Markets Hit Record Highs: Three Opportunities

By David G. Dietze, JD, CFA, CFP™
Founder, President and Chief Investment Strategist
Point View Wealth Management, Inc.
August 22, 2016

This month, for the first time since 1999, all three major indices, the Dow, S&P, and the Nasdaq, hit a record high on the same day. It doesn't feel like 1999. Today, investors fret about weak earnings growth, Brexit, the implications of negative interest rates cloaking much of the globe, and a volatile presidential campaign.

The pundits point to many reasons why investors should flee the markets: Valuations are sharply elevated versus the last ten years. Economic data is weak, with first half GDP growth well below 2%. Inflation remains a no show, consumer spending is inconsistent, and productivity is disappointing.

Yet, the market continues to grind higher, admittedly on low volume and with low volatility. With interest rates so low, and showing no signs of going higher, TINA still prevails: There is no alternative to stocks for investors seeking yield and returns beyond the meager returns on fixed income.

Selectivity is called for. Here are three sectors offering opportunity:

Financial Services

There's no bubble in financials, the one sector that has never reached its 2007 levels. Tightened regulations and more stringent capital requirements may represent a new normal for this group, but the profit squeeze resulting from low interest rates is likely to abate at some point. Concerns, too, over weak commodity prices posing a risk to the energy loans in their portfolios have lessened with the recent run up in fossil fuel prices.

One catalyst for better performance is that all "too big to fail" domestic banks recently passed the regulators' "stress tests." Their plans to return profits to shareholders via stock buybacks and dividends have been validated. This sector, a traditional rich source of dividends, is poised to increase payouts significantly.

Bank of America (BAC) could reward investors despite the market's current lofty levels. Down 70% from its 2007 peak, just in the last year it's dropped 12% versus a 7% increase in the S&P 500.

Its share price is just 2/3 of tangible book value, a sharp discount to pricey competitors like **JP Morgan (JPM)** and **Wells Fargo (WFC)**, whose price to book is 1.3 and 1.6, respectively.

Yet, Bank of America is a quality franchise, boasting one of the largest financial services networks in the country, with branches in all 50 states.

The catalysts to unlock value: Higher interest rates, for one. We would not be surprised by an activist investor coming along to demand improved performance, in much the same way that ValueAct is now stalking **Morgan Stanley (MS)**.

The ultimate value creation move might be the separation of Merrill Lynch from the traditional bank. If value does not surface soon, CEO Brian Moynihan may consider this option.

Energy

Stocks and bonds may be at record valuations, but that certainly does not include the shares of energy concerns. With crude oil down more than 50% since 2013, the energy patch has been pummeled, dividends cut, profits vaporized, and production slashed.

The **Energy Select SPDR Fund (XLE)**, an exchange traded fund reflecting an index of energy stocks contained in the S&P 500, lost nearly 45% of its value from the summer of 2014 to February of this year. The fund has bounced back 22% since then, as crude oil has rebounded from a 13 year low hit in the same month.

Is it too late to make money in energy stocks? We don't think so. Valuations remain attractive on several measures. While price to earnings ratios remain elevated, we don't think that's the best way to evaluate a highly cyclical industry in times of stress. We would point to other metrics to highlight cheapness.

First, on a price to book value the energy sector has not been so cheap relative to the market in 30 years. Second, energy stocks as a component of the S&P 500 have slipped to a mere 7% of market value, down from 13% during better times. When this has occurred previously, energy has outperformed in the ensuing 36 months.

Fundamentally, energy generation has diminished, credit extension curtailed, employees laid off. This will bring supply back into balance with demand, laying the foundation for more robust fossil fuel prices ahead.

How to play it? Consider **Baker Hughes (BHI)**. It's one of the big four oil-services companies along with **Schlumberger (SLB)**, **Halliburton (HAL)**, and **Weatherford (WFT)**, operating globally for a wide gamut of clients.

It's well positioned to secure awards from national oil companies that want to retain reserves ownership yet do not have the technical expertise to develop their complex and challenging reservoirs. It benefits from the trend toward more unconventional development in onshore shale plays and offshore drilling.

Last year BHI and Halliburton reached an agreement to combine two of the three largest oil services companies, rivaling Schlumberger in size. Halliburton offered to pay over $70/share. The deal did not happen due to antitrust concerns, but the consideration offered reveals how highly Halliburton valued this company, some 35% more than current levels.

We believe BHI is an attractive way to play our upbeat outlook for energy concerns.

Latin America

Latin American stocks have not enjoyed the record highs seen by domestic stock benchmarks, struggling mightily in recent years, along with all emerging markets. Over the first decade of this century, $10,000 invested in **Fidelity's Latin America Fund (FLATX)** became nearly $47,000, while a similar amount invested in the S&P 500 returned about $10,500. In this second decade that same fund has underperformed, dropping 34% versus an 125% gain in the S&P.

Why the slowdown in the last six and a half years? Latin America is highly dependent on commodity prices, which have retreated amid slowing global economies, particularly in China, a major raw materials consumer. Concerns over the strength of the US currency have also weighed; as the Dollar appreciates versus local money, the burden of its US dollar denominated debt impacts profits severely.

Finally, political turmoil, particularly in Venezuela and Brazil, has caused investor flight. Brazil, the largest economy in South America, has seen a rise in corruption and now a major impeachment battle over President Rousseff.

Investors concerned about sky high US stock market valuations will find much to like south of the border. Take that same Fidelity Latin America fund. The dividend yield on its portfolio is 4.8% versus 2.3% on the S&P 500, while its price to earnings ratio is 13 versus the S&P's 19.

Fundamentally, we think the situation is improving in Latin America: Commodity prices are on the rebound, and serve as great inflation hedges, important in light of huge central bank money printing. There are some signs that the body politic is getting fed up with the corruption and mismanagement in Brazil, as the legacy ruling class is under fire for its economic mismanagement.

In sum, for those frightened of the current record breaking stock markets, we believe there are still many opportunities left, including financials, energies, and Latin American stocks.