It is getting harder to find undervalued stocks, with so much optimism currently priced into the equity market. It is also getting harder for many of our clients to understand the reasons for such optimism, given the chaos and negativity being created by our policy makers. We can only surmise that, while individual investors are watching the headlines, institutional investors are focusing on the fundamentals.

As the last of the first quarter earnings reports trickle in, it appears that S&P 500 reported earnings were 15.4% above the first quarter of 2016, and exceeded consensus expectations. This represents the best quarterly performance since the third quarter of 2011. In a reversal of the pattern that has been seen for many quarters, analysts have begun raising estimates for the remainder of this year and into 2018.

Not coincidentally, the S&P 500 Index is up 9% year-to-date (not including dividends), and is now more than 19% above where it was a year ago. The advance is broadly based, with the only sectors not participating being Telecom and Energy, which are down 5.1% and 7.3% year-to-date, respectively. However, even energy stocks are up almost 11% over a year ago. Further evidence of the strength of this market is the fact that all S&P sectors, except energy and telecom, are currently trading above their 200-day moving averages; and the moving averages are rising for 8 of the 11 sectors – energy, telecom and real estate being the exceptions.

Optimism abounds on the economic front, as well. Both the CEO Confidence Index and the National Federation of Independent Business (NFIB) Small Business Optimism Index are at or near their highest levels since 2004. The Conference Board’s Consumer Confidence Index, which had declined in May, rose moderately in June, and is at a level historically consistent with continued economic growth. Most manufacturing indicators point to continued expansion, as well. In a “best-of-all worlds” scenario, for the capital markets at least, inflation remains below the Federal Reserve’s target of 2%, despite the positive indicators, due chiefly to declines in energy and import prices.

The yield on the 10-year Treasury has declined (chart, below) along with inflation expectations, pushing its spread vs. the 2-year Treasury to its narrowest since before last year’s election.
Additional rate hikes this year would likely push the yield curve even lower (reduce the spread further) and recession probability models based solely on the slope of the yield curve would interpret this as increasing the odds of a recession. However, the spread between lower rated corporate bonds and Treasuries has also narrowed (following chart) indicating that the odds of an economic downturn in the next 12 months have lessened. Furthermore, there is little evidence that the most economically sensitive sectors – housing, capital expenditures, and durable goods – are over-extended.

Globally, interest rates are remarkably unchanged. We are eight years into a global economic recovery, and short-term interest rates remain close to their 2009 levels! In fact, 2-year yields in the Eurozone and Japan are lower than they were in the depths of the 2008-2009 meltdown, while economic conditions are measurably improved.

If we are looking to what might go wrong and derail this market, the most likely culprits would be the Federal Reserve or Wall Street, itself. Continued Fed action in the face of diminishing inflation pressures represents the biggest and most immediate potential headwind. But there is also the eventual risk that the current optimism that is leading analysts to raise earnings estimates and economic growth expectations, may raise those expectations to unattainable levels, setting the stage for future disappointments. We noted earlier that first quarter S&P earnings were well above last year’s level, and analysts have begun raising earnings estimates for the rest of 2017 and into 2018. That is fine, but the tide of rising expectations is a powerful force, and we must be watchful that warranted optimism does not give way to irrational exuberance. That does not even remotely describe the current environment, but we mention it because every bull market that has not been killed by the Fed, has died by its own hand of unrealistic expectations.

The U.S. equity market is overvalued, but not horribly overvalued. According to Morningstar’s analysis, stocks are, on average, trading at 105% of their fair market value, based on future cash flows. Current price/earnings multiples are above their long term mean, but this has been the case since September 2013. Those who have kept cash on the sidelines, hoping for a pullback, are now sadly aware of the fact that it has been more than 8 months since we have seen even a 5% correction – the
longest such sustained advance since 1928. This does not seem to be a good time to fight the tape, so we remain fully invested, but diversified both globally and among asset classes. We remain alert to signs of increasing volatility, but for now are content to shut out the distractions of the daily news, and focus on the opportunities of a bull market that appears to still have legs.

Joseph J. Tascone
Senior Vice President &
Senior Investment Officer

Michael D. Blatt, CFA
Vice President &
Portfolio Manager

Michael S. Lares, CFP
Vice President &
Portfolio Manager