Market Perspectives | A Glance at How the World Affects You

Brexit and a Fully Valued Market

June 20, 2016

The stock market has entered the proverbial "sell in May and go away" season, which typically brings summer doldrums and sometimes deep selloffs, as evidenced in 2015 and 2011. Through the end of May, however, the stock market had strung together four straight winning months. Now, we are heading into July and stocks continue their resilience. At the very least, the latest confluence of foreign and domestic data will likely provide more volatility, as well as the possibility of some new opportunities.

Anticipating the upcoming "Brexit", U.S. stocks pulled back again last week. The Dow Jones Industrial Average, composed of large-cap blue chips, fell 1.1% last week. For the year, the DJIA is up 1.4%. The broader, more diversified S&P 500 dropped 1.2% for the week and is now ahead 1.3% year-to-date. Small-caps, which are typically more volatile than large-caps, declined 1.7% for the week. For the year, the Russell 2000 is higher by only 0.8%.

So what is "Brexit"? Simply put, voters will decide if **Br**itain should **exit** the European Union. Later this week, on June 23, voters in the United Kingdom will decide whether they want to leave or remain in the European Union. Until recently, polls showed the "exit" vote outnumbered the "stay" vote. Market anxiety over the uncertain consequences of a British exit, including the impact on global financial markets, had been rising as support for the "Leave" side strengthened. However, over the weekend, polls showed that the "Remain" side had recovered some lost ground, giving investors more confidence to move into riskier assets. At the moment, it appears that cooler heads are prevailing and the UK will remain part of the trade zone.

From our vantage point, the risks of leaving are high. For one, an exit vote would introduce an immediate period of uncertainty for the United Kingdom, as concerns over future treaties trump the potential benefits of lower subsidies to the union. The pound sterling would likely plunge, raising the cost of imports to UK consumers. How quickly could the UK economy recover? That depends on whether economic and political leaders are able to focus on global macro trends, in addition to rebuilding their own trade infrastructure. Moreover, a vote to exit could substantially weaken the European Union and shift even more of the financial burden on the Northern countries; Germany would be in the crosshairs. Making this more obvious is globally declining interest rates, and as uncertainty rises, the probability of rates for financially strong sovereign bonds headed lower still. German 10-year notes are now negative. Hard asset securities (gold stocks, chemicals, and energy companies) should move higher if the outcome is "exit".

Investors were also unnerved by the Federal Reserve's recent meeting where Fed Chair Yellen spoke of a lower outlook for U.S. GDP growth and potential interest rate hikes. Additionally, she failed to give unambiguous guidance on upcoming plans. The results covered several markets. Oil prices slipped to close on Friday at $48.26 per barrel. At this point, according to our technical charts, we expect oil to remain range bound throughout 2016; $25-$55 per barrel. U.S. bond yields dropped to 1.6% and gold prices continued to find support near $1,300 per ounce. To underscore the aforementioned, we expect gold prices to rise if the UK ultimately votes to leave the EU. Finally, the VIX (volatility index) rose for the week and is now trading toward the high end of its three-year trading range.

The Bottom Line: For the balance of 2016, we remain neutral to positive on stocks – bullish factors outweigh bearish factors at this juncture, if only by a small margin. Still, we look for an improving economy, with GDP growing on average 2.0% for the next 2-3 quarters; relatively low interest rates, though the 10-year Treasury bond yield is expected to gradually rise toward 3.00% in 2017; 6%-10% EPS growth in 2016-2017 and rebounding global economies. Corporate earnings have been under pressure for several quarters so a rebound in the second half is a reasonable expectation. Furthermore, the Federal Reserve is not likely to make impetuous moves given recent statements about their view of the economy. Having said all of that, we also believe that several risks are in view: Europe and the BRIC nations, economic trends in China, oil price volatility and a low inflation environment that could turn deflationary, and domestic markets which look fully valued.

What do we mean by "fully valued"? First, we look at dividend yield for the Dow Jones Industrial Average, Dow Jones Transportation Average and the S&P 500 which have (historically) remained between 3% (overvalued) and 6% (undervalued). The normal yield range for the Dow Jones Utilities Average usually stays between 3% and 12%. Currently, the S&P 500 yields 2.1%, Dow Jones Industrial yields 2.7%, Dow Jones Transportation yields 1.7%, and Dow Jones Utilities yields 3.7%. From this perspective, yields (with the exception of utilities) are outside of normal ranges which indicates greater extremes of market valuation.

Next, we consider Price to Earnings (P/E), a useful tool which expresses the price of a stock compared to its earnings. Currently, we estimate the S&P 500 is trading more than 21 times trailing 12-month operating earnings. When we calculate P/E using GAAP (Generally Accepted Accounting Principles), the ratio moves to nearly 24 times trailing 12-month earnings. Longer-term valuation measures—such as the Shiller P/E and price/trailing peak operating earnings—are similarly elevated. How does this compare with historical averages? Price to Earnings around 15 to 17 is said to be fairly valued and when P/E reaches 10 or below, the market is said to be undervalued.

As for what might happen after the vote, we have to believe that current market condition will have a lot to do with that. For the most part, price momentum indicators point toward lower prices as the longer term market remains overbought. If the Brexit vote is in favor of remaining a part of the European Union, we should still expect some drag on the market. If the Brexit vote is positive (Britain leaves the EU) it will exacerbate a market sell-off.

For the time being, we have focused on our fundamentals while tactically holding cash for buying opportunities. Regardless of how "Brexit" concludes, we're optimistic that we'll be able to gradually put our cash to work.