Market Commentary - November 2015

September 28th now appears to have been a successful retest of the August lows. Since then the market has rallied about 11% and is now less than 2% off its all-time high. The market is likely to encounter stiff resistance near the old high, which is typical in bull markets when prior highs are tested.

One observation on the recent rally is that large cap stocks are clearly leading the way. The S&P 100 (the top 100 largest stocks by market capitalization in the S&P 500) has advanced 13% since the lows in August while the Russell 2000 (small caps) has advanced only 5%. This large cap bias favors our clients' large cap portfolios, though we wish the market advance was broader. **The narrow advance of late helps to confirm our view that while the bull market remains intact it is getting later in the cycle.**

With earnings reports in from about two-thirds of S&P 500 companies, corporate earnings have slid about 1%, but are up 6.1% ex-energy. Once again, actual results have been better than initially expected. Earnings for 2016 are now expected to rise 6.7%, about in line with our outlook.

The Bulls and the Bears

This month we will summarize key arguments for the bulls and bears as they continue to battle at this important juncture. Let's start with the bear arguments:

Bear Argument Number One...

The global economy is growing at stall speed. China's growth has slowed. Many of the commodity exporter countries are already in recession (Brazil, Russia and Venezuela, among others), and this weakness may spread to more developed countries, including the U.S. U.S. exporters are already feeling the pinch.

Our response is that a steady but slow growth economy is part of the new normal which we wrote about last June. China has stabilized and we do not see a U.S. recession on the horizon. Also, commodity prices are cyclical, including oil. Eventually prices will bottom and then rise, giving relief to commodity-driven foreign economies.

Bear Argument Number Two…

The Fed is likely to begin rate normalization (increase interest rates) later this year or early next year. Our economy is not strong enough to withstand higher interest rates, and it is never a good idea to fight the Fed.

We think the Fed will raise rates only sporadically and by small increments once they start the cycle. The stock market has advanced in 12 of the last 14 monetary tightening cycles going back to the 1950s, and stocks have typically risen almost 10% in the first year after tightening begins. Fearing the Fed is unfounded.

Bear Argument Number Three…

It appears that U.S. corporate profit margins have peaked which will result in much slower profit growth ahead. A strong dollar will also hurt earnings growth.

Yes, we agree profit margins are inching down which points to slower earnings growth ahead. We think 2016 and 2017 earnings growth will be in the mid-single digits range. Since we don't expect much in the way of P/E expansion or contraction over that time period, equity rates of return may only be in line with profit gains.

Now, for the most common bull arguments…

Bull Argument Number One…

Valuations are very reasonable at only 16x 2016 expected earnings given low interest rates, low inflation and a growing economy.

We agree that valuations are only modestly stretched but slow earnings growth will keep a lid on P/E ratios. We do not expect P/E multiple expansion, so equity returns are likely to be in line with profit growth as stated above.

Bull Argument Number Two…

If disappointing third quarter corporate profits push us into a profits recession (two consecutive quarters of lower earnings), it will only be due to the fact energy company earnings have plunged this year because of lower oil prices. Ex-energy profits are expected to rise 5% this year and next.

We agree. Energy profits will be a drag on S&P 500 earnings until the second half of 2016 when year-over-year earnings comparisons should ease.

Bull Argument Number Three…

Interest rates will remain abnormally low indefinitely due to moderate GDP growth and low inflation. This may provide another spark to the stock market as the attractiveness of bonds is diminished.

We agree that rates will remain low a while longer but may eventually rise if the Fed raises rates faster than market expectations, the U.S. economy accelerates, or wage inflation pushes overall inflation closer to 2%. For this reason, our fixed income ladders remain short with a maximum maturity of six years.

"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."

-- Sir John Templeton

We do not see unbridled investor optimism and certainly not euphoria at this time. Many investors remain nervous. This adds to our confidence that the bull market remains intact although future returns are likely to be modest. Over time, we expect the S&P 500 to make new highs--But first, the market must digest its recent gains.

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