Foothills Asset Management, Ltd.
INVESTMENT COUNSEL

Watchful Waiting

June 10, 2016 **S&P 500 Index 2096**
10-Year T-Note Yield 1.64%

If You Don't Have the Time or Interest to Read the Rest

- The stock market is at a tricky juncture. Having been trendless for much of the last 2 years, there are good arguments on both the bull and bear sides of the ledger.
- Valuations remain stretched; however in an era of ultra-low interest rates, price-earnings multiples should be at levels above the historical averages
- The technical condition of the stock market has improved since February but share prices need some help from faster growth in corporate profits.
- We favor strategies that emphasize dividend income. Even here selectivity is key as some of the highest yielding stocks are getting relatively expensive. Focus on dividend growth rather than pure yield.
- Notwithstanding the risk of short-term stock market volatility, we think stocks will generate better returns over the next few years than bonds or cash / money market funds.

The stock market has been frustrating to bulls and bears alike for much of the last 18 months. As the area inside the box (below) shows the S&P 500 Index (white line) has been stuck between roughly 1800 and 2100 since September of 2014. In addition, the long-term moving average (green line) is drifting sideways. **This is the epitome of a directionless market.**

The market will resolve one way or the other but predicting the direction is nothing more than a guess. Furthermore, the timing of the resolution will occur on the market's schedule, not the schedule of individual investors. **In short, we are at a tricky juncture and we will have to wait for the market to render a verdict. There are good arguments on both the bull and bear side of the ledger.**

S&P 500 Index *Daily Data 05/31/2011 to 6/08/2016*

Source: Bloomberg

As we have written ad nauseum, valuations in the stock market remain stretched. According to Ned Davis Research, at the end of May 2016 the median (middle) P/E multiple of stocks in the S&P 500 Index was 23.2 times earnings for the last 12 months. That isn't record-high valuation, but statistically the market only trades at higher multiples 10% to 15% of the time. For reference, the long-term average multiple going back to 1964 is 16.9 times earnings.

In an era of near-zero interest rates, the stock market should trade at above-average multiples. Unless interest rates on medium-term government bonds rise back to the historical norm of 5% to 6%, we do not think the stock market will trade below the long-term average of 16.9 times earnings. That is not to say that someday, interest rates couldn't move back to historical norms, but the prospect of that occurring in the foreseeable future is very slim.

There have been some encouraging things occurring beneath the surface in the trading of the stock market. First, oil and commodity prices have stabilized and recovered. While the defensive utility stocks still hold the top spot in our sector model, the economically sensitive energy, materials and industrial companies have

moved into the upper echelon. This shift in market leadership bolsters our confidence that a recession is not on the horizon.

This leaves investors with a conundrum. Stock valuations remain stretched, but the alternatives of bonds and cash / money market funds don't look very attractive. The yield on 10-year government bonds is 1.70% and the yield on money market funds remains close to zero.

We advocate a "neutral" position in balanced accounts between stocks and bonds. "Balanced" will differ from one investor to another based on their respective goals, investment time horizon and tolerance for risk. That said, we think most investors should have a mix of stocks and bonds in their diversified portfolios. For more aggressive investors that may imply 65% stocks and 35% bonds. For more conservative investors those percentages may be reversed. Many investors will find themselves in the 50 / 50 camp.

Over the next several years we think stock returns will beat bonds and cash. That said, we do not believe the stock market cycle has been repealed. There will inevitably be episodes when share prices swoon by 10% to 20% or even more.

Bonds add ballast to a diversified portfolio. Bond prices and stock prices often, though not always, move in opposite directions. If stock prices take a dive, bond prices often rise to cushion the decline in equity prices. Bonds also provide a source of liquidity to re-balance one's portfolio, buying stocks when share prices fall.

Since stock valuations are bumping up against the high end of historical norms, we think investors should focus on getting more of their return from dividend income, rather than relying on capital appreciation. Here too, selectivity is important. Our valuation work suggests that stocks with the highest dividends are no longer cheap. We prefer to focus on modest dividends (1% to 3%) that can be increased regularly over the next several years.

We would advise investors to gradually re-balance their portfolios toward their long-term allocation targets. If readers find themselves over-weighted in equities due to the run up in share prices, take a few profits. For investors who find themselves under-weighted, add a few percentage points to equities each month until your allocation is in line with your long-term goals.

Many years ago as I began my career, a mutual fund salesman was extoling the virtues of long-term investing. He said, "Investing is like growing an oak tree. It won't do very well if you dig up the acorn every day to check its progress."

Throughout periods of euphoria and panic, investors are best served by keeping a steady hand and not over-reacting to short-term news or market gyrations.

INVESTMENT STRATEGY

Our stock market view is neutral. The stock market has been stuck in a trading range for close to two years. The economy is likely to continue to grind forward, but at a tortoise-like pace that doesn't make people feel very good. We would advise investors to gradually re-balance the asset allocation of their portfolios toward strategic norms.

We advise bond investors to stay higher up on the credit quality ladder. As this commentary is being written, interest rates on long-term U.S. Government bonds are approaching the lows achieved in May 2014 and February 2015. A significant breach of 1.60% for 10-year bonds would imply another leg lower in interest rates. Low interest rates aren't sexy for investors but high-quality bonds to add stability to a portfolio. Given the cross currents of the market, most investors should have some ballast.

Finally, maintain some cash reserves. It is not satisfying to earn zero on a money fund balance but if the election year cycle plays out along the lines of historical patterns, investors may get a good buying opportunity later this year.

Foothills Asset Management is a fee-only investment advisor. We create sensible strategies and manage portfolios to help our clients achieve their financial goals while sleeping well at night. If you or somebody you know would like to have a no-pressure discussion about their investment needs, please call Keith Wibel at 480-777-9870. There is no cost or obligation.

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