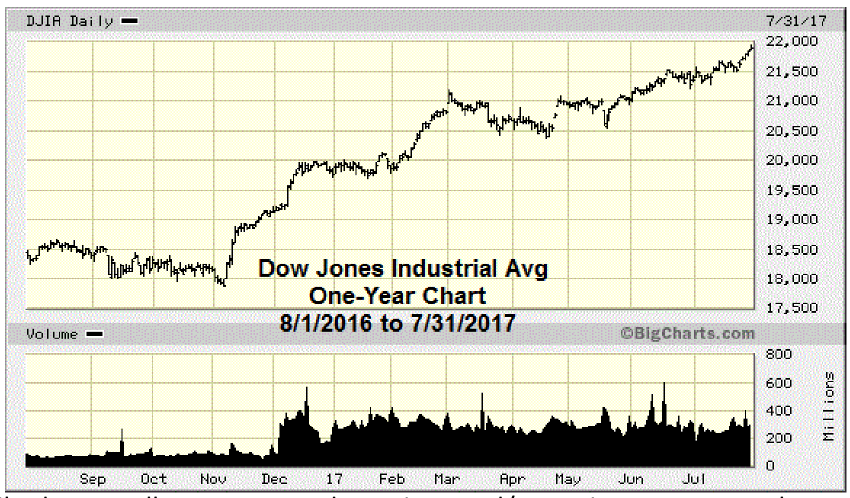
Calm Before The Storm

The Dow Jones recorded new highs on ten of the twenty trading days in July and rose 541 points or 2.5% for the month while the S&P advanced 1.9% and the tech heavy NASDAQ gained 3.4%. The latest gains put the ***Dow and S&P 500 indices ahead by just over 10% for the year*** (not including dividends). From a longer-term (and much more important) perspective, stocks extended the long bull market to eight years and four months, with accumulated gains of about 270%, based on the S&P 500 index.



You would think that hitting new records on half the days of the last month would produce confident, even aggressive investors. You would think investors would be fat, happy and basking in glory! You would think investor attitudes would be best described by terms like complacent, exuberant, irrational and/or speculative. In fact, *investors are exhibiting few of the typical reactions to an aging bull market.* Both Individual and professional investors can be described, generally, as measured, cautious and/or anxious. For example, the AAII (**American Association of Individual Investors**) monthly survey in July showed more respondents classifying themselves as "neutral" regarding the markets' near-term prospects than either bullish or bearish. The AAII bullish reading stands at just 34.5%, below its historical average of 38.5% for the 22nd consecutive month. Professional investors express guarded enthusiasm based on the **TIM Group Market Sentiment** indicator reading of 50.6% bullish while the **CBOE VIX,** an index designed to measure expectations of future volatility, traded at 8.8 last week, a *post-crisis low* which indicates professional options investors are not expecting volatile market conditions anytime soon.

The quite understandable reason for such investor caution is that the market has reached ***extremes***. As mentioned above, the age and gains of this bull market are extreme. There have only been two setbacks of 15% since this bull began (in 2011 due to the European debt crisis and again in late 2015 to 2016 in response of the collapse in oil and chaos in China). While stock prices are high, valuations are also stretched, if not extreme. According to **FactSet**, the future 12 month P/E ratio (price divided by earnings) for the S&P 500 is 17.8 compared to a 5 year average of 15.4 and a ten year average of 14.0. A longer-term measure of valuation, the **Shiller P/E ratio**, which uses decade-long statistics, is above 30, a point reached only twice before—in 1929 and in the bubble between 1997 and 2002—***two periods which ended decidedly badly!*** An additional extreme for investors to worry about is **interest rates**. Rates have long been at an extreme ***low***—which has helped fuel this long bull market—but that "positive" extreme is threatened by stronger growth and the Federal Reserve's plans to reduce its accommodative policies.

Then we have non-market worries. The market seems oblivious to the disaster in DC but even ignoring the political chaos, the fact that pro-business policies regarding regulation, taxes, health-care, infrastructure spending, etc., are being flushed down a deep rabbit hole could eventually have a negative impact on the market. Of course, the usual global tension suspects from Korea, Russia, Syria, Venezuela, BREXIT and so on, continue to roll over the market like passing dark clouds.

So why does this resilient market keep making continual new highs? It is not smoke and mirrors; there are valid positives. The most important driver of the record stock gains is **earnings** (***always*** **the most important component of stock prices**). As of August 1, about three-quarters of all companies have reported their 2nd quarter earnings and results are shaping up even better than the optimistic forecasts. About 77% of companies beat estimates and profits are on track to grow 9% from last year compared to earlier expectations of 6.4% growth for the quarter, according to **FactSet**. More, some analysts insist that today's earnings are of a higher quality which helps justify higher valuations. The claim is that companies have become more effective through technology, efficiency and restructuring; making them more competitive and making revenues more valuable. (Investors in stocks like Amazon, Netflix, Facebook and other ***dominating companies*** certainly are buying into that claim.)

Other than earnings, stocks are supported by a solid, steadily growing U.S. economy and a resurgent global economy. Last, we can add a point made by Randall Forsyth in the July 31 edition of ***Barron's***. He points out that, historically, strong **credit markets** are a major underpinning for stock prices and *credit markets are showing tremendous health*. As an example he points to the ease AT&T had in issuing the third largest bond offering in history in late July. The $22.5 billion bond offering was "oversubscribed" by nearly three times (i.e. three times as much demand to buy as bonds offered). He quoted an analyst who said the offering demonstrated "*the unparalleled global demand for U.S. dollar-denominated corporate debt."*

So we acknowledge that investors are "on edge" and scrutinizing every decline in the market for signs of the end of the long bull market while each advance is an opportunity for handwringing. As James Paulsen of Leuthold describes it, *"There's a sense that many things are coming together that make you feel like you're headed for a correction. There's so much of that right now, that it almost would surprise me if it happens."* And James Saft of ***Reuters*** reminds us in a July 31 column that bull markets end at extremes but they don't end simply *because* they have reached extremes and he goes on to say that there is no particular reason to expect a reversal of this bull market anytime soon.

We also want to remind clients that we do not manage money with the intention of market timing—which is moving in or out depending on overall market trends. We do try to make adjustments at the margins those few times when it is obvious to be more or less aggressive. And, we attempt to sell over-valued stocks and buy under-valued stocks—for the long-term. For now, we will continue to enjoy the ***calm of the markets*** along with the calm (so far) summer weather. ***We hope you do the same!***

Best regards,

Ted Ingraham

EGI Financial, Inc.
American Heritage Securities, Inc.

Questions or comments?
Email us at: ahs@egifinancial.com or call 330-535-0881. Visit us at www.EGIFinancial.com