"2008 Playbook"

Market Commentary – January 2019

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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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 3.4% in the third quarter of 2018. This is down slightly from the advance and second estimates of 3.5%. Economic growth going forward is front and center, with economists believing that growth peaked in 2018. The Federal Reserve agrees with this assessment. On December 19, the Fed released its revised economic projections. It sees GDP growth of 3.0% in 2018, 2.3% in 2019, 2.0% in 2020, 1.8% in 2021, and 1.9% in the "longer run" (beyond 2021). The forecast for 2018 was lowered from 3.1% and 2019 was dropped from 2.5%. While these forecasts are cooling, they do not project an imminent recession.

To the stock market's dismay, the Federal Reserve did not blink at recent financial market volatility and it did not back down on its campaign to raise interest rates. On December 19, the Federal Open Market Committee (FOMC) raised its benchmark federal funds another 0.25% to a range between 2.25% and 2.50%. This is in addition to "quantitative tightening" (QT), which is the undoing of "quantitative easing" (QE). With QT, the Fed is reducing its balance sheet by $50 billion per month ($600 billion per year). After peaking around $4.5 trillion, the Fed is currently sitting on around $4.08 trillion in total assets. To put this in perspective, the Fed had around $900 billion on its balance sheet in mid-2008, before the financial crisis. The Fed is in tightening mode, and stock investors finally started running for the hills. The S&P 500 dropped about 9% in only three days after the December rate hike.

In hindsight, Fed Chairman Jerome Powell likely regrets his unfortunate comment on October 3 where he said "we're a long way from neutral" with respect to interest rates. While President Trump is correctly upset that the Fed is damaging the economy, Powell cannot appear to be bullied by the President into changing his position. To save face, the Fed had to raise interest rates in December. The real question, however, is how many rate hikes we will get in 2019. The Fed currently projects its federal funds rate up another 50 basis points in 2019 and an additional 25 basis points in 2020. If this happens, the stock market will swim against the current. Our hypothesis, however, is that the Fed will raise rates a maximum of 25 more basis points, and possibly even leave them alone in 2019. Stocks would rally in response.

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 $172.09, which implies a price-to-earnings (P/E) ratio of 14.6 with the S&P 500 at 2,507. The earnings yield (E/P) of 6.86% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.69%. Stock market corrections create amazing opportunities. While it is unknown how low stocks will ultimately go (and it is possible they have already bottomed), tremendous value has been created by the recent decline.

Many stocks were taken out to the woodshed and shot in December, presenting us with our first cyclical bear market within the secular bull market that started in March 2009. The S&P 500 found support around 2,350 in December and has had a "dead cat bounce" up to 2,507. A test of the December lows is likely, followed by more back-and-forth movements. Strong resistance should be around 2,580, which was formerly strong support that got sliced in December. Should 2,350 fail as support, there should be solid support around 2,120 (the 2015 highs).

Stock market pullbacks should be embraced, not feared, as this is an excellent time to plant seeds for (hopefully) future profits. We are relying on our 2008 playbook, which worked beautifully then: buy stocks incrementally as the market drops to various levels. We bought stocks in many client portfolios in December (our most aggressive buying in years). Should the market continue to fall, we plan even more rounds of buying. Buying low is easier said than done!