Market Perspectives | A Glance at How the World Affects You

Fundamentals Remain Intact

February 9, 2018

Friday's bond market sell-off was likely precipitated by a strong non-farm payroll report for January which showed 200k new jobs as well as a positive December report. Adding to inflation concerns was the report's reading on wages, which grew at an annual 2.9% rate. The Fed left interest rates unchanged after last week's FOMC meeting, but their statement pointed to inflation risk in 2018. They also noted that consumer spending was "solid" (versus their former description of "moderate").

So, interest rates moved higher, and stocks plunged; knee jerk or defensible? In our opinion, Jerome Powell, the new Fed Chair, will not raise rates more than the economy can handle. However, when bonds sell-off, rates move higher. Both the equity and bond markets may need time to digest a less-accommodative Fed as the economy continues to gain momentum. Ignoring the recent volatility is impossible but we believe the decline is transitory and the beginning of renewed volatility as inflation and interest rates become a real part of the economy.

The last four trading sessions have seen investors shift focus from worrying about missing ongoing rally to concerns about valuations and overbought equities. A complicated political backdrop, earnings reports and economic news are top of mind, but the main focus, however, was on an unexpected and precipitous rise in bond yields. As bonds sold-off, equity markets reacted with a prodigious decline. The S&P 500 Index fell 3.8% for the week.

Many indicators are used by experts to gage market volatility. Most notably, the Volatility Index (VIX) soared during the recent selloff more than 60% to reach 17 - the highest level since November 2016. On February 5, it rose another 115% to 37. The volatility index can be, in a word, volatile; four times in the past five years, it jumped over 20; interpreted as buying signals. Current conditions, however, have investors asking if this is a good time to invest.

Depending on an investors goals and appetite for risk, the VIX is almost 4-times its recent low, which is typically a strong oversold level that presents a buying opportunity. If you are not in it for the long term, keep in mind that the current bull market is now 108 months old. Measuring the period from 1940 to the present, we find that the average bull market lasted 96 months with gains of 231% on the S&P 500. Comparatively speaking, the current bull market may not be as long in the tooth as some believe. Lest we forget, positive fundamentals (a solid economy and strong earnings growth) remain intact.

Looking ahead, positive returns from January send a bullish signal for stocks in 2018 despite the February selling. Looking back at the monthly, quarterly and annual returns in the stock market since 1980, January is usually a good month. On average, stocks rise 0.9% in the month and returns are positive 62% of the time. Interestingly, when January returns are positive, annual returns are often in the black as well. In fact, this has happened 21 of the 24 years in our study. This is known as the January Effect. Perhaps January 2018 was a bit too strong. Even so, bullish market fundamentals appear intact: the economy is growing, corporate profits are expanding, and interest rates remain low.

At this point, stocks appear fairly valued, but we expect market choppiness to continue. Nevertheless, equity markets are positioned to do well amid a strong fundamental backdrop of solid global growth and strong earnings. Monetary policy (tightening) and inflation (rising) are changing, but these don't appear to be headwinds. Indeed, rising interest rates and reasonable inflation are considered indicators of a strong economy. However, the problem for stocks is interest rates rising too quickly. In our opinion, the catalyst was last Friday's job report, exacerbated by knee jerk and automated selling. We believe prices can continue to advance, but volatility is likely to remain elevated.

OmniStar financial group

For decades, investors have consistently made decisions based on emotions; fear and greed are the most common. Yet, stock prices are affected by many factors over varying periods. For example, short term (weeks and months) themes are mostly driven by technical factors and investor sentiment. Over a one- or two-year horizon, economic and business cycle developments are important factors. Finally, the long term (five years and beyond) is most influenced by valuations. We encourage clients, and investors in general, to stay focused on your personal index number and ignore broad market indexes and volatility. A personal index number is the rate of return necessary for you to achieve your goals.

With so many factors affecting market performance, you cannot expect all of them to stay aligned, thought they sometimes do during investment cycles. At the start of the current bull market in March 2009, for example, sentiment had hit extreme lows, economic data was finally turning positive, the Federal Reserve launched its quantitative easing program and valuations had dropped to extraordinarily cheap levels. Markets had only one way to go, up!

Unfortunately, it looks more complicated today. From a technical perspective, prices appear to have gotten ahead of themselves. The cyclical outlook, however, still looks good given that economic and earnings growth continues to improve. And valuations are not excessive. Another factor is insider trading which often foretells of market direction. Insiders historically buy into sell-offs, something we have not seen over the last several trading days. If insiders don't jump at the opportunity to add shares at discounted prices, we look for additional selling over the next several weeks to months.

Our Perspective: bond valuations remain extreme, interest rates are still near historical lows. Considering stock prices and earnings trends, as well as bond yields and inflation rates, we conclude that stocks are the better bargain. Yes, stock prices are not as attractive as they were in 2009, when they were trading at 3 standard deviations below fair value; the current reading is closer to 0.7 standard deviations. But they also are clearly not trading at the high valuations that were reached in the late 1990s, just before the dot-com bubble. The first six weeks of the year have been a roller-coaster ride for investors. We think that once the volatility dies down, investors will gravitate back to the fundamentally favored asset class of equities.

Best Regards,
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President & CEO