"Lopsided"

Market Commentary – July 2023

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The third estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 2.0% in the first quarter of 2023. This is higher than the advance estimate of 1.1% and the second estimate of 1.3%, but lower than the 2022 Q4 reading of 2.6%. On June 14, the Federal Reserve revised its economic projections that were last released in March. It now sees GDP growth of 1.0% in 2023, 1.1% in 2024, 1.8% in 2025, and 1.8% in the "longer run" (beyond 2025). Reports of GDP growth refer to *real* GDP (net of inflation), rather than *nominal* GDP (including inflation). The Fed projects inflation, as measured by Personal Consumption Expenditures (PCE), to be 3.2% in 2023, 2.5% in 2024, 2.1% in 2025, and 2.0% in the longer run. Once inflation has been factored out of GDP, the coming years are expected to be starved of growth.

On June 14, the Federal Open Market Committee (FOMC) finally paused its interest rate hike campaign by maintaining the federal funds rate at a target range of 5.0% to 5.25%. However, they also indicated that they are not yet done raising rates by projecting a federal funds rate of 5.6% by the end of 2023 (0.5% higher than today). Following this peak, the FOMC forecasts 4.6% in 2024, 3.4% in 2025, and 2.5% in the longer run. In retrospect, the Fed has been very aggressive with its rate hikes: rising 5.0% across 10 consecutive meetings, starting on March 16, 2022. Meanwhile, the Fed's balance sheet stood at $8.341 trillion on June 28, almost exactly the same as on March 1 before the sudden failures of three major banks. It seems that the banking crisis has eased and the Fed has resumed its plan of trimming $95 billion per month from its balance sheet. The next decision on monetary policy is scheduled for July 26.

Technical factors of the market are bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $229.11, which implies a price-to-earnings (P/E) ratio of 19.4 with the S&P 500 at 4,450. The earnings yield (E/P) of 5.15% represents fair value relative to the 10-year U.S. Treasury note yield of 3.81%. The yield spread continues to drop and is now 1.34%. However, it is critical to peel back the onion to uncover what is really going on. The seven largest companies in the S&P 500 make up $11.1 trillion of the $39.1 trillion index market capitalization with a weighted P/E of 40.8. If 28.3% of the index has a P/E of 40.8, then 71.7% of the index has a P/E of 11.0 for the overall P/E to be 19.4. A P/E of 11.0 is an E/P of 9.09%, which is cheap compared to the 10-year Treasury note yield of 3.81% (a yield spread of 5.28%, which compares to the S&P 500 in April 2020 in the heart of the COVID-19 stock market crash). The S&P 500 has become extremely lopsided toward these seven overvalued companies, which is dangerous for index investors.

As expected, the S&P 500 broke out to the upside in June and momentum continues to be to the upside. Resistance areas should be around 4,600 (March 2022 high) and 4,800 (all-time closing high). Support areas include 4,226 (50-day moving average), 4,200 (February, April, and May 2023 highs), and 4,002 (200-day moving average). A correction could unfold at any time, which would be healthy. It seems likely that such a correction would involve a rotation from the "overvalued seven" into value stocks.

The mad rush of capital toward the "overvalued seven" is a massive bubble in front of our eyes. We believe that the main root cause is the cult of index investing, where investors blindly invest money in companies they do not know (via index mutual funds and exchange-traded funds). As the great followers they are, these investors "buy the index". Corporate retirement plans are also to blame, as many plans emphasize or solely include index funds. Active managers of mutual funds have to make the difficult choice of either joining the mania or underperforming the index and losing clients (so they often buy the bubble). To top it off, there are speculators gambling on upward momentum, thinking they are brilliant for earning such high returns. When this bubble eventually bursts (timing unknown), capital will likely flow back into the stocks that are forgotten today. Markets do not stay lopsided forever.