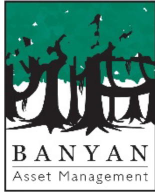

"Loud And Clear"

Market Commentary – May 2022

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The advance estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. decreased at an annual rate of -1.4% in the first quarter of 2022. This is a drastic change from the growth of 6.9% experienced in 2021 Q4, and it represents the first quarterly decline in GDP since 2020 Q2 (Great Cessation due to COVID-19). The components of the 2022 Q1 GDP number are: consumer spending +1.83 percentage points, investment +0.43 percentage point, net exports -3.20 percentage points, and government spending -0.48 percentage point. The sum of these numbers equals -1.42%. To add some historical perspective, over the past 20 years (2002 Q1 to 2022 Q1), GDP has averaged +2.14%, with the following components: consumer spending +1.54 percentage points, investment +0.59 percentage point, net exports -0.16 percentage point, and government spending +0.17 percentage point. Consumer spending, which is the most important component since it historically represents about 70% of U.S. GDP, was actually a little stronger than average in 2022 Q1. Net exports, however, were drastically lower in 2022 Q1, indicating that weakness is likely temporary. While there is a temptation to believe the U.S. economy is falling off of a cliff, another interpretation is that it is still digesting the effects of the unprecedented Great Cessation.

The Federal Reserve is evaluating aggressive plans to tame inflation and loosen tight labor market conditions, which is being heard loud and clear by financial markets. The target federal funds rate currently sits in a range of 0.25% to 0.50%, following the first 0.25% rise in March. Futures markets predict aggressive rate hikes in 2022: +0.75% by June, +1.50% by August, and +2.25% by November. Moreover, futures markets see the federal funds rate peaking at 3.36% by August 2023. As for shrinking its colossal $8.9 trillion balance sheet, minutes from the March Federal Open Market Committee (FOMC) meeting revealed potential plans to cut $95 billion per month ($60 billion for Treasury securities and $35 billion for mortgage-backed securities). Balance sheet assets peaked at $8.965 trillion on April 13 and currently sit at $8.939 trillion. The next FOMC monetary policy announcement is scheduled for May 4, where futures predict a 0.25% increase in the federal funds rate (with a 62% probability of a 0.50% hike).

The annual update of our universe of stocks confirmed many of last year's picks and uncovered some new potential gems. We analyzed a total of 1,830 companies one at a time, with a cumulative market capitalization of $43.0 trillion. Our research identified "our universe", which is comprised of stocks we believe have the best risk/reward prospects (based on a combination of low valuation, low beta, low debt to market cap, and high dividend yield). Only 73 stocks made the cut (up from last year's record low of 65). Our stocks have the following market capitalization ranges: <$500M (16 stocks), $500M to $2B (15 stocks), $2B to $10B (14 stocks), $10B to $100B (18 stocks), and >$100B (10 stocks). In the coming months, we will perform in-depth fundamental research on the companies in our universe with attractive technical chart patterns to determine which ones to buy.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $233.07, which implies a price-to-earnings (P/E) ratio of 17.7 with the S&P 500 at 4,132. The earnings yield (E/P) of 5.64% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.89%. The spread between the earnings yield and 10-year Treasury is 2.75%, a bit higher than 2.66% last month.

The S&P 500 broke a support level on the last trading day of April, suggesting that further selling awaits. Technology stocks are being decimated, with the Nasdaq 100 down -21.2% year-to-date (without dividends). Index investors have not enjoyed the first four months of 2022. Value stocks, meanwhile, are benefitting from strong relative performance in 2022. High dividend yields (coupled with low-debt balance sheets) should somewhat cushion downside risk while the Fed tackles inflation.