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Investors in the game must take their turns at bat

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Expectations for the market heading into 2018 were very high – that company earnings would be up 18 percent year on year. The market was stretched to meet these high expectations. Aided by the tax cut bill, actual earnings far exceeded forecasts. By early May, with most companies reporting, actual earnings were up an astounding 27 percent. Normally, one would expect the market to show a similar increase, but it did not. The market has barely moved since the start of 2018, compared with a 7 percent increase as of this time last year.

With earnings strong, the price-earnings ratio of the market dropped from over 18 times earnings to about 16 times earnings – closer to the historical average. Fixed income became a better investment than equities; even cash earned more than equities because equities remained flat since the start of earnings season. Yields on the 10-year Treasury bond rose to 3 percent, making fixed income competitive with equities. In addition, volatility rose dramatically. Was the market getting tired? Was the market tipping over?

The May jobs report came in with the number of jobs created at 164,000, down from the expected 192,000. But the rate of unemployment fell to 3.9 percent – the lowest since December 2000. The rate of unemployment for black workers fell to 6.6 percent – the lowest ever. Wage growth was tepid at 2.6 percent.

Meanwhile, the labor pool is shrinking: 410,000 more people dropped out of the workforce, out of a total of almost 96 million employed. This shrinking labor pool is the largest reason for the drop in the unemployment rate. A shrinking labor pool is not good for the economy since total income drops and workers are in short supply. Maybe an increase in the labor supply would not be so bad. Maybe rather than complain about the lost jobs, one should look at the lost supply of labor.

The 10-year Treasury bond is an important gauge for the markets and the economy. This number, at which money can theoretically be invested credit risk free, is an important gauge of the economy. If bonds trade above 3 percent, investors then can pull money out of equities, because one can invest risk free and get 3 percent. Depending on one's view of the economy, 3 percent risk free might be a good place to hide out. Money market yields are now increasing, so even cash is becoming competitive with stocks, which has not been true for 10 years. Increasing interest rates can be seen as a barrier to economic growth and equity market increases, but if interest rates are going up because of a strong economy, that can be seen as a good sign.

In addition, the prospect of a tariff war is seen as a distinct threat not only to the U.S. economy, but to the global economy and therefore markets. These threats can be seen as another reason the markets have not responded to increased equity earnings. With increased tariffs, prospects for U.S. companies do not look good. The administration has imposed new tariffs on steel and aluminum, only to back off in some cases, but leave other, smaller countries still subject. This has been negative for all concerned. Even if the administration has delayed the tariffs in some cases, uncertainty has added to risk, and as all investors know by now, the markets hate uncertainty.

Using faulty mathematics, the administration proposes yet more tariffs.
President Trump has now withdrawn from a multilateral treaty to limit Iranian nuclear weapon production. The other signatories to the treaty include our closest allies: England, France and Germany, all of whom argued against our withdrawal. So now we are at odds with our closest allies and potentially are allowing Iran to return to nuclear production. No doubt North Korea is watching closely how we deal with disarmament treaties.

Such erratic policy creates more uncertainty and undercuts markets. Still, as investors we have no choice but to invest as well as we can. We believe that the markets will find a way to succeed; indeed, certain sectors of the market – primarily technology and consumer discretionary – are up over 5 percent year to date. Like a baseball player we must go the plate every time our turn comes, and take our “at bats.” We have survived worse. We are still batting.

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