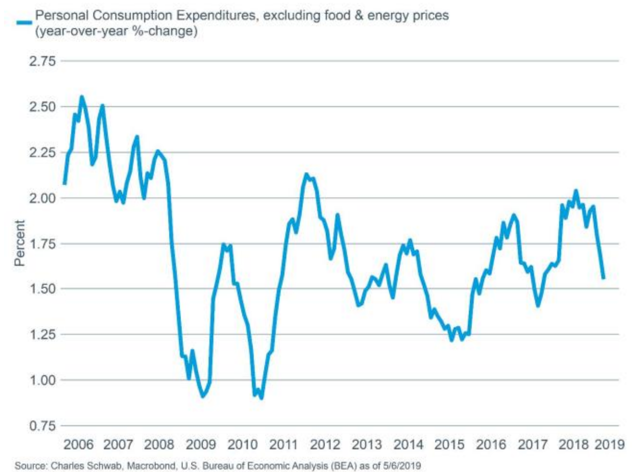
Chart source: Gurufocus

On the bright side, the Economy is on firm footing; Inflation remains subdued: With consumer spending almost 70% of GDP, and a very tight labor market, the economy is still on very solid footing. At the same time, the broad measure of inflation remains subdued; however, wage pressure is rising. Net, from the Fed's perspective, the economy is 'OK", not too hot and not too cold - thus warranting a neutral Fed policy. This is good news for investors and will continue to be supportive for stocks.

Unemployment Rate Very Low at 3.2%



Inflation Very Subdued at 1.8%



The big wild card is the US - China trade deal and its impact growth. A failure or lengthy delay to a trade deal will impact global growth. With China the major manufacturer of the world, it will probably be hit the hardest along with many emerging Asian markets. However other countries including the US will be impacted too as the strength of the dollar change and tariffs impact profits. The uncertainty will make it difficult for businesses to make plans about future spending and the longer the uncertainty persists, the greater impact it will have on the global economy.

In sum, it looks as though we are riding the coaster back down for a while as a healthy correction is underway. The run up in stocks this year left the market priced for perfection. At the same time, a low growth environment presents a more vulnerable position because small changes can have a big impact. The break down in trade talks was the catalyst for this correction. But corrections are healthy because it realigns expectations to a more balanced posture such that when good news surfaces again, the rally will resume. For now, keep your seat belt buckled and your arms in the car!

Investment Strategy is "Neutral". There has been no change in the risk positions. Both stock and bond exposure remain in the neutral zone. The positive price momentum in stocks is balanced against a weakening forecast from the bond market.

These are my thoughts. As always, please contact me with any questions or concerns.
Best Regards,
Barbara

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