viewpoint

MARSHALL & SULLIVAN

Marshall & Sullivan, Inc. / Registered Investment Advisor

Fall 2019 newsletter

Looking Long-Term

Whenever someone asks us “what will the market do next quarter” we immediately cringe because it’s impossible to guess short term market moves. Next we make an educated guess using projected earnings growth, the S&P 500’s current price-earnings ratio versus its historical average and the interest rate environment. Then, we frame our prediction with some qualifiers about unfavorable and or unexpected news. In the end, we are as vague as possible because predicting market moves on a short-term basis is just a guess.

Take this quarter for example. It was a very choppy quarter for the market. News headlines heavily affected trading. The quarter started with the S&P 500 hitting all-time highs with the perception that a trade deal would be made with China and rate cuts by the Fed. Then the trade talks fell apart and the treasury curve briefly inverted (see side note). This led to the market pulling back 6%. Next economic news and company earnings came out better than expected and the market rose again setting another new high. Then, news came out about a possible impeachment proceeding along with intensified trade worries causing the market to again pull back. In the end, the market was almost flat for the quarter. In other words, a lot of action with little to show for it.

This whipsawing led Liz Ann Sonders to send out an investment note summing up recent market action stating; “One of the lessons that should come from observing what has been happening is that trying to trade around headlines is a potentially treacherous exercise. With so much daily noise, we continue to recommend a disciplined strategy around diversification and rebalancing.”

If you look at the S&P 500 on a longer-term basis, you see that it is the earnings that tell us the direction and amplitude of the market. Over the last 3 years the S&P 500 was up 35%. Earnings for the S&P 500 were also up 35%. The Price-Earnings ratio is 17 now…just as it was 3 years ago. This is right around the historical average. And, during this time long-term interest rates have been relatively flat.

So, what does the future hold? Analysts are projecting earning growth for 2020 of anywhere between 5 and 10% and interest rates to stay low. If this holds true, we should see the market up between 5 and 10% over the next year.

The question is: how it will get there? We are predicting a wilder ride for the market over the next year with significant pullbacks along the way. However, despite a steady stream of political, economic, election, trade, and interest rate news, we still believe the year will end above where it started because earnings are projected to grow, and price earnings ratios are close to historical averages.

In preparation for next year, we have been rebalancing our portfolios. If you have been a client for more than 3 years you will have seen more trading in your account this year than you have for a long time. We have sold a couple of long-term holdings that are no longer growing their earnings and have trimmed a few positions that have become too large as a percentage of your portfolio. We are also carrying more cash than we usually do; if we are right and we have a volatile market over the next 12 months, you will see us spending this cash to pick up a bargain or two just like we did during the most recent pull back.

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INVERTED YILD CURVE

A yield curve is a plot of interest rates over time. Usually the further out you go along the curve the higher the interest rate. The yield curve becomes inverted when the 10-year interest rate falls below the 2-year rate. This means short term borrowing is more expensive than long-term borrowing.

Every recession in the past 50 years has been proceeded by an inverted yield curve but not all inverted yield curves were followed by a recession. We feel this inversion, which was very brief, was not a recession signal because short-term rates were/are being held up artificially by the Federal Reserve. If we are wrong and a recession does develop, we feel it will be mild just like our economic growth has been.