HBK Wealth Management

Haire · Bohmer · Kilcoyne

# WEEKLY MARKET COMMENTARY

A Candid Look into the Current State of the Markets

March 2015

Our roads to success may have twists and turns and ups and downs; together we can navigate a course and enjoy the scenery along the way.


**David Haire**
HBK Wealth Management
President
9075 Centre Pointe Dr.
Suite 100
West Chester, OH 45069
513-942-9700
Fax: 513-942-9701
d.haire@hbkwealthmanagement.com
www.hbkwealthmanagement.com


## In This Issue


Weekly Market Commentary | Week of March 2, 2015

## KEY TAKEAWAYS

- The Nasdaq Composite just hit 5000 today as this report was going to press and is nearing its all-time record closing high of 5048.
- Even with the Nasdaq at 5000, we do not believe stocks have reached bubble territory.
- The Nasdaq has a much stronger foundation today of valuations, profits, and sentiment.

## A VERY DIFFERENT NASDAQ

The Nasdaq Composite just hit 5000 today as this report was going to press and is nearing its all-time record closing high of 5048 set during the peak of the internet bubble in March 2000. The 15-year journey back to these highs after the bubble burst included two recessions along the way--one of them "Great." This accomplishment has sparked renewed concerns that the Nasdaq's ascent reflects a stock market bubble that may soon burst. Even with the Nasdaq at 5000, based on valuation and sentiment measures, we do not believe stocks have reached bubble territory. As we walk down memory lane to the days when we got stock picks from cab drivers and chat rooms, we see that the Nasdaq's foundation is much stronger today.

### ANOTHER BUBBLE?

To assess whether the Nasdaq reflects excessive speculation that has historically characterized bubbles, we look at several measures of valuation and sentiment. A comparison between where these measures stand today and their levels back in 2000 reveals that the environment then was very different. This comparison enhances our comfort with our positive stock market view, based on our investment process incorporating fundamentals, valuations, and technical analysis.

### Valuations Then Versus Now

The Nasdaq valuation comparison between 2000 and 2015 is dramatic based on a variety of different valuation metrics. The March 2000 price-to-earnings ratio (PE) of 107, based on then current year estimates, bears no comparison to the latest reading at 25 (as of February 27, 2015). The forward PE, based on the following year estimates, tells the same story, with a PE of 75 then and 21 now. No comparison. Underlying these lofty valuations then was a set of Nasdaq companies that was much less profitable. The top 10 holdings today generate nearly five times the earnings of the top 10 as of December 31, 1999 (excluding WorldCom and its cooked books).

Valuation measures based on book value, or the value of company assets minus liabilities, also reveal a much more expensive Nasdaq then versus now. One of the symptoms of the internet bubble was the lack of assets supporting valuations (though there were plenty of page views, eyeballs, and clicks). The price-to-book value ratio (market cap divided by book value) at the peak in March 2000 was over 7, compared with 3.9 as of February 27, 2015.

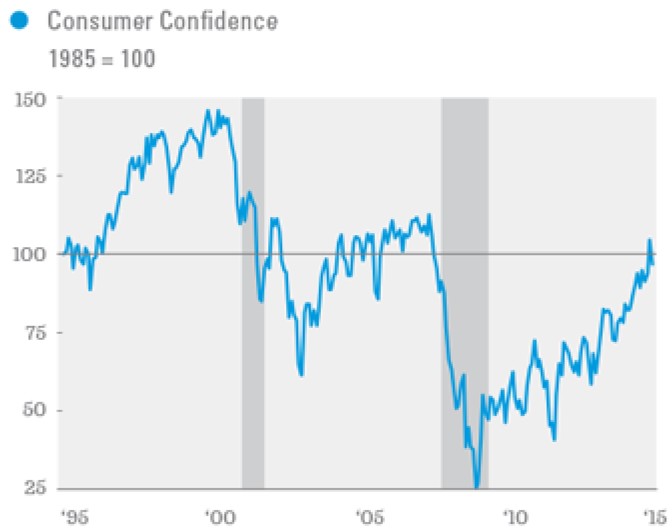
Nasdaq cash flow valuations tell the same story, highlighting the lack of cash generated by many of the richly valued internet companies in the early 2000s. The Nasdaq Composite's price-to-cash flow ratio (market value divided by operating cash flow generated) approached 100 at the March 2000 peak, compared with roughly 20 currently.

The significant amount of dollars going into technology sector investments then versus now is also instructive. The significant investment flows into the sector pushed the Nasdaq up 189% during the two years leading up to the peak on March 10, 2000, a much steeper ascent than the 57% gain in the index during the past two years. The technology sector represented 35% of the S&P 500 at the Nasdaq's peak, compared with a current level near the long-term average at about 19%. The Nasdaq had a 57% technology weighting then, versus 43% today. Clearly, some of the more popular valuation measures demonstrate that the modern day Nasdaq is much more reasonably valued than it was when it last reached 5000.

### Sentiment Then Versus Now

Another way to gauge a potential speculative bubble is to look at measures of sentiment, which in 2000 far exceeded today's levels based on most metrics. Excessive consumer and investor confidence during the internet bubble led market participants to push valuations to unsustainable levels. For example, the Conference Board's reading on consumer confidence peaked at an all-time record high of 145 during January 2000 (data back to 1969), compared with the most recent reading of 96 in February [Figure 1]. More caution among consumers is indicative of a much more rational market environment and an absence of the types of excesses that lead to significant stock market downturns.

1 CONSUMER CONFIDENCE A FAR CRY FROM INTERNET BUBBLE LEVELS




Source: LPL Research, Haver Analytics 02/27/15
Shaded area indicates recession.
All indexes are unmanaged and cannot be invested into directly.
Data are seasonally adjusted.

Measures of investor sentiment can also help distinguish between these two very different market environments. According to the American Association of Individual Investors (AAII) survey of bulls and bears, the percentage of bulls reached a record high of 75% during January 2000 (a record that still stands), versus a much more rational level of 42% today (as of the latest reading on February 26, 2015) [Figure 2].

**Click here for Figure 2, Percentage of Bulls Based on AAII Survey.**

How much investors invest in equities is another way to assess sentiment. Based on data from the Investment Company Institute (ICI), net purchases of equity mutual funds by individuals exceeded $25 billion per month at the peak in early 2000, compared with just $6.5 billion during the latest reported month (January 2015). The ICI has reported net outflows to equity mutual funds in aggregate since the financial crisis (2008-2014), reflecting a healthy dose of investor skepticism.

Yet another way to assess what investors are doing is based on stocks held as a percentage of household assets, data tracked by the Federal Reserve. This statistic reached an all-time high during the first quarter of 2000 at 53.6% (data back to 1952), while the most recent reading for the third quarter of 2014 stood at 40.8% [Figure 3]. This reading is in the middle of its 20-year range and, given the relatively less attractive value in fixed income markets, seems reasonable.

**Click here for Figure 3, Stocks As a Percent of Household Financial Assets.**

Margin balances provide another sense of investor enthusiasm. This is the one statistic that looks like it did during 2000, partly due to lower interest rates that make margin debt cheaper to carry. As a percentage of market value, according to Ned Davis Research data, margin debt peaked at 1.7% during the internet bubble, and stood at a similar 1.9% as of year-end 2014. As a percentage of gross domestic product (GDP), margin debt was between 2.5% and 2.6% both during early 2000 and as of the latest reading (January 31, 2015). This statistic is one to watch, but we believe the risk may be manageable, based on strong consumer balance sheets and the overall valuation picture.

There are a number of other ways to assess market sentiment, including looking at initial public offerings (remember the Pets.com IPO), venture capital and private equity deal activity, CNBC ratings, and many others. Regardless of the metric used, almost without exception, the difference in sentiment between 2000 and 2015 is dramatic.

**CONCLUSION**

The stark differences between the internet bubble environment when the Nasdaq last hit 5000 and today are evident when comparing valuation and sentiment measures. The Nasdaq has a much stronger foundation of valuations, profits, and sentiment today. We maintain our positive stock market view for 2015, as noted in our *Outlook 2015: In Transit* publication, with a preference for the now attractively valued technology sector. And for those of you looking for stock picks, please consult your LPL Financial advisor, and not a cab driver or a chat room.

**Click here for the infographic, A Very Different Nasdaq.**

*IMPORTANT DISCLOSURES*

*The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.*

*The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.*

*Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.*

*All investing involves risk including loss of principal.*

*Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.*

*All indexes are unmanaged and cannot be invested into directly.*

*INDEX DESCRIPTIONS*

*The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.*

*The Nasdaq Composite Index measures all Nasdaq domestic and non-U.S.-based common stocks listed on the Nasdaq stock market. The index is market-value weighted. This means that each company's security affects the index in proportion to its market value. The market value, the last sale price multiplied by total shares outstanding, is calculated throughout the trading day, and is related to the total value of the index. It is not possible to invest directly in an index.*

*DEFINITIONS*

*American Association of Individual Investors (AAII) is a nonprofit organization that arms individual investors with the education and tools they need to build wealth.*

*The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETF), and unit investment trusts (UIT). Members of ICI manage total assets of $11.18 trillion and serve nearly 90 million shareholders.*

*The Consumer Confidence Index is a monthly survey of 5,000 U.S. households, published by the Conference Board since 1967, measuring American consumer outlook and confidence.*

*The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.*

*Trailling PE is the sum of a company's price-to-earnings, calculated by taking the current stock price and dividing it by the trailing earnings per share for the past 12 months.*

*Forward price-to-earnings is a measure of the price-to-earnings ratio (PE) using forecasted earnings for the PE calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there is still benefit in estimated PE analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.*

*Price-to-book ratio is the stock's capitalization divided by its book value. The value is the same whether the calculation is done for the whole company or on a per-share basis. This ratio compares the market's valuation of a company with the value of that company as indicated on its financial statements.*

*Price-to-cash flow is a measure of the market's expectations of a firm's future financial health.*

*To purchase on margin is to borrow money used for the purchase of securities. Margin debt represents of the dollar value of the securities purchased and carries an interest rate. This means the value of margin debt will change each day as interest accrues and the values of the underlying securities fluctuates.*

Weekly Economic Commentary | Week of March 2, 2015

## KEY TAKEAWAYS

- Reports on the CPI and unemployment rate for January 2015 sent the Misery Index down to 5.6%, its lowest level in 56 years.
- Despite the low reading of the index, headlines and polls indicate the index may not be capturing the nation's mood.
- Wage growth may be the key to improving consumer sentiment about the state of the U.S. economy.

## THE MISERY INDEX

### THE MISERY INDEX: JUNE 1980

In June 1980, the U.S. economy was just exiting the first of two back-to-back recessions. The June 2, 1980, cover of *TIME* magazine was "The Big Blowup," referring not to the awful state of the U.S. economy, but to the recent eruption of Mount St. Helens in Washington state. The Business and Economy section of the magazine that month, however, was full of stories about just how bad the U.S. economy was:

- June 9, 1980, "Consumers Feel the Pinch": "With the economy in a downward spiral of still uncertain depth, many consumers have decided to cut their losses. . . . More Americans are unemployed, many others are doing without overtime pay, and inflation has eroded earnings."
- June 16, 1980, "The Bad News Gets Worse": " . . . not only has the next recession begun, but it is already shaping up to be one of the worst slumps since the Great Depression of the 1930s."
- June 30, 1980, "Harder Times in the U.S.": "While the Europeans generally hope to suffer only a mild slowing of economic growth, U.S. business continues to reel downward."

The unemployment rate hit 7.6% in June 1980 and the inflation rate (as measured by the year-over-year percent change in the consumer price index [CPI]) soared to an incredible 14.4%, pushing the Misery Index (year-over-year percent change in the CPI plus the unemployment rate) to 22.0% [Figure 1]. In retrospect, the 14.4% reading on CPI in June 1980 marked the high point for inflation in the late 1970s/early 1980s. Unfortunately, for the U.S. economy, the next recession (the one that would begin in mid-1981 and last through the end of 1982) would ultimately drive the unemployment rate to 10.8%. The economy in the early 1980s was truly miserable, matching the nation's mood.

1 THE MISERY INDEX DECONSTRUCTED

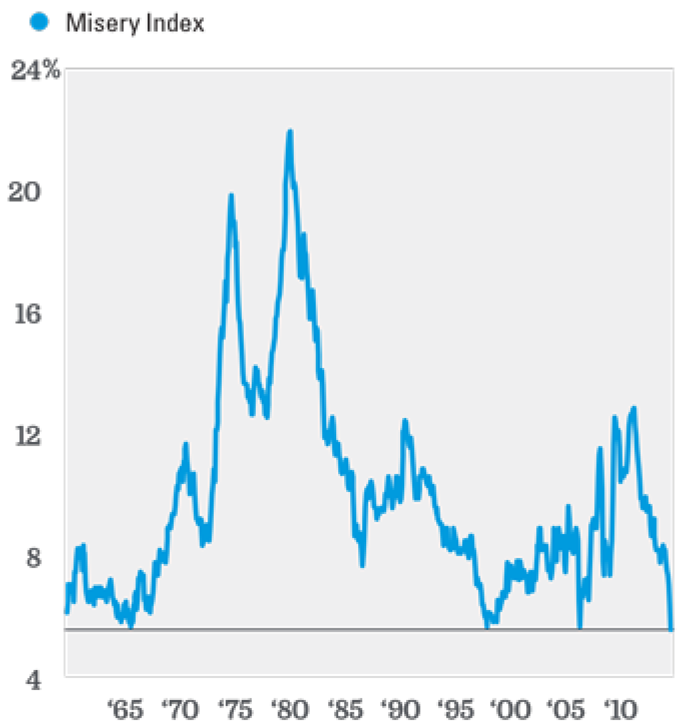
| | Unemployment Rate | + | Inflation Rate | = | Misery Index |
|---|---|---|---|---|---|
| May 1959 | 5.1% | | +0.3% | | 5.4% |
| November 1965 | 4.1% | | +1.6% | | 5.7% |
| June 1980 | 7.6% | | 14.4% | | 22.0% |
| April 1998 | 4.3% | | +1.4% | | 5.7% |
| October 2006 | 4.4% | | +1.3% | | 5.7% |
| January 2015 | 5.7% | | -0.1% | | 5.6% |

Source: LPL Research, Haver Analytics 02/27/15

### THE MISERY INDEX: THEN AND NOW

Interrupted only by the 1990-1991 recession, the Misery Index fell steadily for the next 20 years [Figure 2], hitting just 5.7% in April 1998, with the unemployment rate at 4.3% and the inflation rate at just 1.4%. By this time, *TIME* magazine had a Technology section, and the stories that month were about the latest "web-search" engines and Windows 98, while the Business section discussed "How OPEC Lost Control of Oil" and the latest wave of mega mergers in the banking sector. Times were good, and the nation's mood--and the Misery Index--reflected it.

2 THE MISERY INDEX HIT A 56-YEAR LOW IN JANUARY 2015




Source: LPL Research, Bureau of Labor Statistics, Haver Analytics 02/27/15

Last month, reports on the CPI (-0.1%) and unemployment rate (5.7%) for January 2015 sent the Misery Index down to 5.6%, surpassing the lows hit in 2006, 1998, and 1965, leaving the index at the lowest level in 56 years (May 1959). Although the economic and business headlines have certainly improved since 1980, they don't quite have the same feel to them as they did in 2006, 1998, 1965, or even 1959--the last time the Misery Index was lower than today.

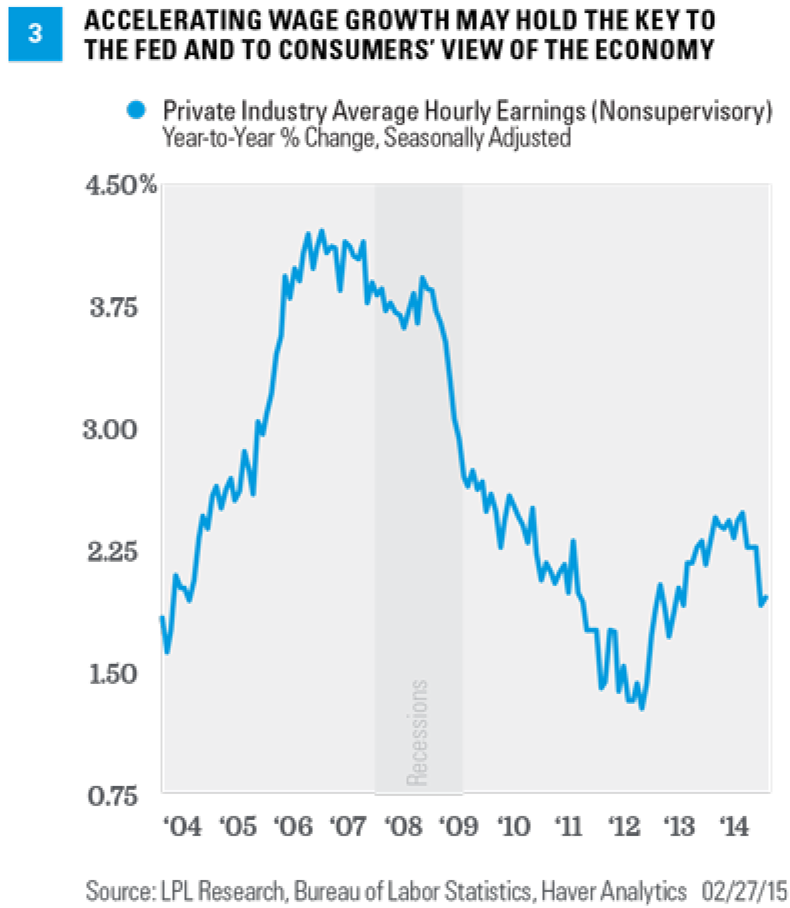
But are the unemployment rate and the inflation rate still the best measures of the misery (or lack thereof) of the American people in 2015? The index itself was created by economist Arthur Okun in the 1960s, and updated by economist Robert Barro in the late 1990s, who added interest rates and gross domestic product (GDP) to Okun's index; and it could use a refresh as we head toward the second half of the 2010s. That is a good topic for a future edition of the *Weekly Economic Commentary*.

So why, with the economy closing in on a sixth year of expansion, the S&P 500 within a few points of an all-time high, and gasoline prices near six-year lows, doesn't the nation's mood match the best reading in 56 years on the Misery Index?

According to the latest Gallup poll asking Americans what the nation's most important problem is, the "economy in general," "unemployment and jobs," and the "federal budget deficit/federal debt" were the top economic concerns; while "dissatisfaction with government," "healthcare," and "terrorism" topped the list of non-economic concerns. Although it would be easy to add a numerical value for the deficit or debt levels; the approval rating of Congress; tax rates; the number of pages of federal, state, and local regulation; or the even the latest approve/disapprove numbers on the Affordable Care Act to get a better gauge of American's "misery," that still may not capture what's going on.

**CONCLUSION**

The disconnect may come down to wages. Federal Reserve (Fed) Chair Yellen noted not once, but twice in her prepared remarks on monetary policy and the economy before Congress last week (February 23-27, 2015), that wage growth remains "sluggish." Indeed, average hourly earnings in January 2015 were just 2.0% ahead of their January 2014 level, and running well below the pace of wage growth (4.0%) seen prior to the onset of the Great Recession in 2007 [Figure 3]. Yellen's signal to markets last week was that while the Fed was happy with the progress the labor market has made toward the Fed's goal of "full employment," it was not yet convinced that the inflation portion of the Fed's dual mandate was on the right track. As we have written many times in this and other commentaries, wages are a key component of business costs, and the economy won't see a sustained rise in inflation back toward the Fed's 2.0% target until wage growth begins to accelerate. Once that happens, the Misery Index may or may not be at all-time lows, but perhaps consumers will feel better about the state of the economy.




*IMPORTANT DISCLOSURES*

*The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.*

*The economic forecasts set forth in the presentation may not develop as predicted.*

*Consumer price inflation is the retail price increase as measured by a Consumer Price Index (CPI).*

*Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.*

*This research material has been prepared by LPL Financial.*

*To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and makes no representation with respect to such entity.*

*Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by Any Government Agency | Not a Bank/Credit Union Deposit*

*Tracking #1-359379 (Exp. 03/16)*