It’s All in the Numbers

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To virtually no one’s surprise, the Federal Reserve Open Market Committee (FOMC) chose to keep the Fed fund target range at 75 to 100 basis points as part of a policy statement that did not provide anything the market had not already assumed.

For a brief moment after the 2 PM Wednesday release of the policy statement, the market initially put a dovish slant on the section of the policy statement that said, “The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction, and it anticipates doing so until normalization of the level of the federal funds rate is well under way.” This, however, quickly gave way to the recognition that the statement essentially offered nothing new. The market’s interpretation of gradual adjustments was for two more rates hikes this year including one in June. As this week began, market expectations for a June boost in the Fed fund target rate increased to 100%.

Although the FOMC received attention, numbers attracted most of the market’s attention.

Nonfarm payrolls rose 211,000 in April. The private sector added 194,000, but the government sector increased only 17,000. The unemployment rate fell one-tenth to its lowest level in ten years at 4.4%. The participation rate fell modestly to 62.9 in January. The average workweek moved up 0.1 to 34.4 hours. Average hourly earnings for all employees rose 0.3% for the month and 2.5% year-over-year. The U6 series currently is at a post-recession low.
Initial unemployment benefit claims fell 19,000 to 238,000, only 15,000 higher than the absolute low set Feb. 25 this year. This was the 113th consecutive week with new claims below 300,000.

The 2017 S&P 500 earnings estimate increased by 23 cents to $130.76. This is the 4th straight weekly increase from the $129.66 low. By last Friday, 83% of the companies in the S&P 500 reported actual results for the first quarter of 2017. Of these, 75% beat the mean earnings estimate and 66% beat the mean sales estimate. This put S&P 500 earnings on track for a 13.5% year-over-year increase. If 13.5% is the actual growth rate for the quarter, it will mark the highest year-over-year earnings growth since the third quarter of 2011. Compared to March 31, nine industry sectors have higher growth rates today due to upward revisions to earnings estimates and upside earnings surprises, led by the Industrials sector. Last week was the busiest in terms of the number of companies reporting calendar first quarter results, but this week still has a busy slate of releases as more than 500 companies are due to report.

Numbers out of France were important also as Emmanuel Macron won the French presidential election by a much wider margin than had been expected. While his election removed the uncertainty about France’s role in the European Union, equity markets in Europe were lower this morning, and the US. equity market opened with a modestly negative bias.

Numbers in oil inventories and the price of oil were in focus last week.

After dipping briefly below $44 a barrel, the price of West Texas Intermediate crude rallied near the end of the week. The recent drop in the price of crude raised concern that it was a harbinger of weaker economic conditions, but we suspect that dynamics specific to the industry are the main reasons for the price drop.
Despite last week’s solid numbers and most of the U.S. economic data remaining in an expansion mode, we enter this week with many of the same concerns expressed in previous reports.

Even with the improved 2017 S&P 500 earnings estimate, the market’s valuation is elevated. Many major market indices are overbought technically although not at extreme levels yet.

The Dow Jones Transportation Average (DJTR) has lagged many other major market measures. As illustrated in the chart on the left (courtesy of Stockcharts.com), the DJTR has been trapped in a wide range. The line marked with an “A” in the chart represents an obvious level of resistance, but it is line “B” that needs to be monitored most closely. A break of the level this line represents (roughly 8700) could send the Average down toward 8100. A significant drop in DJTR most likely would drag the rest of the market with it.

The Volatility Index (VIX) has been an area of concern as it has sunk close to the lowest level in three years. To many traders this represents a worrisome degree of complacency that if shaken could send the market sprawling lower. However, as data assembled CFRA-Standard & Poor’s today suggests, this is not necessarily a bad omen.

As CFRA-Standard & Poor’s reported this morning, “In each of the past 67 years, the S&P 500 posted an average of 51 days in which it rose or fell by 1% or more in a single day. The maximum was 134 days in 2008, while the minimum was only three days in 1964. One standard deviation above and below the mean of 51 was 83 and 20, respectively. Those two thresholds are important, because whenever the volatility count was 83 or higher in a particular calendar year, the S&P 500 declined an average of 7.7% in price, and fell two out of every three times. However, whenever the volatility count was
below 20 – like 2017 appears to be headed – the S&P 500 gained an average of 18.3% in that calendar year and rose in price 91% of the time. Whenever the volatility count was between these extremes, the S&P 500 gained an average of 9.9% and rose in price 77% of the time.”

Numbers again this week will be in focus.

In addition to the continuing earnings report barrage, the Job Openings and Labor Turnover Survey (JOLTS) data will be scrutinized to see if the pace of job openings remains solid. Friday’s retail sales report also could be influential. Numerous measures show that U.S. consumers remain in a solid fiscal position, but overall retail sales have not been a strong as the data suggest would be expected. The recent auto sales pullback adds to the concern that consumers are spending cautiously.

Many U.S.-centric investors have not recognized the major improvement occurring overseas, particularly in Europe.

As the chart of the Dow Jones Europe Index on the left shows, European markets have done very well lately. Although many European indices are in extremely overbought conditions that could lead to an interim pullback, we would suggest making some European exposure part of an equity portfolio, particularly on a pullback. The French election result substantially lessens the chance of political upheaval in the European Union, which in turn could help to sustain economic improvement in the region.

The biggest fear many investors express is that the market could experience a major pullback. This is understandable given the move stocks have had for as long as they have. But this same argument could have been proposed numerous times in the last 2-3 years.

Several factors need to be considered now.

The general expectation is that the FOMC will raise interest rates two more times this year, but we are not nearing an inverted yield curve that typically is present before a major market decline.

The economy is not teetering on the brink of a major slowdown or recession. Although all aspects of the U.S. economy are not as strong as might be optimal, overall the data continue to suggest that a recession is nowhere in sight.

Stocks are not at excessive valuations. Corporate earnings are not weakening, and in fact, they have accelerated the other direction. There are numerous examples through many decades that major bull markets tend to peak at a higher multiple of earnings than is present now, which suggests that the number investors desire is a higher one for the S&P 500 that we think has not yet been reached.

And, of course, there are the Washington policy initiatives that could influence the equity market. Should tax reform and foreign earnings repatriation come closer to achieving Congressional approval, stocks should react favorably.

Have a great week.
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