HEARTWOOD INVESTMENTS

201 Tower Park Dr., STE 100 | Waterloo, IA 50701 August 24, 2015

"August: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, October and February."

--Mark Twain

Markets Open Sharply Lower in the U.S.

Stock markets in the U.S. opened sharply lower Monday morning, August 24th, down more than 5% from where they closed on Friday. That was panic selling. Soon, the market had recovered about half of the opening loss. The day is yet young as we write this comment. It remains to be seen where prices will settle. We are confident that things will settle down pretty soon.
We encourage investors to be calm.

Selling pressure in both domestic and overseas markets carried over from the previous week with increased force. Last week the Dow Jones Industrial Average declined 1,000 points in total, a drop of about 5.7%. Nothing fundamental changed in the U.S. over the weekend to justify a further 1,000 point decline. The selling seems to be a reflex response to much larger percentage price declines in Chinese markets. For example, the Shanghai Composite Index of domestic Chinese stocks declined more than 11% last week. Monday trading in China took the Shanghai index down a further 8.9%.

Investors might benefit from pausing to reflect that the U.S. markets stand on different economic ground than the domestic Chinese stock market, and a sell-off in China might not justify wholesale selling here. We will develop that idea further in a separate article. However, people in a panicky frame of mind seldom pause or reflect.

Investor Sentiment Turns Sour

We bow to the obvious: market sentiment has turned strongly to the risk-off side, with nervous investors seemingly in a sell-everything mood.

In our experience going back to the 1970s, markets seldom bounce right back when prices turn downward so briskly. For a while, a new trading range may emerge below the previous one. The low end of the former range tends to become the high end of the new one. For example, the S&P 500 index spent the first half of 2015 trading between 2,000 and 2,130. It would not surprise us to see the market trade lower in search of support, and for market rallies to struggle to break above 2,000 until prospects become clearer for economic growth and corporate earnings.

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Fundamental Valuations May Be Approaching Attractive Levels

Warren Buffet famously said, “In the short run the market is a voting machine. In the long run, it is a weighing machine.” We agree. Fundamentals prevail over sentiment sooner or later. Here, there is some basis for patience in the midst of panic. Fundamental measures of market value may be close to levels that have supported share prices in the past.

A number of U.S. economic indicators stand at levels normally associated with healthy growth. Housing activity and employment data come to mind, both of them trending upward. The pace of growth is less than we would like to see, but it looks fairly firm to us. Corporate earnings in the second quarter of 2015, outside the energy sector, are on pace to be up more than five percent from the same period last year.

The S&P 500 price level at Monday morning’s opening is down to below 18 times trailing-year earnings, compared to a level above 20 earlier this month. Looking ahead to analysts’ estimates for 2016, prices may be closer to 16 times potential earnings next year. In our experience, P/E ratios of 16 to 18 are a bit above historic averages but not so terribly high that investors need to be concerned. Further selling below this morning’s prices could push market prices down to levels that have afforded attractive entry points in the past. Stocks are not mere pieces of electronic paper. They represent ownership of productive, real assets and future earnings. If investors continue to sell shares at price levels much below what we see today, they may find that they sold too cheaply.

For that reason, we encourage investors to be patient. Let the storm pass over and then see whether it may have blown some opportunities our way.