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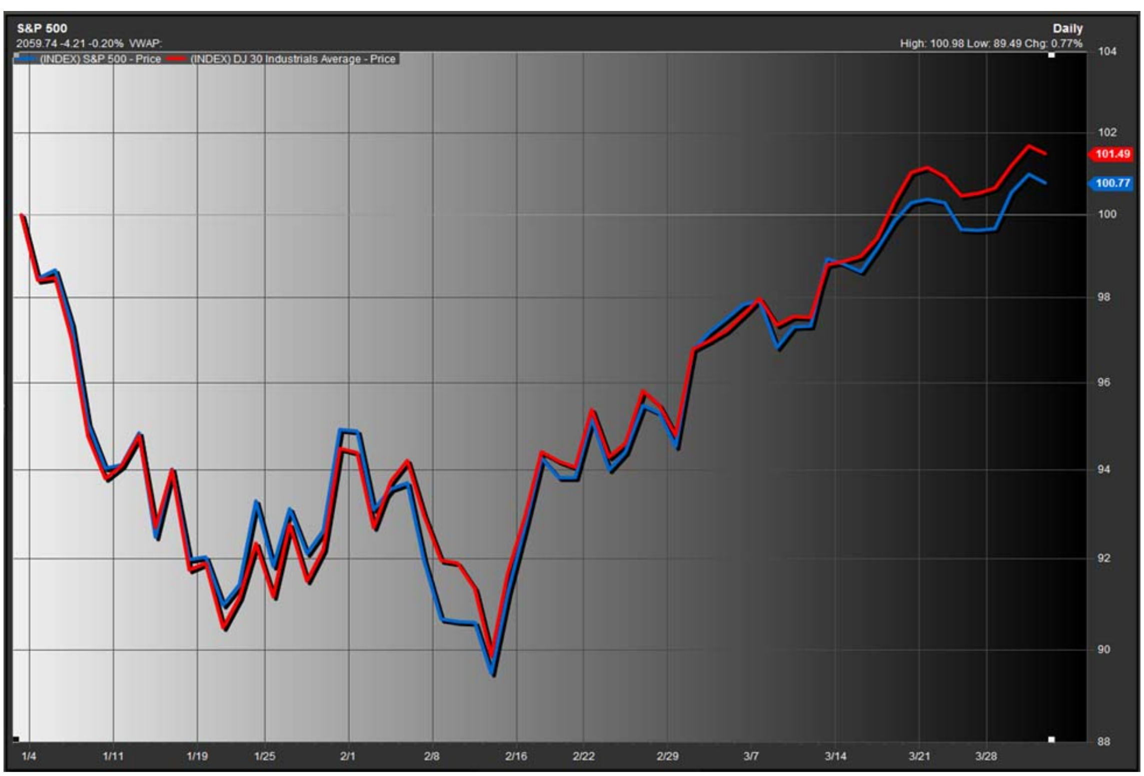
2016 First Quarter Report: The Bear Market That Wasn't

April 2016

A bit of common insight about the stock market fluctuations is often illustrated by suggesting that investors evaluate investment performance every 12 months. Stock and bond markets seem much less volatile if the investor reviews performance less frequently. Many homeowners effectively do this by only considering the value of their homes when they receive their property tax bill. They don't "Zillow" property values of their home hourly, weekly or even monthly. They simply look to see if their property taxes have increased or decreased, and if so, to consider if it's due to a change in value, changes in interest rates and/or tax laws. It's a long-term holding, so if it's gone down a bit since the last time they looked, they don't panic and call their broker, ready to sell.

Consider the gyrations of the markets over the past quarter. This year began as the worst start to a calendar year ever for the US stock market. Yet the Wilshire U.S. Large Cap index gained 1.25% in the first three months of 2016 while the widely-quoted S&P 500 index of large company stocks posted a gain of 0.77%. This is remarkable considering that the index was down more than 10% by the second week of February.

The chart below illustrates the point by showing market prices of both the S&P 500 (blue) and Dow Jones Industrials (red) since January 1st.



...and if we look at the performance of these two indices over the last 12 months you'll note that they are virtually back to where they started; they have no gain.

Even small companies, as measured by the Wilshire U.S. Small-Cap index, gave investors a 0.85% return during the first three months of the year. However, the technology-heavy Nasdaq Composite Index lost 2.75% for the quarter.

Meanwhile, markets outside the U.S. performed poorly. The broad-based EAFE index of companies in developed foreign economies lost 3.74% in dollar terms in the first quarter of the year, in part because Far Eastern stocks dropped 6.06%. In aggregate, European stocks lost 3.18%, and are now down more than 10% over the past 12 months. Emerging market stocks, as represented by the EAFE EM index, fared better, gaining 5.37% for the quarter.

Looking over the other investment categories, real estate investments, as measured by the Wilshire U.S. REIT index, were up 5.20% for the first quarter. Commodities, as measured by the S&P GSCI index, gained 3.78% in the first quarter, largely due to a 3.5% rise in oil prices since the end of last year.

Amazingly, interest rates continued their downward drift, leading to gains in bond portfolios. The Barclays Aggregate Bond Index (US bonds) returned 3.03% for the first quarter. Treasuries continued their long trend of paltry returns to investors; 3-month notes yielded 0.21% at the end of the quarter, while 12-month bonds were yielding just 0.60%. Go out to ten years, and you can get a 1.78% annual yield. We anticipate these gains will not continue unless the Federal Reserve inexplicably push overnight rates below 0%, as the Japanese and Swiss have done recently.

The easy call at the beginning of the year would have been to bail out when the markets were declining and sit out the widely-predicted start of a painful, protracted bear market. Some analysts were talking openly about another 2008-2009 drop in share prices. But 10% market declines are simply a part of the market's normal turbulence, and anyone who spooks as soon as they see a month of bearish sentiment is likely to miss out on the subsequent gains. Since hitting their 2016 lows on February 11, both the S&P 500 index and the Nasdaq Composite have gained roughly 13% in value.

However, that doesn't guarantee that there will be gains going forward.

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The Market Watch website reports that half of the S&P 500 sectors are reporting declines in earnings per share this quarter over the same period last year, and a poll by the FactSet analysts suggests that seven out of the ten sectors will end the earnings season reporting declining earnings.

Part of the support for stocks this past six weeks has come, yet again, from the U.S. Federal Reserve Board, which had originally signaled that it planned to raise interest rates four times this year. After its most recent meeting, the Fed is projecting just two interest rate hikes this year, and Fed Chairwoman Janet Yellen has clearly indicated that the Fed will remain cautious about disrupting the markets or the economy as it unwinds its various QE initiatives.

Investors also seemed to take comfort that the Chinese stock market has stabilized—for now, at least. Recently, Chinese officials reported the first rise in an important manufacturing statistic—the purchasing managers index—in eight months.

But arguably the biggest short-term stabilizer of U.S. and global stock markets was the rise in oil—or, more precisely, the end of a long unnerving drop in the price of crude that caused anxiety to ripple through the investor community. Analysts are not sure how the price of a barrel of crude oil is connected with the value of stocks; indeed, for most companies, lower energy costs are a net plus to the bottom line. But investors seemed to take comfort in the fact that the price of the world's most important commodity had stabilized. And consider that the day the stock market hit its low for the year—February 11—was also the day when oil futures hit their low of $26.21 a barrel.

In the U.S., employment growth has remained strong, with 215,000 new jobs added in March, above predictions of 199,000. Overall, the economy has added millions of jobs in the last two years. Wage growth continues to be low—up 2.3% today over a year earlier—but while that's discouraging for workers, companies (and their bottom lines, and eventually their stock values) are benefiting from relatively cheap labor. In addition to the steady employment conditions the Institute for Supply Management's manufacturing index expanded for the first time since last August, suggesting that U.S. manufacturing activity is picking.

So, the U.S. economy bounces along at a modest pace while China does the same and Europe continues to struggle a little. Current conditions lead us to conclude that stock and bond markets will continue moving within a range, so returns will likely be modest.

HAPPY SPRING!!

The Berkeley Team

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