Investment Management of Virginia

Investment Viewpoint

October, 2015

Overview

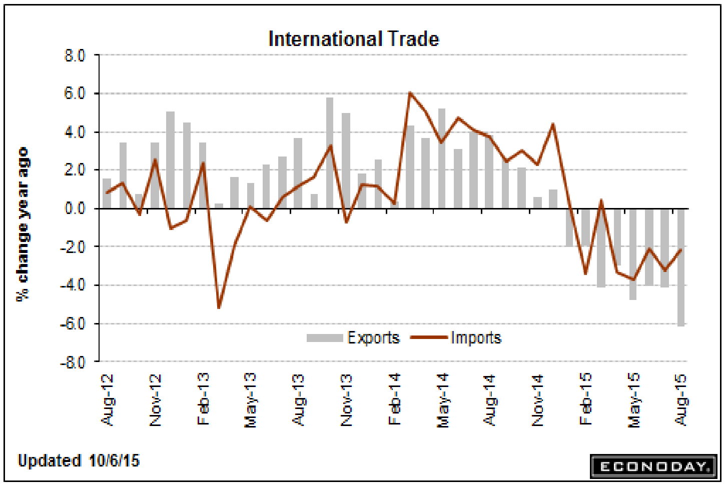
Uncertainty led to poor equity market returns in the third quarter. Collectively, the Federal Reserve's decision not to raise rates in September, fears about China's slowing growth, weakness among emerging markets, and ongoing carnage in commodities, all weighed on worldwide markets. The S&P 500 Index declined by 6.4% on a total return basis for the third quarter. The S&P Mid Cap 400 and Small Cap 600 lost 8.5% and 9.3%, respectively. The larger capitalization Dow Jones Industrial Average also declined, retrenching 6.9%. International markets were generally worse, with the S&P Developed Ex-U.S. BMI (Broad Market Index) down 10.2%, and the S&P Emerging BMI down 18.7%. Conversely, high credit quality fixed income generally held its own in developed markets; emerging market debt and high yield bonds did not.

The major catalysts behind the late August market correction appeared to be the Chinese central bank's decision to devalue its tightly controlled yuan currency, a move seen as an acknowledgement that China's growth was undershooting expectations, perhaps portending broad, global economic weakness. From its May 21st high to its August 25th low, the S&P 500 Index shed 12.4%. While corrections are never pleasant, they are to be expected in the course of long-term stock price movements. According to S&P Capital IQ, while there have been 11 recessions since 1948, there have been 31 market declines of 10% or more (corrections). Thus, corrections have occurred on average approximately once every two to three years. Prior to August of 2015, the last market correction of 10% or more was in 2011.

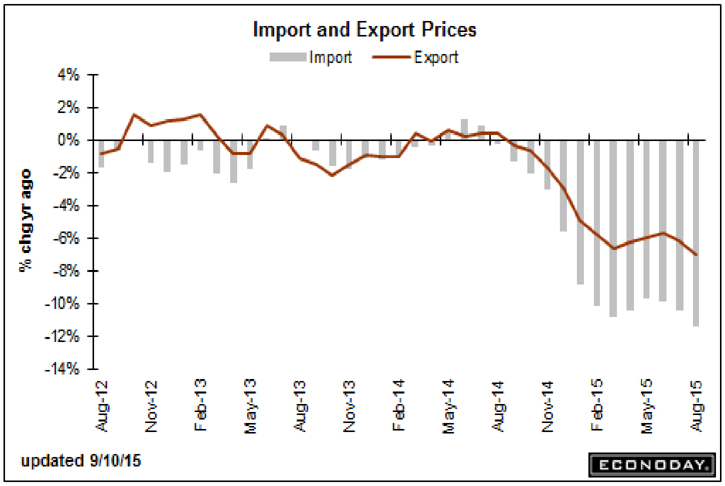
Historical data suggest that corrections are not always good predictors of recessions. Most recessions begin – and bull markets end – with an overheating economy, rising inflation or inflationary expectations, spiking commodity prices, and a cycle of aggressive Fed tightening. As of September 30th, none of these trends appeared to be present. In fact, the world, including the Federal Open Market Committee, seemed more concerned about the potential for deflation, as was reflected in weak foreign currencies and markets, declining commodity prices, and slowing international trade with weak pricing trends.

The U.S. economy remained a relative bright spot, led by strength in retail, autos, housing, construction, services, and employment trends. Second quarter GDP came in at a surprisingly strong 3.9% annualized rate of growth, reflecting a rebound from the weather-constrained first quarter. Manufacturing, however, which has been negatively affected by the strong dollar, declines in capital spending (especially energy), and contracting export orders, weakened through September 30th. Inventory overhangs and weak pricing power likely will have crimped growth and earnings when third quarter GDP is reported. On a positive note, this trend has been a boon for consumers with the means and confidence to spend.

In sum, the U.S. economy remains in a low growth environment with low inflation and low interest rates. These trends could be healthy for the markets long-term, especially now that much progress has been made in moving traditional valuation metrics, including P/E ratios, closer to the mid-points of their long-term averages. However, demand among our overseas trading partners needs to revive, and pricing power needs to return for earnings to expand. In most economies, a little inflation would be welcomed as well. Presently, virtually every major central bank around the globe is attempting to stimulate growth through low interest rate policies.



Updated 10/6/15



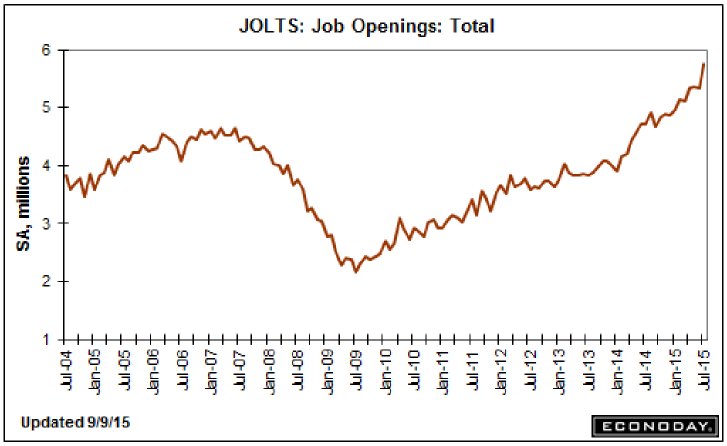
updated 9/10/15

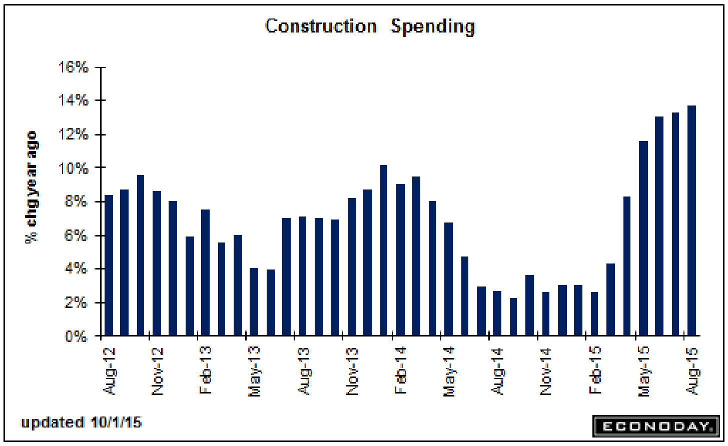
Economic Trends

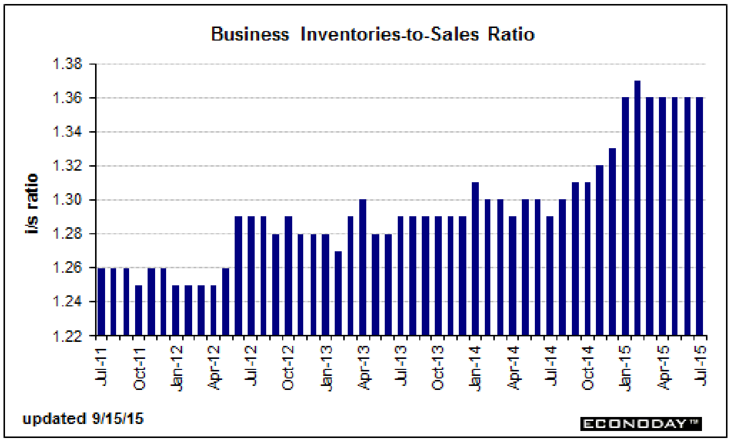
- JOLTS (Job Openings and Labor Turnover) reports have indicated acceleration in job openings since early 2014. The quits rate, an indicator of worker confidence, remained unchanged for a fourth month in July at 1.9 percent, a very low reading.
- Personal incomes rose 0.3 percent in August. The wages & salaries component was also very solid, at plus 0.5 and 0.6 percent the last two months, respectively. Consumer spending also recorded gains in August, rising 0.4 percent.
- The Conference Board’s consumer confidence reading was expected to drop in September, following the turmoil and stock market losses in August. Instead, confidence improved in September. Much of the gain was attributed to the present situation component, suggesting ongoing strength in the labor market and in consumer spending.
- Motor vehicle sales surged 2.3 percent in September to an 18.2 million rate, the highest monthly annualized rate since July of 2005. Sales of North American-made vehicles rose 4.3 percent to a 14.7 million rate, also the highest since July of 2005. Foreign-made vehicle sales declined.
- Construction spending generally advanced 0.7 percent in August, reflecting year-on-year gains of 13.7 percent. Specifically, multi-family construction jumped 4.8 percent (up 25.0 percent year-on-year); construction of single-family homes rose 0.7 percent (up 14.0 percent year-on-year); and private non-residential construction added 0.2 percent (up 17.0 percent year-on year). Public construction trends remained subdued.
- At 50.2, the ISM Manufacturing Index reading for September was at its lowest point since May of 2013. September new orders came in at 50.1, the lowest point since August of 2012. Backlog orders, at 41.5, reflected a fourth month of contraction, as did export orders (46.5). With inventories elevated, any recovery in manufacturing is likely to be slow.

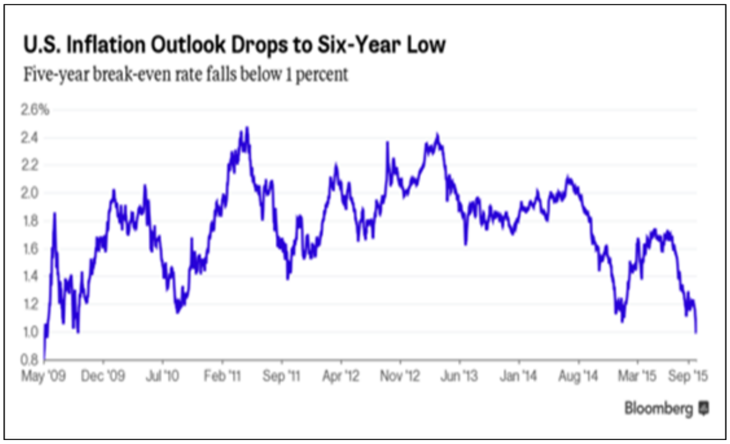
Financial Conditions/Monetary Trends

- The difference between yields on five-year notes and similar-maturity Treasury Inflation Protected Securities, a gauge of expectations for consumer prices, fell below 1 percentage point near the end of September. The “break-even rate” was the lowest in six years. The outlook for inflation, according to this indicator, has been falling as stocks and commodities have tumbled.
- Citing weak global economic conditions, slowing net exports, and dollar strength, the Federal Open Market Committee kept the Fed Funds target at 0.0% to 0.25% in September. Although the Fed would like to be out in front of inflation and begin the process of “normalizing” rates here in the U.S., it did not want to make dollars more expensive for – or draw funds out of – other struggling global economies, especially emerging markets.
- Credit conditions tightened anyway for many corporations, as the spread between U.S. Treasuries and high yield bonds widened. Nevertheless, commercial and industrial loan growth remained healthy; and money growth continued to compound at mid-to-high single digit, annualized growth rates.





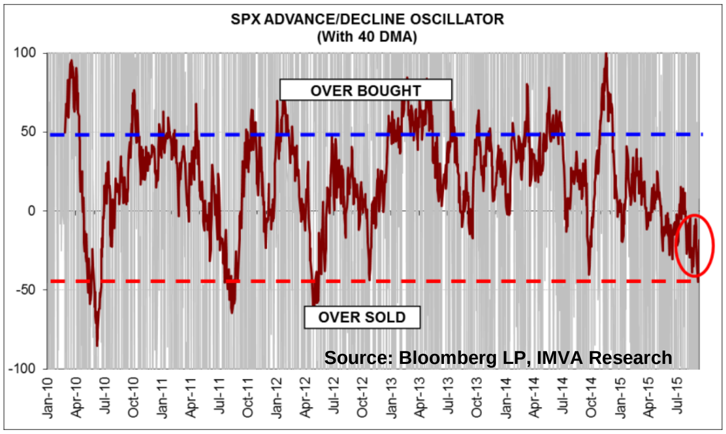




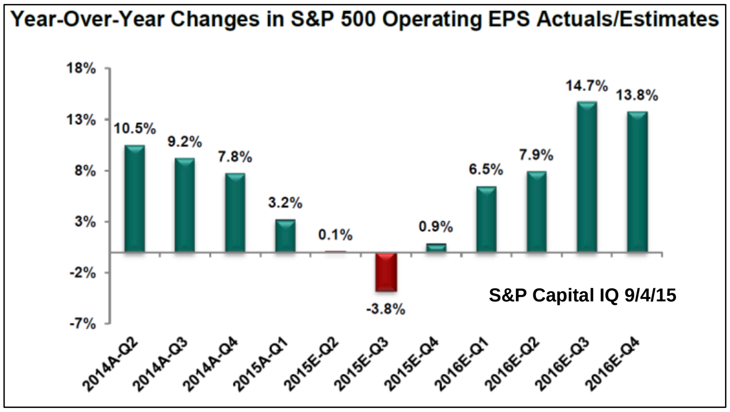
- Judging by the continued decline in the velocity of money (nominal GDP/money stock), the effects of expansionary monetary policy may have played out; zero percent interest rates no longer appear to be moving growth expectations. Looking ahead, stimulus through fiscal measures would likely be more beneficial.

Sentiment Indicators/Market Trends

- Most of the sentiment/market trend indicators we follow reflected "over-sold" conditions and low "bullishness" at the end of the third quarter, representing a huge shift downward from the optimism at year-end, 2014 (see chart to the right).
- Put-to-call ratios, which had risen to approximately two standard deviations above the norm, also suggested over-sold conditions.
- Lastly, the VIX, a volatility index, surged during the quarter to levels only seen seven other times in the past twenty-five years, generally indicating excessive pessimism.



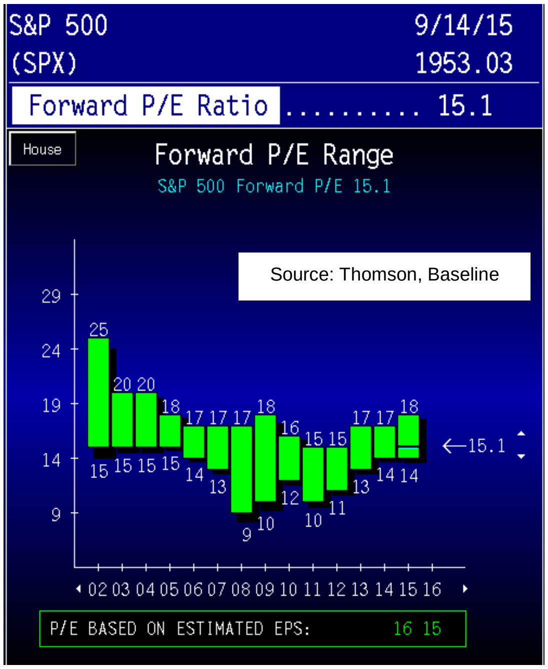
Source: Bloomberg LP, IMVA Research


Year-Over-Year Changes in S&P 500 Operating EPS Actuals/Estimates

S&P Capital IQ 9/4/15

Equity Market Valuations & Earnings

- As can be seen in the middle chart, the S&P 500 Index is expected to have posted declining earnings growth for the third quarter of 2015, the first decline since the third quarter of 2009. Excluding the energy sector drag, earnings growth may have risen 3.4%, according to S&P Capital IQ.
- In a similar vein and over the same timeframe, S&P 500 revenues likely contracted 2.9% as corporations were forced to contend with weakness among global trading partners and currency exchange headwinds.
- Many expect earnings growth to turn positive and reaccelerate in the fourth quarter of 2015 on into 2016. When third quarter earnings and management outlooks are reported in the weeks ahead, forward looking estimates will adjust.
- With a forward earnings multiple (P/E) of 15.1x, the U.S. market's valuation appeared reasonably attractive on a long-term basis in September. According to Standard & Poor's, that level equaled the 15-year quarterly average of the forward 12-month P/E ratio.
- Generally, U.S. economic fundamentals appear to afford the most favorable backdrop for growth, albeit slow growth, around the globe. Ultimately, the return to more encouraging growth trends will require help from the rest of the world in the form of increased orders, firmer pricing, and stabilizing currencies. Eurozone member countries have shown measured progress; Japan and China have continued to implement stimulative central bank policies; and emerging markets should improve when growth picks up in the developed/consuming economies.


S&P 500 9/14/15
(SPX) 1953.03
Forward P/E Ratio 15.1

Forward P/E Range
S&P 500 Forward P/E 15.1

Source: Thomson, Baseline

P/E BASED ON ESTIMATED EPS: 16 15

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