"Bursting Bubbles"

Market Commentary – June 2022

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The second 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 -1.5% in the first quarter of 2022. This is lower than the advance estimate of -1.4% and much worse than the growth of 6.9% in 2021 Q4. Investors' eyes are on inflation, which has been red-hot. In April, the Consumer Price Index (CPI), a measure of inflation experienced by consumers, jumped 8.3% year-over-year. The good news is that this was slightly cooler than the 8.5% reading in March. Meanwhile, the Producer Price Index (PPI), a measure of inflation experienced by domestic "producers" of goods and services, skyrocketed 11.0% in April. The fact that PPI was greater than CPI suggests that companies are not passing along all of the inflation shock to their customers via higher prices. Inflation has been stoked by many factors, especially ultra-accommodative monetary policy by the Fed, COVID fiscal stimulus (PPP loans, economic relief payments, etc.), supply chain disruptions, and policies to limit the supply of oil. It is a perfect storm.

The Federal Reserve is making good thus far on its efforts to tame the inflation beast. As expected, the Federal Open Market Committee (FOMC) hiked its benchmark federal funds rate by 0.50% to a target range of 0.75% to 1.0% on May 4. Futures markets predict additional 0.50% hikes by July and again by September, followed by four 0.25% increases between October 2022 and March 2023 (maxing out in a range of 2.75% to 3.0%). The other Fed tool to attack inflation is to shrink its balance sheet. After peaking at $8.965 trillion on April 13, balance sheet assets currently sit at $8.914 trillion (barely starting to decline). The Fed plans to ramp up its balance sheet reduction from $47.5 billion per month to $95 billion per month within the next three months. After spiking the punch bowl for so long, the Fed is now giving investors the reality of a rough hangover. The next FOMC decision on monetary policy is scheduled for June 15.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively 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 $232.75, which implies a price-to-earnings (P/E) ratio of 17.8 with the S&P 500 at 4,132. The earnings yield (E/P) of 5.63% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.85%. The spread between the earnings yield and 10-year Treasury is 2.78%, higher than 2.66% in March and 2.75% in April.

The S&P 500 seems to have put in a short-term bottom in May. After the index dropped to 3,900 on May 19, it formed a bullish "hammer" candlestick on May 20 (open at 3,927, drop intraday to 3,810, and recover to close at 3,901). Thinking through the logic, sellers entered the market, pushed prices down, and buyers then overwhelmed sellers to drive prices back up. From the intraday low of 3,810 on May 20 through today, the S&P 500 has rallied 8.4%. Before getting too excited, though, investors should be warned that plenty of resistance exists ahead: around 4,170 (March low), 4,270 (50-day moving average), and 4,455 (200-day moving average). Technicians will be cautiously looking for a "failed rally" pattern, where the bounce in stock prices peters out and begins another wave of violent selling on heavy volume.

The technology stock bubble is finally bursting. Since the beginning of 2017, a massive spread developed between the S&P 500 Large Cap Value and Growth indexes. From 2017-2021 (5 years), the S&P 500 Large Cap Value index was up +54.7%, while the corresponding S&P 500 Large Cap Growth index, led by mega-cap technology stocks, was up +176.1% (both without dividends). We pointed out on December 31, 2021 that this spread of 121.4% suggested a bubble in growth stocks. From January 1, 2017 to May 31, 2022, the S&P Large Cap Value index was up +48.0% versus the S&P 500 Large Cap Growth index up +117.1%. The spread has collapsed from 121.4% to 69.1% in only five months. A massive round of selling is needed to correct the remaining excesses. So far, value stocks have held up fairly well while growth stocks have been crushed. There is no guarantee that this pattern will continue, of course, but we expect value to continue to enjoy a *relative* margin of safety compared to growth.