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Perspectives

Stock prices gains in the past eight years, in large part, are attributed to the easy money distributed by central banks of major world economies. Those days of flooding the streets with liquidity are ending soon as interest rates have already begun to rise. Investors will have to decide if the US economy is strong enough to push stocks even higher this late into a bull market or if we are close to the end of the cycle.

Economists have predicted inflation is due to increase soon, but economic reports from the past quarter are not indicating the push into higher prices will come to fruition in the near-term. In theory, as the employment data continue to improve, wages will be forced higher and companies will have to raise prices. In reality, PPI and CPI (Producer and Consumer Price Indexes) are showing little change in prices recently. GDP estimates for Q1 rose with each month's revision, but only to 1.4%, well below the Q4 and Q3 estimates.

Stocks rose after the presidential election in November for two main reasons. First, the markets hate uncertainty and having a clear winner pleased investors. Second, investors expected big changes from tax reforms and regulations that would help boost the economy near-term. While regulations have been eased and appear to be on a path for further easing, the road to tax reform has been a lot less smooth than the bulls hoped. The case for stocks to push much higher without tax reform gets weaker, with external factors, such as North Korea, putting a new uncertainty confronting investors.

In addition to the technical analysis that leans to the bears' camp that I cover in the chart on page four, stocks and bonds are both more expensive than they have been in years based on forward looking price to earnings (P/E) ratios. High P/E ratios do not guarantee we are on the cusp of a reversal, but they significantly increase the risk of a correction. The Dow Industrials P/E ratio is 18.18, the S&P 500 is 18.72, the Russell 2000 (small-caps) index is 19.21, and the NASDAQ 100 (primarily tech companies) is 21.01. It's not uncommon for large tech companies of the NASDAQ 100 to support higher P/E ratios based on higher expectations for growth, but the NASDAQ is already down 5% from its June high and could fall further before finding more buyers and reversing its trend.

Stocks can lower their P/E ratios in two ways. Companies' earnings can improve more than expected and bring the ratio closer to the historical mean as the "E", the denominator in P/E, increases. The P/E ratio can also revert to the mean when stock prices drop and the "P", the numerator in P/E, decreases. Bulls expect the former, while bears expect the latter and, possibly, a reduction in earnings too.

The saving grace for stocks versus bonds might come from large companies' dividend yield. The Dow's yield is 2.58% and the S&P 500's yield is 2.18%. For comparison the US 10-year Treasury Note, often considered a risk-free yield, yields 2.38%. While most portfolios should have an asset allocation that includes both stocks and fixed income (bonds, notes, REITS, preferred stocks), the balance of how much of which asset should vary as P/E ratios and yields dictate. As much as P/E ratios look less bullish, the yield is more attractive on stocks if the US economy continues to expand, even at a subdued pace. Additionally, bond yields and bond prices move inversely, which makes bond prices fall as yields rise.

Some economic indicators look less robust, as seen in durable goods orders, factory orders, and retails sales. The questions to be answered in the next few reports are whether 1) the recent weakness was an anomaly and 2) the strength shown in the ISM Manufacturing and Services reports, home prices, and employment reports are a better indicator of where the economy is headed.

Summary of Indexes

Courtesy of Morningstar.com

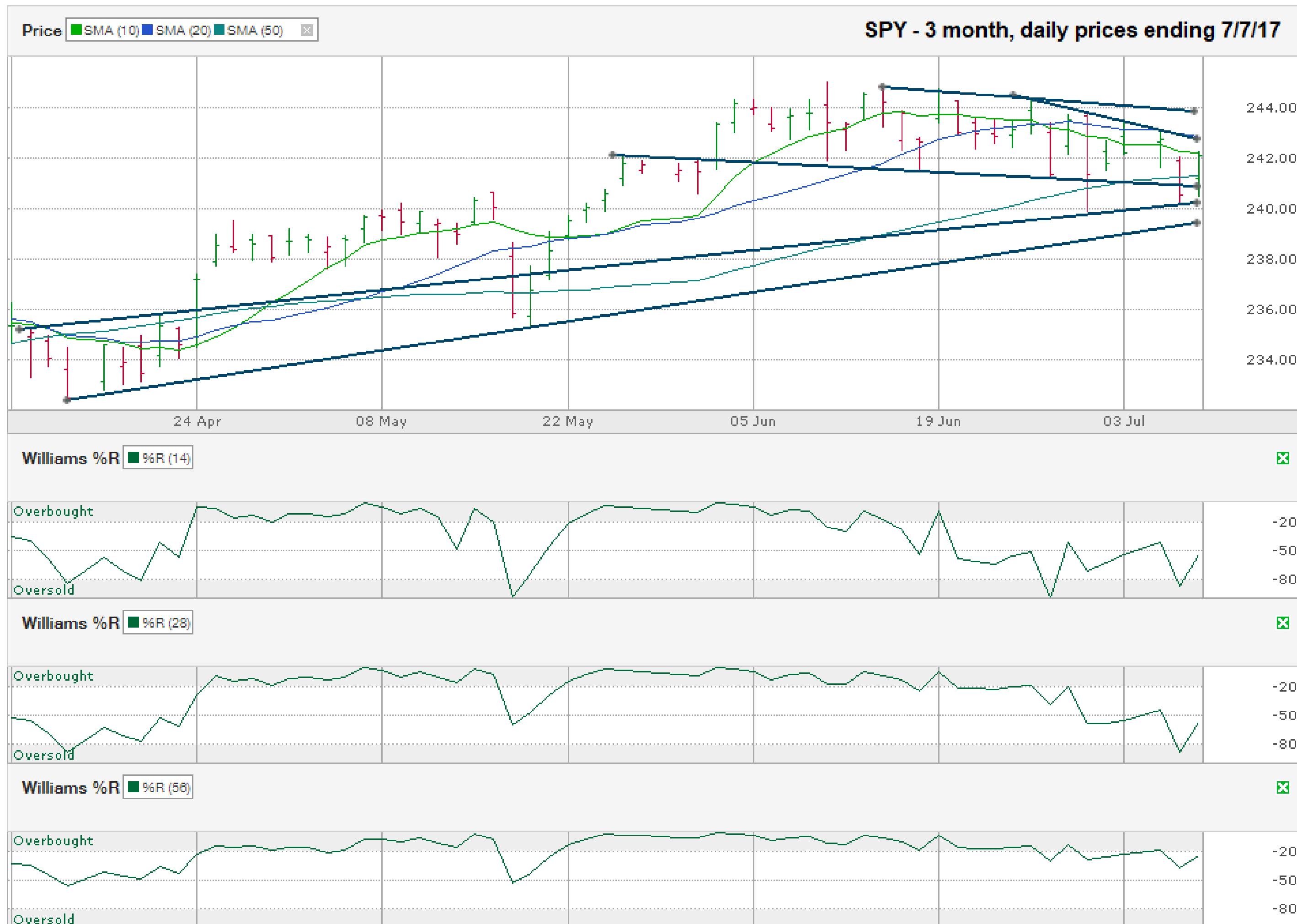
Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	7/7/2017	9.77	22.72	10.72	13.71
NASDAQ Composite	7/7/2017	14.30	26.17	11.39	15.94
Russell 2000	7/7/2017	5.04	24.87	7.56	13.46
S&P 500	7/7/2017	9.49	18.03	9.33	14.77
S&P MidCap 400	7/7/2017	6.04	18.92	8.60	14.79
Global Stock Indexes					
MSCI Emerging Markets	7/7/2017	16.26	21.22	-1.98	1.17
MSCI World, Excluding US	7/7/2017	12.34	20.62	0.38	8.17
Bond Indexes					
Core Bond	7/7/2017	2.02	-1.24	2.75	2.19
Intermediate Core Bond	7/7/2017	1.53	-0.58	2.67	2.27
Long-Term Core Bond	7/7/2017	4.17	-3.96	4.71	3.33
Short-Term Core Bond	7/7/2017	0.93	0.20	1.20	1.11

Fundamentals & Indicators

- The Empire Manufacturing Survey began the past quarter with a strong reading of 16.4, but was followed by only 5.2 in April and then -1.0 in May.
- The Philadelphia Fed's Business Outlook Survey pointed to continued growth over the past three readings. The April survey, at 22.0, was the weakest of the three months. May, at 38.8, was the best, while June, at 27.6, was close to the middle of both. 0.0 is the dividing line between expansion and contraction for this survey.
- Retail sales grew by 0.1% in March and 0.4% in April, but declined by 0.3% in May as consumers became more guarded with their discretionary spending.
- Producer prices index (PPI) declined 0.1% in March, increased 0.5% in April, and remained flat in May. PPI is up 2.4% year-over-year, but the recent weakness has some economists questioning whether the US Fed should delay future rate hikes.
- The Consumer Price Index (CPI) followed a similar, but lower, path as the PPI. Consumer prices dropped 0.3% in March, gained 0.2% in April, and declined 0.1% in May. CPI is up 1.9% year-over-year, adding to the worry that the Fed might be moving too quickly, even after such a long delay in beginning to raise interest rates.
- The Case-Shiller 20-city Home Price Index remained steady in the price increases seen in the past three reports. February increased 5.9%, while March and April increased 5.9% and 5.7% respectively.
- Housing starts decreased in each of the past three reports. The annualized rate in March fell to 1,189,000 (from 1,303,000 in February). April and May saw further declines with annualized rates of 1,156,000 and 1,092,000 respectively.
- Existing home sales increased 4.4% in March, but declined 2.3% in April before recovering 1.1% in May. As supplies have tightened, prices have risen and impeded sales growth.
- New home sales rose to an annualized rate of 644,000 in March, slipped to 593,000 in April, and recovered to 610,000 in May to remain in the upward trend of improving annualized rates.
- Factory orders rose 1.0% in March, declined in both April and May by 0.3% and 0.8% respectively.
- Durable goods orders began the past quarter on a strong note with March orders increasing 2.3%, but lost momentum as April declined 0.9% and May declined 1.1%. The data show economic activity has slowed. While two negative reports do not indicate this change is the beginning of the end, it is worth watching to see how the June report follows these two disappointed months.

- The ISM Manufacturing Index counters the weakness seen in the durable goods orders. The April reading indicated expansion at 54.8 (above 50.0 indicates expansion), followed by 54.9 in May and a stronger 57.8 reading in June.
- The ISM Services Index average for the past three reports was better than the manufacturing reports. The March report came in at 55.2, followed by 57.5 in April and 56.9 in May. The June report, at 57.4 was the 90th straight report to indicate the services sector was expanding.
- Construction spending increased 0.3% in March, but declined 0.7% in April and only recovered to a flat 0.0 reading in May.
- Gross Domestic Product (GDP) reading improved in each revision for the first quarter. The first reading indicated 0.7% growth and improved to 1.2% in the second reading before the third reading showed an expansion of 1.4%.
- Weekly unemployment claims remained below 300,000 for 122 consecutive weeks, which indicates a continuingly strong labor market
- Total nonfarm payrolls continued to improve in each of the past three reports. April added 207,000 new jobs followed by an additional 152,000 in May and 222,000 in June.
- The unemployment rate fell to 4.4% in April and to 4.3% in May before rebounding to 4.4% in June.
- The fluctuations in the unemployment rate were due to changes in the labor force participation rate more than any other factor as the labor force participation rate bounced from 62.9 in April, down to 62.7 in May, and up to 62.8 in June. For perspective, the labor force participation rate was over 66.0 as recently as 2008 and was below 59.0 in 1955.
- The U-6 unemployment rate (includes the total number of unemployed and those employed part-time, but seeking full-time employment) is viewed as a more realistic picture of total unemployment followed a similar path as the headline (U-3) rate. April's U-6 rate dropped 0.1 to 8.6, followed by another drop in May to 8.4, before returning to 8.6 in June.
- The average workweek improved to 34.4 in April, where it remained in May before rising to 34.5 in June.
- Average hourly earnings increased 0.3% in April, 0.2% in May, and 0.2% in June. These steady gains coupled with the improvement in the average workweek indicate strong demand for labor and will help push inflation higher, which makes it easier for the Fed to raise rates.

Index Chart & Analysis



The chart above shows the daily prices for the past three months on SPY, the SPDR ETF that tracks the S&P 500 Index, after closing the week at $242.11, on July 7, 2017. SPY retreated 2.0% from its intraday high of $245.01 set on June 9 before having a slight recovery and then dropping again. Even while setting a new high on June 9, the large-cap ETF started showing signs of weakness as it dipped below its 10-day moving average for the first time in weeks. Since then, it has had only one day when it has not crossed below the 10-day moving average intraday.

On June 16, SPY traded below its 20-day moving average and has had one day since then without crossing below it. Weakness continued as the bearish crossover of the 10-day moving average fell below the 20-day moving average on June 27. SPY took two more days of trading before it fell below its 50-day moving average for the first time in a month and a half. Large-cap stocks rallied for a few days and then returned to the bearish side of the 50-day moving average again for the final two days of the week when SPY tried to rally, but hit resistance at its 10-day moving average.

Each cross below a moving average is a warning sign, even if it closes above the moving average by the end of trading. The trend lines show this same bearish view since early June as SPY has seen lower lows and lower highs. Using the full 3 months visible on this chart, I drew two ascending trend lines. The lower one marks the trend of higher lows and the longer one marks the trend line that began as resistance and became support. This longer line is where SPY found support on both the June 29 and July 6 lows. The two ascending trend lines will be key for technicians to watch in identifying a tipping point.

The Williams %R indicator tells a mixed story. The 14-day indicator signaled it was time to sell on June 16th, but the 28-day indicator didn't echo that signal until June 30, just a few days after the 14-day indicator reversed its signal. The 56-day indicator has yet to turn bearish, but could in the coming days if it gets a confirmation (follow through) day of weakness. However, if Monday is a positive day for the S&P 500, both the 14 and 28-day indicators will turn bullish again.

The moving averages are the only consistent technical indicator in this chart. The trend lines and Williams %R need more time to increase the probability of their accuracy. The next few days of trading after the low-volume holiday week will give strong guidance for the direction of next 2-5% move for the broad market.

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