ICON Insights

Market Commentary - November 2018

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Domestic Equities

The current bull market, which has lasted over nine years, has experienced many short-term setbacks. While it was unpleasant riding through those retreats, investors who did were rewarded by participating in the subsequent market advances. We believe the market’s drop in October will prove to be similar to previous dips and that the broad market will continue its multi-year advance into 2019.

All of these retreats have been accompanied by an economic concern that was compelling enough to be temporarily believed or accepted by many investors. In 2010 and 2011, we believe it was the European sovereign debt crisis and the fear that it would spread recession to the U.S. In mid-2015 and early 2016, we believe it was the rise in the price of oil and the strengthening U.S. Dollar which built a case for recession fears. In our view, the quick 10% drop in late January 2018 was set off by employment data showing wage increases and the ensuing fear of decreased corporate earnings and higher inflation. The economic concern driving the drop this October seems twofold to us. Many investors do not trust the Federal Reserve (Fed) and fear the Fed will tighten monetary policy too fast and too much, causing a recession. In addition, many analysts believe the tariffs and trade war will slow our economy and hurt corporate earnings. We expect both of those concerns will eventually subside.

At the market low for October on the 29th, our market Value/Price (V/P) ratio was 1.10 indicating stock prices, on average, were below our estimate of fair value. A reading of 1.10 is in the typical range for times with uncertainty and economic concerns. During the drop in October, sectors that had been leaders the last few years dropped the most, while defensive, so-called recession-proof sectors like Utilities and Consumer Staples held up best. We are evaluating if this change will necessitate a rotation.

International Equities

Based on the U.S. Dollar Index, the dollar has gained almost 9% this year relative to a basket of major currencies. While that may sound significant, the move brings the Index back to the middle of the range it has been in since early 2015, which is nowhere near the highest levels it has seen over the last 50 years. There is a theory believed by many investors that a strong U.S. dollar is bad for companies in emerging markets. We believe many investors have acted on that theory, sold emerging market stocks, and driven those markets lower for 2018. It appears overdone in our view, as we can now find attractive bargains in emerging markets, especially in sectors such as Energy, Materials, and Industrials.

Bonds

Six-month Treasury Bills are considered to be risk-free, as they are backed by the U.S. Government, and an investor knows exactly what the return will be if held to maturity. In our view, an investor taking no risk should simply hold even with inflation. In other words, the rate on 6-month T-Bills should equal inflation, or investors’ expectation for inflation. Over the last 12 months, the Consumer Price Index (CPI) has gained 2.3%. Economists surveyed by Bloomberg are calling for CPI gains of 2.3% in 2019 and 2020. Last week the Fed Funds rate, which the Fed sets, was 2.22% , and 6-month T-Bills, which over the last decade have tended to move closely with the Fed Funds rate, were 2.35%. The Fed could bump up the Fed Funds target to 2.25% - 2.50%, and T-Bills and inflation would be about in line for a neutral Fed policy in our view.

Summary

I am going to borrow comments from Sam Stovall, an analyst I have interacted with a few times. He sees some investors as jittery and anxious to get out of the market before the next major decline they feel is imminent. He once compared these kind of investors to exuberant first graders playing musical chairs. When the music stops, none of them wants to be the last to sit down. Well, the music stopped in October, and jittery investors jumped for chairs (sold stocks). Based on our calculation of value, we expect the market to move higher over the next year and believe the music can keep playing.

The data quoted represents past performance, which is no guarantee of future results.

Opinions and forecasts regarding sectors, industries, companies, countries and/or themes, and portfolio composition and holdings, are all subject to change at any time, based on market and other conditions, and should not be construed as a recommendation of any specific security, industry, or sector.

Investing in securities involves inherent risks, including the risk that you can lose the value of your investment. An investment concentrated in sectors and industries may involve greater risk and volatility than a more diversified investment. Investments in international securities may entail unique risks, including political, market, regulatory and currency risks. In general, there is less governmental supervision of foreign stock exchanges and securities brokers and issuers. Investing in fixed income securities such as bonds involves interest rate risk. When interest rates rise, the value of fixed income securities generally decreases. High-yield bonds involve a greater risk of default and price volatility than U.S. Government and other higher-quality bonds.

ICON's value-based investing model is an analytical, quantitative approach to investing that employs various factors, including projected earnings growth estimates and bond yields, in an effort to determine whether securities are over- or underpriced relative to ICON's estimates of their intrinsic value. ICON's value approach involves forward-looking statements and assumptions based on judgments and projections that are neither predictive nor guarantees of future results. Value readings are contingent on several variables including, without limitation, earnings, growth estimates, interest rates and overall market conditions. Although valuation readings serve as guidelines for our investment decisions, we retain the discretion to buy and sell securities that fall beyond these guidelines as needed. Value investing involves risks and uncertainties and does not guarantee better performance or lower costs than other investment methodologies.

ICON's value-to-price ratio is a ratio of the intrinsic value, as calculated using ICON's proprietary valuation methodology, of a broad range of domestic and international securities within ICON's system as compared to the current market price of those securities. According to our methodology, a V/P reading of 1.00 indicates stocks are priced at intrinsic value. We believe stocks with a V/P reading below 1.00 are overvalued while stocks with a V/P reading above 1.00 are undervalued. For example, we interpret a V/P reading of 1.15 to mean that for every $1.00 of market value, there is $1.15 of intrinsic value which has not yet been realized in the market price.

The Consumer Price Index (CPI) is a measure of the average change in prices over time of goods and services purchased by households. The CPIs are based on prices of food, clothing, shelter, fuels, transportation fares, charges for doctors' and dentists' services, drugs, and other goods and services that people buy for day-to-day living.

A Treasury bill (T-Bill) is a short-term debt obligation backed by the Treasury Dept. of the U.S. government with a maturity of less than one year.

In the United States, the federal funds rate is the interest rate at which private depository institutions (mostly banks) lend (federal funds) at the Federal Reserve to other depository institutions, usually overnight. Changing the target rate is one form of open market operations that the Chairman of the Federal Reserve uses to regulate the supply of money in the U.S. economy.

The U.S. Dollar Index (USDX) indicates the general int'l value of the USD. The USDX does this by averaging the exchange rates between the USD and major world currencies. The ICE US computes this by using the rates supplied by some 500 banks.

Source: Bloomberg, FactSet

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