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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

Who, me worry? When you witness a decline of more than 5% in one week, you naturally start to think that maybe you are missing something. The markets are always trying to predict the future, it is never really about the present. That is one of the hardest lessons to learn in investing. Wayne Gretzky, the retired hockey player who scored more goals than anyone else, is famous for saying that he would skate to where he thought the puck was going, not to where it was. To figure out where the market may be going, we do first have to consider where it is.

A famous investor once suggested that in the short-term the market is a voting machine, but in the long run, it is a weighing machine. The market eventually weighs earnings, profits are what ultimately count. We began the year with S&P 500 earnings at $124. The market has given back all its gains for the year, however, earnings are currently projected at $157. With less than one month to go, this is most likely a reliable number. That means earnings have grown by 27% while the stock market is unchanged (with dividends). With the index at 2635, we are at 16.8 times current earnings. This happens to be almost exactly what the past several decades have averaged. But where is the puck going, you ask?

Let us start with the earnings estimates for 2019. According to Standard & Poor's, the S&P 500 will earn $174 in 2019. If that number becomes reality, we are now below the average market valuation. However, what started this week off on the wrong foot was the fear of an 'inverted yield curve'. Without exception, when short-term treasury yields move higher than 10-year treasury interest rates, a recession has followed. The following chart shows the 10-year treasury yield when the yield curve first inverted for each recession going back to 1980, and then the number months to when the recession began. What you first see is that it can be anywhere from one to two years. Though this indicator has been very reliable, it has never been tested with rates this low. Let us assume that it continues to be accurate.

	Treasury Yield	Recession	Months
Sep-78	8.6%	Jan-80	15
Sep-80	11.9%	Jul-81	10
Dec-88	9.1%	Jul-90	18
Feb-00	6.4%	Mar-01	13
Dec-05	4.4%	Dec-07	24
Current	2.9%	?	

One problem you immediately have is that the yield curve has not 'inverted' yet, and the Fed just announced that they may hold off on the next interest rate increase. We will eventually experience another recession, so let us assume this one is 12 months away. Earnings may not make it to $174. Now let us assume they peak the middle of next year at $165. The next chart shows how much earnings have declined in the last three recessions. If earnings do reach $165, and then decline by

	EPS		EPS	Decline
Jun-07	$91	Jun-09	$39	-57%
Dec-00	$56	Dec-01	$39	-30%
Mar-89	$25	Dec-91	$19	-23%

30%, we would fall back to $115. At that point the market would be trading 23 times earnings, which is not excessive considering we would be in a recession. You can play with the numbers forever and still not get it right. However, it is good to "weigh" the situation and determine for yourself what makes sense. The real problem is most likely something else, the voting.

We now live in an era where news headlines are voted on in seconds, and with so much passive money invested in indexes and program trading, the moves can be substantial. A key word can come up in a Fed speech or a tweet, and the market sells off hundreds of points in a few minutes. That is called voting. If something weighs 30% more than it did 12 months ago, and you don't have to pay anymore for it, that is called value. Jamie Dimon, JP Morgan Chase's CEO, says business is strong. Warren Buffett just invested a lot more money in bank stocks. Not that these guys are always right, but it appears we are witnessing the pre-election polls, which historically have been very inaccurate.