Monthly Commentary

March 2017

Taking down the spinnaker

Successful investing requires both courage and brains, but in different quantities at different times.

In a deep economic and market slump courage is the key, since it is a no-brainer that both the economy and markets will eventually recover.

However, once both markets and the economy have fully recovered, it is brains that count, since investors need to find strong returns in markets which generally promise only mediocre ones.

This is particularly relevant this month, as the current bull market celebrates its eighth birthday.

Eight years ago, on March 9, 2009, the S&P 500 closed at 677, down 57% from where it had been just 18 months earlier. 10-year Treasury yields had fallen from 3.6% to 2.9% over the previous year and, given a core inflation rate of 1.8% year-over-year, real yields were well below their long-term average.

Investors were depressed and scared. However, good long-term returns from stocks were almost inevitable at that point since economic and market fundamentals were at unsustainably low levels.

- Payroll jobs had fallen by over 650,000 in February and the unemployment rate had risen by 0.5% in just one month.
- Housing starts had slumped to just 466,000 in January, less than a third of their long-term average.
- Light-vehicle sales had fallen to just 9 million units, more than 40% below their long-term average.

In the meantime, the Federal Reserve had slashed short-term interest rates to near zero and the federal government was set to unleash a significant stimulus package.

Dr. David Kelly, CFA
Chief Global Strategist
J.P. Morgan Asset Management

Most importantly, the lessons of Lehman Brothers had not been forgotten and the government was determined not to let any of 30 named major financial institutions go bankrupt.

Once all of this was clear, it was also obvious that the economy would begin to heal and would foster a recovery in corporate earnings. Unemployment does not rise forever and the huge pent-up demand implied by dismal vehicle sales and housing starts meant the economy was setting itself up for a bounce-back.

In nautical terms, it was time to hoist the spinnaker and take advantage of a strong cyclical tailwind propelling a stock rebound.

Eight years later, the financial landscape has changed completely. Vehicle sales, at 17.5 million units in February are back above their long-term average. Housing started at 1.25 million units in January and now closing in on what will likely be a lower post-financial-crisis trend.

The unemployment rate is 4.8% and, in the jobs report out on March 10, could well fall to 4.7%. Meanwhile, initial unemployment claims last week fell to 223,000 – their lowest level in almost 44 years.

In a speech on March 3, Janet Yellen made it clear that, barring a significant negative surprise in the next few days, the Fed will raise interest rates for the third time in this expansion when the FOMC meets on March 15. Most importantly for investors, both stocks and bonds are now significantly more expensive than they were eight years ago.

On the equity side, the S&P 500 closed at 2,383 on March 3, boosting the forward P/E ratio to 17.8 times, about 12% above its 25-year average. Remarkably, however, Treasury bonds are also more expensive than they were eight years ago with a 10-year yield of 2.5% despite a pickup in core inflation to 2.3% year-over-year.

While confidence is far higher than eight years ago, returns for both large-cap U.S. stocks and high-quality bonds now face a significant valuation headwind.

With earnings growing more slowly, dividend yields and bond coupons low, and the potential for P/E ratios and real yields to mean revert, a traditional 60/40 U.S. stock/bond portfolio could well generate returns over the next five years that are less than half the roughly 8% annualized gain that such a portfolio provided over the past 25 years.

In nautical terms, it is time to take down the spinnaker and tack to find a better wind. So where is there still opportunity?

One place to look is in U.S. equity sector selection. While stocks are now generally more expensive than average in a rising rate environment, cyclical sectors, such as financials and technology should be able to outpace more defensive sectors such as consumer staples, utilities and REITs.

A second opportunity lies in European stocks, which appear significantly undervalued relative to U.S. stocks, with lower P/E ratios (even relative to their own historical averages), higher dividend yields and likely stronger earnings prospects, given Europe's earlier stage in the business cycle. Moreover, an unhedged position in Euro Zone stocks should, in the long run, be able to take advantage of a rebound in an undervalued euro.

A third area for potentially better returns is in emerging market (EM) stocks, which, despite a good start to the year, remain well below long-term average price-to-book ratios. The commodity slump that has haunted EM equities appears to have come to an end and EM economies should be able to resume their normal sizable growth advantage over developed countries in the years ahead.

Eight years ago, investors were very skittish and too ready to sell at the slightest rumor of “another shoe dropping.” Today, there is the complacency of confusion, as investors wait and wonder about how the Trump agenda might impact the investment environment. There is, indeed, a great deal of uncertainty around this. However, any reasonable reading suggests that the market has priced in a close-to-best-case scenario for both bonds and stocks.

This is not to predict an imminent market correction or to recommend that investors should hide in cash. Given low cash yields, it still makes sense to be in long-term investments including both domestic stocks and bonds. However, it is time to adopt a more diversified and thoughtful approach that recognizes the importance of valuations and relies less on that most naïve of all assumptions – the prospect of wisdom from Washington.

The Market Insights program provides comprehensive data and commentary on global markets without reference to products. Designed as a tool to help clients understand the markets and support investment decision-making, the program explores the implications of current economic data and changing market conditions.

MI-Monthly_March 2017 | 0903c02a81cc5d1b