Market Perspectives | A Glance at How the World Affects You

Market Direction; Fundamentals and Seasonality

May 16, 2016

Equity markets pulled back again last week, and basically, stocks are at break-even as we close the 1st quarter earnings season. Many factors are influencing equity pricing; monetary policy, Japan's failure to move rates further into negative territory, Federal Reserve timing of the next [unlikely in our opinion] rate hike and corporate earnings remaining (generally) weak while the U.S. dollar has continued its decline. The widely followed Dow Jones Industrial Average, composed of large-cap blue chips, fell 1.2% last week. For the year, the DJIA is up 0.6%. The broader, more diversified S&P 500 dropped 0.5% for the week and is now ahead only 0.1% year-to-date. Small-caps, which are typically more volatile than large-caps, declined 1.1% for the week. For the year, the Russell 2000 is down 2.9%.

Partly to blame for the [basically] flat year-to-date returns, U.S. real gross domestic product (GDP) advanced only 0.5% during the first quarter. The consumer sector remained steady, however, growth in new homes was not spectacular due to softening economic conditions. March [new home] sales came in at a 511,000 annualized rate which is on the low side of expectations. New homes aren't showing much price traction, down 3.2 percent in the month to a median $288,000 which is down, not up, 1.8 percent from last year. Year-on-year, sales are up 5.4 percent, right in line with permits which are up 4.6 percent. Optimistically, we note that spring is the big season for the housing market which could produce a needed pickup in the pace of the overall economy. Capital expenditures were the weak link. Basically, the consumer bailed out in the first quarter, both on services and fixing their homes. Otherwise, the economy is devoid any real momentum going into the Spring quarter.

With GDP pointing to a persistently sluggish economy, the Fed indicated that it is less concerned about global financial risks than it previously was, and also pointed to continued mixed economic performance. From their comments, we infer the central bank is focused on continuing improvements in the labor market and is prepping investors for another rate hike in the near term. However, for the Fed to move forward with rate hikes, economic data must improve. At this point, we don't anticipate more than one hike during the remainder of 2016 and our expectation for that is quite low.

Corporate earnings continue their struggles and are likely to fall again. In fact, we believe weak earnings from retailers and gains in the dollar were factors behind last week's equity slide. Nearly all of the S&P 500 companies have reported and earnings are slightly ahead of expectations but revenues are flat to slightly down. According to analysts, earnings growth for 2016 is set to decline by 4%. If we get creative and remove energy, earnings would be up 1%. Nevertheless, poor corporate earnings are beginning to weigh on stock prices. Lest we forget that U.S. corporations have done very little to deploy cheap debt in a productive way. Instead, companies have used more than $2 trillion dollars in acquisitions and stock buybacks over the last year. Ostensibly creating the perception of productive activity.

Finally, the long-lived axiom, "sell in May and go away", is on the minds of investors. Frankly, it seems plausible plan when you consider the remaining risks and headwinds in the aforementioned. Corporate earnings are under pressure according to S&P Global Market Intelligence. They estimate S&P 500® Index earnings for the first quarter of 2016 will be $26.25 per share, a 7.9% year-over-year decrease and the third successive quarterly decline (due in large part to declining earnings in the energy sector).

OmniStar financial group

© 2015 OmniStar Financial Group Market Perspectives

Valuations, broadly speaking, may be rich. The S&P 500® Index is trading at 17.3x its forward 12-month price-to-earnings ratio, which is almost 5% above its 15-year average of 16.5x. We discussed this in our April 5th edition of Market Perspectives. When stocks trade above what is considered fair-value, volatility is usually not far away. Possible triggers which could ignite more selling include persistent signs of an ongoing slowdown in emerging markets (specifically, China) and the potential for Britain to exit the Eurozone after a vote on June 23, commonly referred to as the “Brexit.” Additionally, we are closely monitoring the U.S. Dollar and the relationship between two important groups of stocks; consumer discretionary vs. staples. We don’t manage our portfolios based on the decades old adage, but we do consider seasonality as a relevant tool when markets seem unclear on their next direction.

The Bottom Line: Risk assets have traded unevenly over the past couple of weeks as investors reacted to a variety of cross-currents, including relatively weak earnings, rising oil prices and mixed economic news. Economic growth is not enough to draw investors out of safe-haven assets (Treasury Bonds) and into riskier assets. Therefore, investors are facing somewhat of a quandary; double down on government bonds and other safe-haven assets, or trust that economic conditions are improving, and turn toward equities.

Strictly on a relative basis, the latter is our preferred course. On an absolute basis, monetary conditions (around the world) are a wild card. The Fed is due to raise rates at some point, but even another rate hike (or two) would leave rates quite low relative to the condition of the economy amid a backdrop of low inflation. Comparatively speaking, a number of long-term positives for stocks are in play. At the moment, regardless of these net positives, corporate earnings are not strong enough to increase equity prices. Additionally, we think investors have grown wary of the strong rally which catapulted stocks [almost] to record highs over the last few months.

At this point, equities, high yield bonds and commodities remain overpriced and disproportionate to earnings. From our perspective, this exposed stocks to some kind of market correction or a continuation of what started in January.

Best Regards,
Phillip L. Clark, RFC
President & CCO

OmniStar Financial Group is a Registered Investment Advisor registered in the state of North Carolina. All notices should be sent to OmniStar Financial Group 1236 19th Street Lane NW, Hickory, NC 28601. Please contact your financial advisor if there are any changes in your financial situation, or investment objectives. Our current disclosure statement is set forth in Part II of Form ADV and is available for your review upon request. This material has no regard to the specific investment objectives, financial situation, or particular needs of any reader. The OmniStar Market Perspectives are published solely for informational purposes and are not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. References made to third parties are based on information obtained from sources believed to be reliable, but are not guaranteed as being accurate. Readers should not regard it as a substitute for the exercise of their own judgment. Any opinions expressed in this site are subject to change with-out notice and OmniStar Financial Group is under no obligation to update or keep current the information contained herein. OmniStar Financial Group accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this material. The purpose of OmniStar’s Market Perspectives is to provide general opinion commentary and should not be acted upon without first consulting your financial advisor, tax advisor and/or legal advisor.