Summer 2017

With summer in full bloom after a cold, wet spring, the stock market has posted a solid performance. As of June 30, 2017, the S&P 500 Index is at 2423.4, a gain of 8.2 % for the year to date. Including dividends, the total return for the S&P 500 Index year to date was 9.4%. The Dow Jones Industrial Average also had a total return of 9.4% for the period after a gain in price of 8%.

Although down for the month of June, partially due to profit taking in some technology stocks, the NASDAQ had a total return of 14.6% year to date. Foreign developed and emerging markets have prospered as well this year as measured by the total returns of 14.1% for the Vanguard Emerging Markets ETF and 13.1% for the Vanguard Developed Markets ETF.

The S&P 500 was led by the health care, technology and industrial sectors so far this year. The financial, consumer staples and discretionary sectors lagged the total index, real estate and utilities fared less well and the energy and telecom sectors are down significantly. It is difficult to see the real estate, utility and telecom sectors regaining much of the lost ground if interest rates continue to rise gradually in the second half of 2017. Energy stocks seem dependent on the price of crude oil which may have found a bottom recently.

There are concerns that the gains in the S&P 500 and NASDAQ were driven by a few large cap technology stocks and that the average stock is lagging. The large cap technology stocks in the S&P 500 have done well so far this year with Apple providing a total return of 24.3%, Amazon 29.1%, Alphabet 17.7% and Facebook 31.2%. While these companies have their unique investment merits, there is a bit of the rich getting richer as more money flows into index and sector funds more money flows into these large components of those funds. Looking at all the companies in the S&P 500 however, roughly half "outperformed" the Index so far this year gaining in excess of 8.2%, so the advance has been fairly broad across a variety of sectors.

These positive results for stocks have come, as they often do, amidst worries about geopolitical concerns, the economy and the growing rancor in Washington. While we can't ignore the dangers throughout the world they are sadly ever present and very difficult to analyze. The same may be said about the dysfunction in Washington although there is an interesting study from the Philadelphia Federal Reserve on the topic.

According to a recent report by the Ned Davis Research Group, the Philadelphia Federal Reserve has measured partisanship in Washington since 1981. This is done by examining the degree of conflict over various issues. According to the Philadelphia Fed, the "partisanship index" was the 6th highest on record in May of 2017 and a high reading is usually good for the stock market. Hence while many are rightly frustrated by the inability of Congress to make any progress, the markets seem to prefer gridlock. The Ned Davis Research Group report speculates that this somewhat counter intuitive situation may be due to investors fearing the unintended consequences of new legislation. Another theory is that markets tend to do well while many are pessimistic, the proverbial "wall of worry", so perhaps the current turmoil in Washington will prove beneficial, at least to investors.

The domestic economy continues to advance at a modest pace with GDP growth of 2.0-2.5%. The worldwide economy seems to be doing a little better with growth this year expected to be 3.4% according to the Ned Davis Research Group. Foreign economies, particularly in Europe, are still slightly behind the U.S. in the stage of their recovery from the financial crisis so there may still be good investment opportunities in foreign markets.

Valuations in the U.S. stock market may seem stretched given the modest GDP growth rates but the S&P 500 does not seem significantly overvalued. Argus Research is estimating the earnings for the S&P 500 will reach $134 this year. At current levels that puts the Price/Earnings Ratio for the S&P 500 at roughly 18 X those projected earnings. At this point in the economic recovery with 10 year Treasury Notes yielding 2.34% and inflation at 2.0% or so, the S&P 500 seems to us to be close to fairly valued.

There are certainly risks to the stock market both from within our economy and externally. On a daily basis, computer driven trading based on various algorithms can certainly roil what has been an unusually calm market. Earnings disappointments in individual stocks can quickly chop a stock's price by 10-20% and individual sectors such as energy and industry groups like the retailers are certainly struggling. However, the most common affliction of the stock market in the summer is boredom. Maybe we are all focused on vacation pursuits but since 1980, the average gain in the S&P 500 in the third quarter (July, August, and September) has been less than 1.0%.

Perhaps the summer months will bring unforeseen drama to the stock market but if an underpinning of this advance is the ineptitude in Washington we should be in good shape. We wish you all the best for the summer and thank you for your trust in Knox & Downing Advisors.

John C. Knox, CFA John C. Downing, CFA