

"Cup of Joe"

It's been a rocky two years or so since the oil collapse sent shock waves throughout the financial markets, causing many to make calls of impending doom. Three market pullbacks of 10% decline or more took place, far exceeding the average of one every 18 months. Despite all of the noise, most market prognosticators were way off base in predicting that a recession was imminent. Instead, we have a market that has basically tread water for the last two years, waiting to see if growth will pick up and wondering when interest rates will start to rise. One must always remember that the markets do NOT like it when unanswered questions persist. We didn't know what the bottom in oil would look like. We don't know when and how fast interest rates will rise. We don't know when growth will pick up. And finally, we don't know who will be the next President of the United States. With all of the uncertainty, often times the market likes to take the "wait and see" approach. A range bound market waiting for answers to a lot of questions.

Here is what we do know: Oil has found stable ground, up from the low of $26/barrel to $50/barrel today. This recent rise will help keep a lot of energy companies afloat. This will also provide more stability to the high yield markets that were hit (on the fear that many energy companies would default on their loans). Interest rates will start to rise more steadily, with a high percentage of economists predicting the next increase to happen in July. As long as our economy is stable, this increase should be a positive step towards normalization. Growth looks to be ticking up slowly, as well, but nevertheless, moving in a positive direction. And finally, we won't know who the POTUS will be until November. Most companies wait to see who will be the next President to decide on how to allocate their future capital expenditures. The moral of the story is, with so much indecision and the lack of trading volume during the summer months, markets should remain range bound in the short term.

Here are the positives that we see today -

1. The increase in the price of oil has helped the energy sector stave off lots of rumored bankruptcies. This will also help prop up the earnings of the overall stock market. Energy makes up roughly 12% of the S&P 500, and with the massive selloff, the overall market's average earnings have suffered. What also has suffered is the high yield market. This is the market where companies take out risky loans to fund their often speculative business plans. One important stat to keep in mind: when the high yield market has a double-digit gain for the year, the S&P 500 has had a double-digit gain as well… 100% of the time over the last 30 years. Hard to bet against history!

2. Despite the writing on the wall that interest rates will slowly continue to rise, we are still far off from hitting market equilibrium (when the 10-year treasury interest rate and the average return of the stock market equal one another). When the market is paying a higher return than the bond market, this is called a market premium, making it statistically beneficial to be in stocks instead of bonds. What makes this even more bullish is the fact that the dividend yield on the S&P 500 (2.12%) is also higher than the bond yield to date. In theory, this should push investors to look for much-needed yield in the stocks that are paying those high dividend yields (called dividend aristocrats). This is where the phrase, "stocks are the new bonds", is coming from. These companies have increased their dividend payouts for 20 consecutive years or more. So, with both the dividend yield and the average market return averaging more than the 10-year treasury (1.6%), it looks as though we may not hit equilibrium for quite a while.

3. Historically low gas prices have been providing over a trillion dollars in stimulus without the consumer noticing. How is this possible, you ask? If we have 330 million people in this country and everyone pays $2/gallon for gas verses the high of $4/gallon, this creates an enormous amount of extra cash or "stimulus" for people to spend. Consumers are also benefitting from lower heating bills as well. Once everyone realizes that this money is building up in their checking accounts, they (in theory) should be willing to spend, and as a result, would be one heck of a net positive for the economy. What's interesting is that until recently, retail sales have not shown any signs of this extra money influencing their bottom line numbers. Since we have talked about this anomaly in past email blasts, we feel the delay in spending is due to a psychological fear that the market will crash again like it did in 2008. With the fear fresh in everyone's mind, most consumers are paying off debt or saving this extra money instead of spending it on discretionary items. This isn't a bad thing. It's just not providing the much needed bump to the growth in our country that we desperately need.

Here are the areas of weakness we see today -

1.) Currently, the fear of Great Britain exiting the European Union, or the “Brexit”, is causing volatility in the markets to spike. To give you a quick explanation, Britain is about to vote on whether or not to stay in the EU or go out on its own. This could be a big negative for trade in the UK, having lost its other EU trading partners. It’s also a negative because it could give other countries incentive to do what Britain is doing and leave the EU. Not a good precedent to be setting. This will be voted on June 23rd. Although not a huge economic event, this could still bring major uncertainty (there’s that word again that the markets hate) for the EU for years to come.

2.) POTUS uncertainty. Companies sit tight and don’t spend their money until they know the direction the next President will take. This will be resolved in November, and by the looks of it, the market is not showing too much angst as of yet. GOOD NEWS.

3.) Growth and productivity are waning. What most don’t understand is that monetary policy alone is not enough to bring an economy out of the low-growth environment that we are currently experiencing. It does a great job of providing liquidity to markets, but with the fear of the unknown persisting, many companies used this liquidity to prop up their stock prices instead of grow their businesses. What the economy needs is fiscal (government spending) stimulus (infrastructure, immigration, tax reform, etc.), coupled with the accommodative monetary policy to help get the economy back on the right track. Hopefully we see this after the elections in November.

All in all, we remain cautiously optimistic. We realize that this bull market has lasted over 8 years, but remain prudent in our realizations that, when faced with such low interest rates, stocks still look attractive. We remain extremely well-diversified throughout our portfolios and diligent in our long-term investing approach. Thank you, as always, to all of our clients for all of the support and feedback. We wish everyone a very healthy and prosperous summer and please feel free to check out some of the interesting articles we have listed.

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