"Back And Forth"

Market Commentary – June 2018

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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. grew at an annual rate of 2.2% in the first quarter of 2018. This is lower than the advance estimate of 2.3%. The Federal Reserve has a statutory mandate to foster maximum employment and price stability. The U.S. unemployment rate fell to 3.9% in April, which is the lowest rate since December 2000. To give some additional historical context, the lowest unemployment rate in the U.S. was 1.2% in 1944, while the highest was 24.9% in 1933. When it is tough to find good workers, companies typically have to offer higher wages. There are rumblings of this in the fast food and retail industries, where recent news headlines seem to focus on higher wages. Eventually, higher wages help drive inflation. The consumer price index, a common measure of inflation, was +2.5% in April. The Federal Reserve targets an inflation rate of 2%, so inflation is finally "normalizing".

The Federal Open Market Committee (FOMC) is poised to continue raising its target federal funds rate in the months ahead. While it left the rate in a target range of 1.5% to 1.75% with its monetary policy announcement on May 2, the Fed signaled that a rate hike is likely to be announced on June 13. Moreover, it continues to gradually roll back on quantitative easing by shrinking its balance sheet ($4.40 trillion on March 31, 2018, down from $4.45 trillion on December 31, 2017). Overall, the Fed is actively making monetary policy less accommodative.

According to the stock selection process of Banyan Asset Management, the next step after updating our universe is to perform in-depth research on individual stocks. This research centers on the fundamental and technical analysis of stocks to determine which ones we should buy. Our fundamental models rely heavily on a discount rate to discount future cash flows to present value in order to calculate the fair value of a stock. The higher the discount rate, the lower the fair value of a stock. For the current vintage of fundamental analysis, we have decided to raise our risk-free rate from 3.0% to 3.5%, increase the equity risk premium from 5.6% to 5.84%, and bump up the discount rate minimum from 7.0% to 8.0%. These factors result in calculations yielding lower valuations than in the previous years. Still, we are finding some excellent opportunities to capitalize on should the market get weaker.

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 $160.97, which implies a price-to-earnings (P/E) ratio of 16.8 with the S&P 500 at 2,705. The earnings yield (E/P) of 5.95% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.82%. Interestingly, the spread between the two yields continues to be in a range of about 2.7% to 3.2%.

The S&P 500 did not break to the downside in May, and ended up continuing a sideways pattern known as a trading range. Support below exists at the 50-day moving average (2,672), the 200-day moving average (2,638), and around the lows from February, March, and May (2,600). Resistance above is at the May high (2,730), the March high (2,780), and the all-time high from January (2,872). The decline today was on very high volume, which is ominous; however, the support levels below should be strong.

Looking at the other major market indexes, there are some similarities and differences between 2017 and 2018. What is the same between the two years is that technology continues to be hot and growth is still outperforming value (although the relative outperformance is not as drastic as in 2017). On the other hand, small caps are outperforming mid-caps, and mid-caps are outperforming large caps. The Dow Jones Industrial Average, which was up a whopping 25.1% in 2017 (without dividends), is actually down 1.2% in 2018 thus far. Investors would be wise to not chase indexes (or more generally, hot performers) and stick to their investment style. Banyan Asset Management's style is once again coming into favor.