

## **Investment Commentary**

### **For the year 2015**

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By

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**“There are two types of market timers: those who don’t know what they’re doing and those who don’t know they don’t know what they’re doing”**

-John Bogle, Founder of Vanguard

**“This is your Templeton Moment. Don’t blow it!”**

-Keith Fitz-Gerald, Investment Pudent

The good news for the past year are the takeovers and mergers we participated in. While the major U.S. averages fell, after having reached new all-time highs, and our portfolios were down an average of 8.9%, we were fortunate to have several of our holdings bought or merged. These include DRA Properties, International Rectifier, EZChip, PMC-Sierra (both pending), Dupont and Dow Chemical (merger pending), Alteria, Anadigics (pending), Lorillard, Covidien PLC, Exelis, Riverbed Technology, Kraft Foods (merger) and Remy International. These and the **dividends and interest** we collected made up for the losses we incurred in our oil related and emerging market investments.

Equity markets acted much in line with our expectations in so far as they did finally gave us the overdue correction in August and September. We had not experienced a drop in index averages of 10% or more since 2011. With the DJIA close of 15,666 on August 25<sup>th</sup>, down from its all-time high of 18,312 on May 19<sup>th</sup>, a drop of 14.5%, we “corrected”. The other major indexes, such as the NASDAQ and the S&P 500 followed the same pattern, reaching new all-

time highs, correcting and then recovering by years end. When this was over, the DJIA was down -2.23%, the NASDAQ was up +5.73% and the S&P 500 was up +1.3% for the year. The Russell 2000, reflecting smaller capitalized companies was down -5.71% and the emerging markets index, reflected in the iShares MSCI Emerging Markets EFT (EEM) was down -16.2%. The Dow Jones Utility index was down -6.52% and the Transports were down -17.85%. Bonds had an off year too with the high yield sector (as measured by SPIDERS Barclays High Yield ETF-JNK) down -6.8%, the Long-term corporate sector (as measured by the Vanguard Long-Term Bond ETF-BLV) down -4% and Long-Term Treasuries (as measured by the Vanguard fund VUSTX) down -1.54%. For what it's worth, Warren Buffett's Berkshire Hathaway was down -14%.

We took advantage of the drop in stock prices to add to our portfolios with individual positions, such as Corning, Veeco, Enpro Industries, ABB Ltd, STMicroelectronics and Spectra Energy, and mutual funds, as we wrote that we would in our previous commentaries. You have seen these transactions on your monthly statements.

World events, such as China's economic slowdown, Europe's economic funk, Middle East warfare, global terrorism, our Fed increasing interest rates (an ever so slightly .25), the oil and commodity , our US political scene (presidential election drama) and the dynamics of technological change, among others, hung clouds of **uncertainty** over our equity and bond markets. Robo-trading increased its influence in the dynamics of the investment markets. Much of the daily trading volume is from computer trades that skim pennies off each move in stock price and move markets by momentum in prices rather than fundamentals. We have at least two worlds operating on the same trading platform, one run by computers and the other by investors, and with computer trading apparently dominating, investors have been given a back seat. I wrote about this briefly in my last letter. If our holdings are out of the favored indexes or funds used by robo-traders, we miss these moves.

The impact of the drastic fall in oil and commodity prices has yet to be fully felt in our world, but this is beginning to surface as witnessed by the fallout in global equity markets since the end of 2015. This will unfold more over the next twenty-four months, as production cut backs, debt defaults, mergers and possible bankruptcies take place. During this, I plan to hold onto our investments here until the downturn subsides. It's too late to sell, in my view. We may add to these holdings.

Despite the calls by some to "sell everything!" and the market downturn since the beginning of the year, **we do not believe that we are entering a prolonged bear market** or a full blown economic recession in the United States. The recent drop in stock prices continues what we believe is a normal and overdue corrective dynamic of our markets which **should be used as an opportunity to accumulate** shares in investments at discounted prices.

It is most difficult to make sense and determine direction with all of the diverse options floating through our communication channels today. It's worse than the Conference of The Birds. We distill all of this "noise" to empirical data to find our direction. We identify five major indicators of an approaching Bear Market. None of these at the present, indicate that we are entering one. These are:

**Tight Money**- Despite the fact that our Federal Reserve finally commenced its gradual increase in the Fed's Fund Rate off of zero, further increases will be gradual. They have to be, as we must consider the impact of higher US interest rates on the world markets. The rest of the world is lowering interest rates. Each increase in US rates increases the value of our dollar against other currencies. This hurts our exports and economic activity in the US. Until the economic activity picks up globally, increases in the Fed's Fund Rate must be gradual and measured. The Fed has made it clear that this will be their course. So, we don't see Tight Money as an issue today. This is a positive for stock prices.

**The Yield Curve**- An inverted yield curve, when short term rates exceed long term rates, frequently is an indicator of a downturn in stock prices and has **preceded every recession** during the past half century. Until we see short-term rates approaching long-term rates, we remain in the bullish camp. Today, January 19<sup>th</sup>, the 90 day T-Bill rate is .23%, and the 10-year Treasury rate is 2.03%.

**High Inflation**- The Federal Reserve has a 2% inflation target. Annual CPI through November stands at 2.0% and personal consumption expenditure (PCE), the Fed's favorite inflation gauge, stands at 1.3%. We don't see high inflation on the horizon at this time.

**Rapid Growth**- Today economic growth is far from rapid. In fact, fears of a slowdown in China, Europe and the US contributed to the downturn in stock prices since the beginning of 2016. The average real GDP growth is in the 2% range. Most projections for 2016 are in the same range, somewhere between 2-3%. This is not rapid. Leading Economic Indicators (LEI) through November increased 1.5% for the six-month period and point to a 3% annual rate, again, not a rapid rate. We believe that the severe drop in oil and commodity prices and the strong dollar will serve as headwinds against rapid growth at least in the near term.

**Equity Overvaluation**- While some mavens continually harp that our stock prices are overvalued, I don't agree. Some are, but others are not. The S&P 500 index, for example, has had an average PE ratio of 16-16.5 over the past 50 years. We are expecting average earnings of the components of this index to reach \$127 by the end of 2016. Using the lower PE of 16, we arrive at an S&P 500 index of 2032 this year. It trades at 1882 today, or 8% less than target. When we stretch the PE ratio to 16.5-17, which is reasonable in a low interest rate environment, we arrive at an S&P 500 value of 2159.

Our reasons for believing that our markets are still in a corrective phase and not entering a prolonged Bear Market or a Recession still hold. We watch for these to change before we take a different course.

Additionally, we see the weakened earnings in the oil and natural resource sectors bringing greater profits to all other businesses. This will move our overall economy forward. Presently, our Leading Economic Indicators (LEI) continue to improve moderately. As I wrote earlier, the current 3% annual improvement rate is a healthy clip: not too fast and not too slow. I note that **since 1959 no recession** in the US has commenced with the LEI advancing. Our housing index (HMI) remains above 50 (the threshold for optimism) at 61 and points to continued improvement in our housing sector. Housing affordability stands at its **highest level** in six months. In December home sales nationwide reached 5.26 million: the highest level since before the 2008 recession. Wage growth is improving, as the total of all wages gain in the US rose by .5% in November, adding to a “string of sturdy gains in 2015”, according to Mark Trumbull in Bloomberg Business Week. Furthermore, hourly earnings jumped by 2.3%. We are completing our 6<sup>th</sup> straight year of job growth exceeding 2 million jobs for **only the second time** in our history. The recent US budget compromise passed by our US Congress includes \$305 billion for infrastructure. This should help power continued job growth into the New Year. Remember, that despite the recent increase in Feds Funds rate of a meager .25%, interest rates are still at historic lows. All of these facts point to continued, moderate increases in business earnings and reason to believe that S&P earnings should continue to improve this year.

**In summary**, we continue to find our world of investing difficult and full of uncertainty. Reading the tea leaves is an arduous task. Nevertheless, in relying on our tried and true criteria as described above, we chart the right course into the future. We intend to use these periods of stock market weakness to accumulate investments. When our indicators indicate a change in course, we will take it. Certainly the start of this year has proved challenging with our markets off to their “worst start ever”. I also think that the movie The Big Short which arrived in theaters over the Holiday’s contributed to the sour mood.

As the legend goes, in 1939 on the eve of WWII, John Templeton, starting out in what became a legendary career in money management, borrowed \$10,000 and bought shares in every company on the New York Stock Exchange that was trading under \$1. These 104 companies, including 34 that were bankrupt, were worth a large fortune a few years later when the war was over and we settled into the post war era. Only four were worth less. Mr. Templeton’s career blossomed. We may be in another “Templeton Moment” now. We don’t want to blow it.

Thank you, as always, for your continued confidence and business.

Please give us a call should you have any questions, comments, concerns and changes in direction in your financial plans.