Eastern Bank wealth management

ON OUR MINDS

Widespread Panic?

Michael A. Tyler, CFA®, Chief Investment Officer

May 18, 2017

The stock market took a pounding yesterday as investors grappled with potential fallout from the growing political strife in Washington. It was a classic "risk off" day, with bond prices soaring as investors sought stability. This was not an irrational reaction to the day's news: Investors are right to think about whether the political imbroglio might become such a big distraction that it calls into question whether Congress will be able to enact any of the President's economic agenda this year. If the answer is no, then any anticipation of accelerated economic growth stemming from President Trump's proposals would have to be jettisoned, leading to lower forecasts of GDP and corporate earnings growth – and hence to lower stock prices.

Let's say, just as a thought experiment, that politics overwhelms economics, and that we get absolutely no legislative action this year. That could also mean no action next year, as everyone in Congress focuses on the midterm elections rather than on governing. If the situation deteriorates politically, it's entirely possible for Democrats to regain control of one or both houses of Congress, effectively closing the window permanently for any of the President's economic proposals.

How would stock prices respond to this worst-case scenario? Stock prices today are only slightly expensive at 17.2 times year-ahead earnings, not nearly so expensive as to prompt fears of a bear market. Further, in this scenario it's quite likely that the Federal Reserve would exercise more restraint, keeping interest rates near historically low levels; when interest rates are so low, it's much easier to justify stock valuations that are higher than traditional levels. In short, no need for investors to panic.

The behavior of stock prices is further reason for calm and patience. Chart 2 on the next page shows the S&P 500 over the past three years, with a few technical indicators. This weekly chart conveys a few salient points:

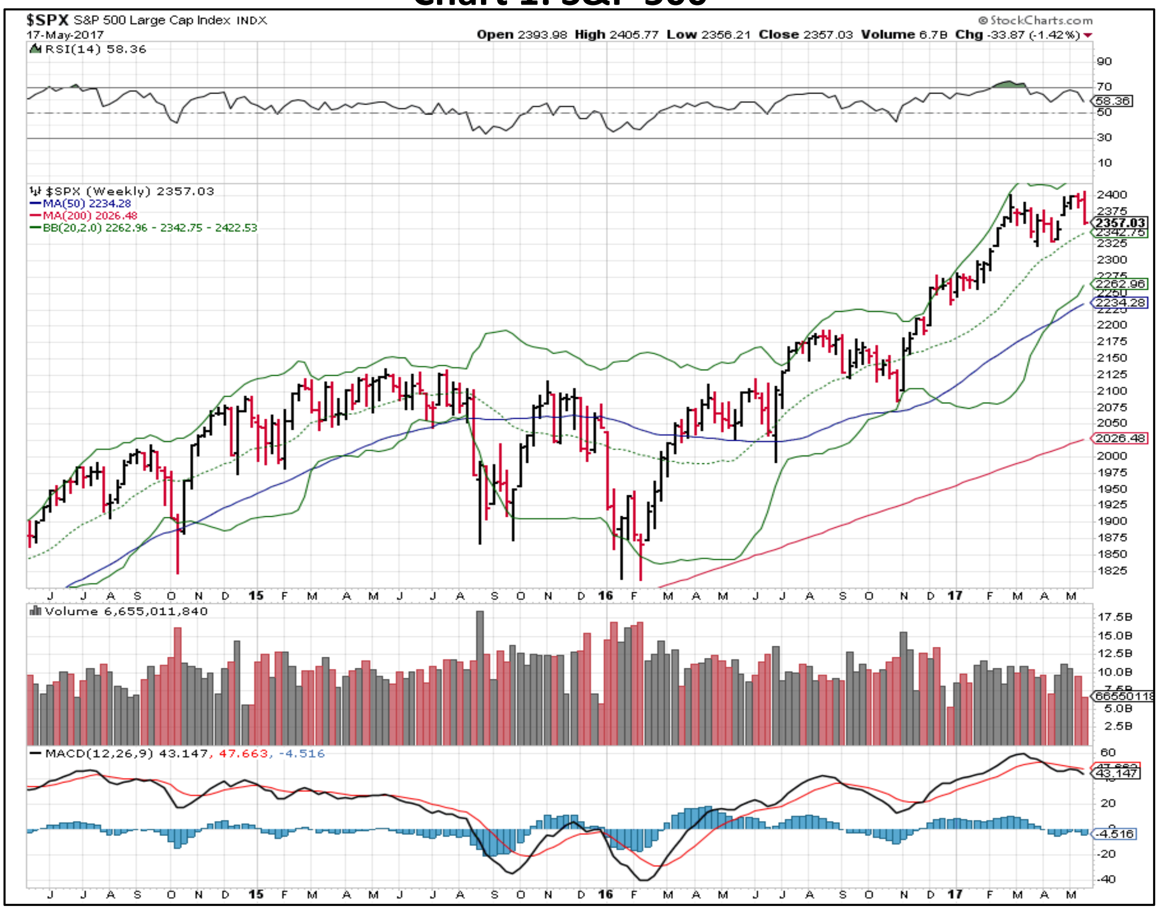
- Yesterday's price action is barely a blip, and did no damage to the market's health. The market is still comfortably ahead of its short-term (blue) and long-term (red) moving averages. It is well within its recent volatility channel (the two green lines).

- Stocks were "overbought," which is to say that their near-term momentum may have carried them a bit too far upward. The panel at the top of the chart shows "relative strength," which was running uncomfortably hot recently and has begun to cool off (back below 70); the panel at the bottom shows that the MACD has finally dipped a bit as well.[1]

[1] MACD is "moving average convergence-divergence." It compares the short-term and long-term moving averages in order to show whether a stock (or index) is gaining or losing momentum. As the MACD lines dip, momentum is slowing; the blue bars show the difference between the short-term and long-term indicators.

- Trading volume is tracking fairly steadily; we're not seeing the spikes in volume that would accompany panic sales (as for example in the brief but steep corrections in October 2014, August 2015, and January 2016).

Chart 1: S&P 500



Source: StockCharts.com

In short, despite the headlines and the screaming heads on television, stocks are taking the political storm in stride. Part of the reason, no doubt, is that fundamentals are still strong. We've said it before and we'll say it again: it's all about the earnings. The S&P 500's EPS growth in the just-completed first quarter was a robust 14% compared with a year ago, exactly the same as the index's advance in that time. (To the degree that the Federal Reserve's policies affect stock prices, we'll have more to say soon about the Fed's likely course of action.) We see no reason to change our investment posture at this time.