FirstPoint Financial

WEEKLY MARKET THOUGHTS

June 2, 2014

What is the Shape of Our Economy? What is the Shape of Our Market?

The month of May is now in the books. The old market saw of “Sell in May and Go Away” has not yet proven prophetic – not yet. For those unaware of this saw, the theory is as follows. Historically, the vast majority of positive stock market movements (going back to 1950) have occurred during the months from October to April. May through September have proven difficult periods for stock market movements. The saying “Sell in May and Go Away” has gained wide acceptance, and as with many things within the stock market, when everybody knows something will probably happen – it won’t. But the period of May through September is still young.

Following are returns various markets have generated:

Asset Class (Index)	Month of May	Year to Date	Trailing 12-Months
S&P 500 Index	+2.1%	+4.1%	+18.0%
Russell 2000 Index	+0.7%	-2.5%	+15.3%
EAFE Index (Foreign Stocks)	+1.0%	+2.1%	+14.9%
iShare Emerging Markets	+3.0%	+1.8%	+3.3%
10-Year U.S. Treasury Bond Change in Yield	-0.17%	-0.55%	+0.35%

As can be seen above, the month of May generated profitable experiences for many investors. Some are puzzled by the decline in interest rates we have seen so far this year, in the face of a slight rise in inflationary pressure. While we too are somewhat surprised by this counter-rally in bonds, we need to keep in mind where interest rates were 18 months ago. Rates (as measured by the U.S. Treasury 10-year Bond) bottomed at 1.3% early in 2012. Subsequent to this bottom, rates rose to slightly over 3.0% by the beginning of this year, representing an increase of 170 basis points. Since then, rates have fallen by 55 basis points, about a third of the upward move we witnessed in rates from the lows in 2012. This backfilling is not unusual for any market that has generated large moves – either upward or downward.

We are concerned that the bond market is “talking” to us – telling us the weak growth of the first quarter wasn’t simply a fluke of inventory write-down and weather. Per our discussion below, *we are still in the economic growth reacceleration camp, as the weight of the evidence is still pointing toward an improving economic growth rate as the year continues to move forward.*

The fundamental "stuff" of slightly higher interest rates in the future is still present. We are looking at this move back downward in rates as a gift from the market, and investors may want to take advantage of this downward shift in rates.

Stock Market Outlook

Most investors understand that profit growth expectations and realizations are what, over long periods, drive stock prices. We have long stated that, historically, there has been a strong correlation between stock prices and earnings. In fact, studies show that stock market pricing is positively correlated to corporate earnings 83% of the time. When earnings rise, so do stock prices. When earnings fall… well, you get the picture.

Corporate earnings growth is driven by two main factors – "top line" growth (sales growth) and profit margin expansion or contraction. Current profit margins are about as high as they have been in some time. The main variable in earnings that many in the investment community (including me) have been anticipating this year has been a rise in sales growth rates. It is tough for most companies to show strong sales growth in the face of an extremely weak macro-economic environment. I, along with many others, have been forecasting 2014 GDP growth of 2.5% to 3%, and subsequent S&P 500 average earnings growth of 8.0% this year. Given what happened during the first quarter, is this level of growth still probable? And if not, what will happen to corporate earnings estimates and subsequently to stock prices? This raises the general question "What is the Shape of our Economy and Stock Market?"

Where We Have Been

Strong debate is occurring within the ranks of economic and market forecasters as to the durability and shape of the current economic expansion. Fundamentally, the current economic expansion has been unlike any other the United States has seen since the end of World War II. It has been weaker, with seriously lower levels of job creation, than any other expansion.

Since the second quarter of 2009, (the end of the last recession) real GDP has grown by 11.1%. Since 1961, our economy has experienced seven previous expansions that averaged 21.1% growth, excluding the abbreviated expansion of 1980. The current expansion is 59 months long. The average expansion since 1961 was 71 months. Many are fully aware the current expansion has been among the weakest we have witnessed. Our leaders in Washington have attempted one stimulus plan after another – both on the fiscal and monetary sides of the question. The results of these plans have been lackluster, at best. At one time, some in Washington were asking the public to give their policies time to work – claiming that things would get better with time. Well, real economic growth has been 10% less than during the average historical expansion and the current expansion is within one year of expiring – given historical norms. This underperformance of 10% represents real GDP of $1.4 trillion less in output than the historical average growth expansion. Serious money – serious underperformance.

Time has run out for the Washington policy makers. The job they have done has been ineffective to-date as far as the power of the current expansion is concerned. There are those who would argue the counter-factual, that growth would have been much weaker if government fiscal spending hadn't increased by 28% since 2007 and the Fed hadn't ballooned the raw size of its balance sheet to $4.3 trillion, an increase of 30% over the last 12 months. I guess we will never know if those arguments are accurate or not. What we do know is the current economic expansion has been very weak by historical standards. That's a fact. Perhaps government-centered Keynesian demand-driven macro policies are not all they are cracked up to be.

Last week, the BEA revised first quarter GDP growth from 0.1% to -1.0%. While first quarter GDP will be revised one last time, it is doubtful the revision will be enough to push the growth rate back into positive territory. I am in the camp that first quarter GDP's organic economic growth was nowhere near as weak as -1.0%. Our calculations show that private inventory work-off occurred at a clip of -$38.4 billion, which lowered reported GDP by 1.62%. Additionally, extremely harsh winter weather slowed overall economic activity. These two issues are not repeatable – they won't negatively impact forward GDP growth. Combined, these two items lowered the first quarter GDP by roughly 2.5 – 3.0%. So, organic first quarter GDP growth was probably actually in the 1.5% - 2.0% range.

Heavy Lifting

This means that for the rest of the year, economic growth needs to accelerate significantly and rapidly if indeed we are to see total 2014 GDP growth of 2.5% to 3.0%. Arithmetically, for the total-year GDP growth rate to reach the Federal Reserve's own forecasted 3.0% for the year, the last three quarters of the year will need growth at a rate of at least 4.0%. For reference purposes, our economy has grown in excess of 4.0% only two of the last 17 reported quarters! So, GDP growth forecasts have been coming down, along with corporate growth expectations. I lowered my own forecast from 3.0% to 2.5% 2014 growth within the last month. I expect the Fed will lower its stated expected GDP growth forecast sometime soon.

Where We Are Going

Now that we have a handle on what has been happening with GDP growth, what of the remainder of the year, including second quarter GDP and corporate profit growth rates? We always use the weight of the evidence method in making forward-looking forecasts. Currently, the weight of the evidence is skewed toward growth accelerating. Consider the following recently released forward-looking sentiment indicators:

- **Flash PMIs –** both manufacturing and service-based PMI's (Purchasing Managers Index) are showing strong upward tilts.
- **Consumer confidence surveys are mixed –** but still encouraging. May's Consumer Confidence Index came out at a reading of 83.0, up from 81.7 in April. Late last week, the University of Michigan Consumer Survey came out at 81.9, down from 84.1 in April.
- **Digging deeper into the Consumer Confidence survey brings encouragement.** Confidence among folks 35 years old and younger jumped to the highest level seen since September 2007! Why is this important? This is the group that drives household formation and all the hard spending that goes along with that important metric.

We are comfortable with our GDP and corporate profits growth reacceleration story for the rest of 2014.

Inflation – the #1 Metric

If someone asks me to identify the most important factor that drives long-term returns on various asset classes, I would choose inflation. Inflation (both realized and expected) drives interest rates and stock market valuation (Price Earnings) ratio levels and directly affects consumer and business spending behavior.

Unnoticed by many in the markets is the fact that inflation, while still low, bottomed last October at an annual rate of 1.0%. Since then, inflation (all-in CPI) has risen to a 12-month trailing rate of 2.0%. While not a show-stopper, it is worth noting that inflation has risen during a time when underlying economic trends have been anything but robust.

Inflation's upward push to 2.0% has moved the real yield on the S&P 500 Index into negative territory, as dividend yields for this index are now lower than 2.0%. For inflation to remain at these levels and continue to rise, wage costs will need to rise. They have been doing so in a stealthy, slow manner as the jobs picture continues to brighten (see our earlier March 22 piece entitled "Inflation Where Art Thou" for a more robust discussion regarding employment costs and inflationary pressures).

As long as inflation stays in this vicinity, we don't expect stock market multiples to rise significantly. If for some unknown reason inflation starts to rise from these levels, market P/E ratios may indeed start to fall, leading to an overall market correction. We are not currently concerned about an upward push in wage and inflationary pressures. But these are factors that need to be watched. For those counting, our modeling work suggests inflation will rise to an average of 2.6% over the next two to four years.

Bringing it Home

A weak first quarter (which has helped drive interest rates downward since the first of the year) could be followed by a hoped-for economic rebound. The stock market has provided total returns in the 3% range year-to-date (7.2% annualized). Not bad and somewhat normal. We are now historically in the weaker part of the stock-market calendar. GDP growth estimates have come down (except for the Federal Reserve's forecast), and earnings estimates have been modified for the remainder of the year.

We continue to stand by our view that the domestic stock market (as measured by the S&P 500) will outperform the broad-based bond market this year. With the Fed continuing to taper quantitative easing activities and a rebound in overall economic activity, we are in the camp looking for slightly higher interest rates later in the year.

Our annual outlook for the stock market has rested on earnings gains and we retain that stance. Companies have to deliver on earnings estimates. By-and-large earnings estimates don't appear too stretched. Could the stock market show weakness this summer? Absolutely. If this were to occur, we would treat that correction as a reason to put capital to work in the market, rather than flee.

We believe the bull still has the upper hand on Wall Street.

We will be back next week.

William B. Greiner, CFA
Chief Investment Officer

More Information

FirstPoint Financial

FirstPoint TV

Market Insight

P. S. Please feel free to forward this commentary to family, friends, or colleagues. If you would like us to add them to the list, please reply to this e-mail with their e-mail address and we will ask for their permission to be added.