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Economy & Market Valuation

The S&P 500 Index was up by approximately 4% in the second quarter of 2017. The US economy keeps chugging along at a slow and steady pace. There is a lot of talk that the stock market is overvalued by looking at the traditional stock market metrics like P/E ratio, P/S ratio and so on. It is true that the market is overvalued but the question is - can it get even more overvalued before we see a downturn? Bull markets are generally killed by recession or external shocks rather than by valuation. Interest rates are still very low by historical standards and are even lower in Europe and Japan. The market is placing a very high probability on tax reforms or tax cuts in the next 12 months which will be positive for the stock market. We also think that the current bull market is in its 8th inning (with reference to a baseball game that has 9 innings). We keep a very close eye on economic indicators that have the potential of predicting a downturn in the economy like inverted yield curve, weekly unemployment claims, total payroll, inflation, building permits, housing starts and many others. Our approach to investing will change whenever we see signs of an impending economic downturn. We would increase cash in our portfolio when we see signs of an economic downturn. In our opinion, this approach provides two benefits. Firstly, it will help us to avoid losses when the market drops, and, secondly, it will provide us cash to help us ride the market upwards when the recovery happens.

Investment philosophy and Examples

As you might have noticed, Bank of America is a long time holding in our portfolio. Banks generally do well when the economy is growing and have the potential to provide market beating returns. Bank of America is seeing improving profitability fueled by increase in interest rates and reduction in operating expenses. We plan to hold on to Bank of America while the US economy is on a growth path. It is always heartening to see that Warren Buffett is also investing along with you. Warren Buffett is now the largest shareholder of Bank of America and has publicly stated that he plans to hold on to his Bank of America investment for a very long time.