Tug of War - FED Action vs. Weak Earnings

The first quarter of 2016 took equity investors on a wild ride but stocks ended about where they began with the S&P 500 up +1.35%. The stock market got off to a shaky start falling -1.5% on the first trading day and continued its downward path until bottoming on February 11th with a peak to trough decline of -11.4%. The abruptness of the decline caused a sense of panic for investors which spurred the world's central banks into action to calm fears. Both the European Central Bank (ECB) the and Bank of Japan (BOJ) announced further easing measures while the Federal Reserve reversed course and became much more dovish in their outlook. The result was a rip-roaring rally for the S&P 500 of +13.8% to end the quarter in positive territory.

Confusion is probably the best way to describe the message of the markets early in 2016. Like stocks, oil and junk bonds experienced big swings while going nowhere by the end of the quarter. Meanwhile, despite the ECB and BOJ aggressive actions meant to weaken their currencies it was the US dollar that weakened by -4.2%. The barbaric relic gold had its best quarter in thirty years up about +16%. On the equity side emerging markets starred rising about +5.5%. Only time will tell whether or not these are trend changes or merely dead cat bounces.

The other markets that moved decisively in the quarter all suggest the market is worried about growth. US interest rates defied expectations and fell decisively below 2% increasing bond values. Historically an inverted yield curve has been a reliable barometer of a pending recession. With the Fed suppressing short term rates it will be almost impossible for the yield curve to invert. However, a flattening of the yield curve may provide the same signal. The yield curve is at its flattest in almost nine years and should be closely monitored. Hard to believe but the meager rates in the US are quite lush compared to the yields in other developed sovereign bond markets. Currently there is about $7.6 trillion of developed country sovereign debt with a negative yield. Less than two years ago there weren't any. Clearly we are in uncharted territory which adds to the confusion.

The message from the stock market is also one of caution. Utilities, telecommunications and consumer staples were the big winners in the first quarter. Investors ran toward defensive sectors that provide a decent yield -probably not a sign that animal spirits are ready to soar anytime soon.

A **big story during the quarter was the collapse in earnings estimates**. According to Thomson Reuters, forecasts for US profit growth in the first quarter sank from +2.3% to -6.9%, while forecasts for the full year dropped from +7.6% to +2.0%. **It will mark the third straight quarter of weaker S&P 500 earnings - the longest such period since the end of the financial crisis**. And it is not all energy driving the downward revisions. S&P 500 earnings excluding energy are still expected to be down -3.3% in the quarter. Even more worrying is that these estimates are adjusted numbers that do not conform to Generally Accepted Accounting Principles (GAAP). Thomson Reuters notes that in 2015 adjusted earnings were 29.5% above the GAAP number, historically a red flag for the stock market. The decline early in the quarter makes sense in light of these figures. With the recent rebound stocks are once again fully-valued. The price-to-earnings ratio using GAAP earnings is about 22 times, a historically high figure.

Bulls will rightly point to a healthy labor market and improvement in worldwide ISM manufacturing surveys in March for reasons underlying the recent rally. The manufacturing sectors of China and the US have returned to health and are slightly expanding again. For many months, they had pointed to recession. **Continued improvement will be needed to support stock prices.**

Regardless of short-term market turbulence we continue to see opportunity in large cap value stocks, mid- and small cap stocks, and international stocks. **Our focus is on companies with strong balance sheets and attractive valuations. Once again our hope is that at some point during the year we will be able to ring the all-clear bell and invest the cash currently in the portfolio.**

Please contact us if you have any questions. Best wishes.

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