

April 12, 2016

"I am drawn to characters who see the future, or think they do."

John Irving, Novelist

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The resiliency of the S&P 500¹ stock market index is impressive!

- In the first quarter of 2016, the S&P 500 earned 1.3% (including dividends). During the quarter the S&P index dropped over 10% and then recovered.
- Over the last fourteen months, the S&P 500's performance was flat (a 0% total return). During that period the combined revenues and earnings of the 500 companies in the index dropped each quarter. Also during that period, the S&P 500 twice dropped over 10% and then recovered.
- Over the last twenty-one months, since the end of June 2014, the S&P 500 returned a total of 8.8%. During that time, U.S. small-cap stocks, mid-cap stocks, the Dow Jones Transportation Index, energy stocks, pharmaceutical stocks, basic material stocks, emerging market stocks, Japanese stocks, European stocks, high yield bonds and commodities all entered bear markets (a bear market is defined as a price drop of at least 20% from the recent high).

As illustrated in the notes above, even with the increased volatility, the S&P 500 has been incredibly resilient. With other asset classes and market sectors reeling (creating new potential opportunities!), the S&P 500 has acted as a safe haven for U.S. and foreign investors. As of March 31st, the S&P 500 finished the quarter just 2.8% off of its all-time closing high. The good news is the underlying demand for the type of high-quality businesses typically found in the S&P 500 indicates investors are not speculating indiscriminately, or that we are not in a period of "irrational exuberance." The bad news is that the S&P 500's resiliency has left it expensive relative to many valuation metrics. Eventually, a resumption of broad revenue and profit growth is a necessary ingredient in maintaining the S&P 500's resiliency.

Interest rates are depressed.

The Federal Reserve (the Fed), along with other central banks around the world, has pulled down interest rates on high-quality bonds through two primary mechanisms:

- 1) Lowering overnight lending rates – to impact short-term interest rates.

In the U.S., the Fed controls the "federal funds rate" which establishes the interest rate for overnight lending between banks (it also controls the discount rate that is the interest charged for banks borrowing money directly from the Fed). The current federal funds rate is set in a range between 0.25% -- 0.5%. Prior to a rate hike of ¼ of 1% this past December, the federal funds rate had been set in a range between 0% -- 0.25% since December 2008. The federal funds rate acts as the benchmark for all other short-term interest rates in the U.S. and, all else being equal, a low federal funds rate pulls down the interest rates on all short-term bonds. Currently, both the Bank of Japan and the European Central Bank actually charge negative interest rates for the deposit of overnight funds. In Japan banks pay (-0.1%) and in Europe banks pay (-0.4%) for depositing money.

- 2) Purchasing bonds/debt – to impact intermediate-term and long-term interest rates.

¹ Definition: The S&P 500 stands for the Standard and Poor's 500. It is a stock market index that tracks the 500 most widely held stocks on the New York Stock Exchange or NASDAQ. It seeks to represent the entire stock market by reflecting the risk and return of all large cap companies.

In a “quantitative easing” program (QE), a central bank creates money and buys bonds or other financial securities (most of the purchases have been in government or government-backed bonds of the respective country or region). The Fed, the Bank of Japan, the European Central Bank and the Bank of China have all embarked on some version of QE. By increasing the demand for bonds, a central bank can lower the interest rates bond issuers/borrowers need to pay to attract bond buyers/lenders.

Typically, in a period of extended economic growth, interest rates would be materially higher than they are today. During our last economic expansion from 2002 – 2007, the federal funds rate was raised by a ¼ of 1% seventeen times, from an initial interest rate of 1% in 2003 to 5.25% in 2006. The yield on the 10 year U.S. Treasury note also reached 5.25% in 2006. In the current recovery, since it began in 2009, the Fed has raised the federal funds one time by ¼ of 1% off of a 0% floor. The 10 year Treasury note is currently trading with a yield of 1.78%. From 1962 to 2010 the yield on the 10 year U.S. Treasury note never closed below a 2% yield! For investors and savers, today’s interest rates are both depressed and depressing.

The Future

What I see in the future, or think I see, is that business activity and the financial markets will continue to move in cycles. The cycles are a reflection of human nature. Our capacity for greed and fear drive the booms and the busts. The cycles may vary in strength and duration, but pendulums swing and cycles revert to the mean. The very act of creating central banks to exert counter-cyclical forces is also a reflection of human nature. Empowering central banks to tighten financial liquidity in the booms and support financial liquidity in the busts demonstrates humanity’s desire to control our environment and moderate our extremes. In today’s financial markets, due at least in part to the Fed’s extended use of a low federal funds rate and QE, I see the S&P 500 and interest rates as out of sync. By now, seven years into a new business cycle, and seven years into a bull market for the S&P 500, interest rates should be higher and bond yields should offer an attractive alternative to stocks. From a portfolio management perspective, in the near future, while bonds remain an appropriate diversification in a portfolio to help moderate the volatility of stock investments, it is unrealistic to expect bonds to significantly contribute to a portfolio’s total return. What I see in the future, or think I see, is the S&P 500 and interest rates coming back in sync, one way or the other. (I just don’t know when!) What I definitely know to be true about the future is each new cycle, whether large or small, will create new investment opportunities.

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We are very pleased to announce that Julie Pribble, CFA has joined Peak. Julie has over 28 years of experience as a portfolio manager and personal financial advisor. She started her career in Springfield, Illinois at a regional bank now a part of JP Morgan Chase. After moving to Denver, Julie joined Wagner Investment Management in Cherry Creek in 1998 as a portfolio manager and then Managing Director. In July 2010, when the firm became a part of CoBiz Wealth, Julie served as Sr. Vice President and Sr. Portfolio Manager. Julie specializes in providing investment expertise, highly personalized investment advice, thoughtful counsel and a long term commitment to meeting client needs. She reflects our commitment to building on and improving the quality and level of services that we provide to all of our clients. Welcome Julie!

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We appreciate your business and we continue to work hard to earn the trust you have placed in us. Please let us know if you have a friend or family member that could use our assistance.

John McCorvie, CFA