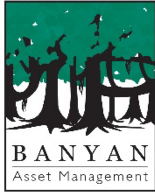

"Hiding In Plain Sight"
Market Commentary – August 2023

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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. grew at an annual rate of 2.4% in the second quarter of 2023. This is modestly higher than 2.0% growth in 2023 Q1. The components of the 2023 Q2 GDP number are: consumer spending +1.12 percentage points, investment +0.97 percentage point, net exports -0.12 percentage point, and government spending +0.45 percentage point. The sum of these numbers equals +2.42%. Overall, this was a decent reading. Consumer spending, which is historically 70% of GDP in the U.S., was a bit light at 46% of GDP. Investment was solid, though, adding +0.97 percentage point to GDP (with nonresidential investment contributing +0.99 percentage point to GDP, while the volatile inventory category added only +0.14 percentage point). Recall that on June 14, the Federal Reserve projected 1.0% GDP in 2023 and 1.1% in 2024. Economic data seems to be coming in stronger than projected by the Fed.

Concerned that stronger economic growth may further stoke inflation, the Federal Open Market Committee (FOMC) decided on July 26 to raise its benchmark federal funds rate another 0.25% to a target range of 5.25% to 5.5%. The FOMC statement noted "recent indicators suggest that economic activity has been expanding at a moderate pace" and added "job gains have been robust in recent months, and the unemployment rate has remained low". The Fed funds futures market believes that the Fed is done hiking rates, with only an 18% probability of one more 0.25% hike by November. Meanwhile, the Fed's balance sheet stood at $8.243 trillion in assets on July 26, down about $100 billion since June 28. The Fed's plan continues to be a $95 billion reduction in its balance sheet each month. The next decision on monetary policy is scheduled for September 20.

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 $227.33, which implies a price-to-earnings (P/E) ratio of 20.2 with the S&P 500 at 4,589. The earnings yield (E/P) of 4.95% represents fair value relative to the 10-year U.S. Treasury note yield of 3.97%. The yield spread continues to compress and is now 0.98%. The seven largest companies in the S&P 500 make up $11.5 trillion of the $40.3 trillion index market capitalization with a weighted P/E of 33.6. If 28.5% of the index has a P/E of 33.6, then 71.5% of the index has a P/E of 14.9 for the overall P/E to be 20.2. A P/E of 14.9 is an E/P of 6.73%, which is attractive compared to the 10-year Treasury note yield of 3.97% (a yield spread of 2.76%). There are favorable risk-reward opportunities for investors able to look past the "overvalued seven".

The S&P 500 continued its trek higher in July and is now knocking on resistance around 4,600 (March 2022 high). Given that there has not been a significant correction since March, this would be a convenient time for a healthy correction. Support areas include 4,380 (50-day moving average), 4,200 (February, April, and May 2023 highs), and 4,079 (200-day moving average). Should the bullish momentum continue, the final area of resistance should be around 4,800 (all-time closing high).

In his book *The Most Important Thing*, money manager Howard Marks cleverly states "Whatever few awards are presented for risk control, they're never given out in good times." He further explains that risk, which he defines as the *possibility* of loss, is not observable. "What is observable is loss, and loss generally happens only when risk collides with negative events." Our portfolio management strategy strives to control risk with value investing and cash. Value investing attempts to add a margin of safety to our portfolios by emphasizing low valuations, strong balance sheets, low betas, and juicy dividend yields. Cash provides the means to logically buy stocks on sale when other investors are psychologically paralyzed by fear. We do our best to actively manage risk, which is hiding in plain sight. Will investors seduced by the mega-cap technology bubble only see the risk they were taking *after* their capital has evaporated?