MARKET COMMENTARY – AUGUST 1, 2017

Dog Days of Summer (Earnings)

We all think we know the origin of the phrase, "Dog days of summer." It's so hot the dogs lie around panting, right? If you believe this explanation you're in good company, for it is the one given by most people. You'd also be wrong.

The phrase has its origins in the ancient days of our Greek and Roman ancestors, those progenitors of Western society. And instead of gazing downward at the dogs lolling in the grass, we must peer to the heavens for clarification. July and August was when the star Sirius appeared to rise just before the sun. Furthermore, Sirius was the brightest star in the constellation Canis Major, who was the most faithful of hunting companions of another constellation, Orion. This "dog star," rising as it did amidst some of the hottest days of the year, was believed to foretell the coming of fever and catastrophe.

Our modern society frets less about fevers brought on by mosquitoes and contaminated water during the dog days. Instead, one of the new things we have to monitor are earnings reports of companies spanning the globe. How do we read the scattered tea leaves of data in 2017? Do they, like Sirius of yore, portend a coming misfortune? Or, are they indicating something else entirely?

At this moment, roughly 71% of S&P 500 companies have beaten fairly lofty expectations for 2Q earnings. They are doing so with sales that are 3% higher sequentially and 6% higher than this time last year. Margins, too, are excellent. In fact, if this pace continues, the operating margin of S&P 500 companies will be the highest on record!

And we now see that much of the rise in stock prices can be justified quite rationally. With solid company fundamentals, low inflation, low interest rates, and a steady dollar, higher prices are warranted. The porridge is just right.

But we also must acknowledge there are some risks to the glowing scenario just painted. And these potential pitfalls are why we no longer feel comfortable being overweight a client's long-run strategic target to stocks. Forecasts for future earnings growth are moderating. For example, at the beginning of this year it was thought that for all of 2017, the S&P 500 might earn $136 per share. Now that forecast is $127, which gives an elevated forward P/E of 19.5.

There are also two more anecdotal tidbits that steer us more toward conservatism and less toward aggressive behavior in these times. First, we know the markets for labor and parts to be as dynamic as any. A record quarter of profitability is noticed by most, especially vendors, labor unions, and employees. We believe that future costs will inch higher, potentially trimming our current rosy profitability and thereby increasing the market's valuation absent a corresponding uptick in prices.

Second, and we acknowledge that this is on the weak end of fundamental scientific explanation, volatility in stock prices is bouncing around a THIRTY-YEAR LOW. In layman's terms, market participants have become more comfortable (maybe too comfortable) with stocks. They buy them for speculation of future rewards. They buy them for yield. They seem to just buy them. Prices still go up and down every day, but have set a reliably upward, gentle trend. Some of this is structural in the market itself as billions of dollars flows from active management into passive vehicles.

However, history bears witness to the fact that when investors lose all fear of consequences is the exact moment they ought to have more trepidation.

In summary, fundamentals in the market and economy remain mostly strong. Therefore, we remain at full weight to risk assets such as stocks. However, given the extended valuations in the marketplace and perceived complacence among participants, we cannot in good conscience recommend that clients overweight equities in the hope of excess future return. So, while this year's dog days seem to prophesy for only good, other factors keep us neutral with regard to client risk targets.

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Sincerely

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