July 28, 2017

Mid-Year Reflections

The second half of 2017 finds the market in its continued powerful and protracted bull phase. As the months have gone by, the momentum that is "computer trading" has continued to take asset prices quite far above the underlying level of economic growth. You see the headlines every day – the market continues to climb to record-setting levels. But beneath the headlines presents a much more puzzling picture. The markets may indeed continue to rise for the remainder of the year. But as we have said before, there are strong signs that point to a market correction sometime in the future:

High market prices - the S&P 500 is trading at 94% of it's all time valuation - currently it's the 2nd most expensive it's ever been (2000 being the top water mark). At the end of May, 55% of the S&P index return was based upon the performance of just 5 stocks. Wall Street loves to talk about earnings - but despite some recent disappointing economic data, US stocks have sent the Dow Industrials, S&P 500, Nasdaq Composite Indexes to record highs. Many investors say that they are optimistic that the steady increase in stock prices will continue and defy historical odds that suggest the markets will eventually falter.

The labor market is strengthening yet wages remain flat. The jobs that are being created are low paid, unskilled and mostly part time. The higher paying jobs that do exist in this economy are largely going unfilled due to lack of skilled workers. It's hard to grow the Gross Domestic Product (GDP) without a willing and able skilled work force. Surging optimism in the financial markets, however, hasn't carried over into a big pick-up in economic growth. First quarter revised GDP growth of 1.4% is well below the target set by President Trump.

The head of the Federal Reserve (Fed) – Janet Yellen – appears determined to continue the tightening policy she began last December. She just boldly declared last week that "there will not be another financial crisis in our lifetime". The Fed's record of increasing interest rates has almost always led to a recession. Last December thru this February, the "Trump bump" was reflected in the gradual shift of the yield curve to the more historical position - long term yields higher than short term yields - hence signifying a degree of confidence about the future of our economy that had been missing from the bond market for the last 8 years. That confidence however, began to unwind in March when the yield curve turned flat once again. The danger now is if the current Congress doesn't get something done soon with respect to tax relief and other concrete economic stimulus, the yield curve is at risk of going inverted.

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Lastly, the volatility index is at an all-time low. A key gauge of market volatility – sometimes referred to as Wall Street's "Fear Gauge" (a popular way in which traders gauge market anxiety) - hit its lowest level last week in 24 years. With such a low level of fear in the market, any upset could generate a more intensified negative reaction.

From our perspective, a balanced portfolio clearly provides the best combination of risk and return for most investors.

At Kapusta Financial Group, we appreciate your trust and confidence in our team. We continue to monitor the situation very closely and will keep you informed as developments warrant.

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