"Infected By Coronavirus"

Market Commentary – February 2020

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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 2.1% in the fourth quarter of 2019. This is the same as the 2.1% reading in 2019 Q3. The components of the 2019 Q4 GDP number are: consumer spending +1.20 percentage points, investment -1.08 percentage points, net exports +1.48 percentage points, and government spending +0.47 percentage point. The sum of these numbers equals 2.07%. Consumer spending cooled a bit in 2019 Q4 after contributing +3.03 percentage points and +2.12 percentage points to GDP in 2019 Q2 and Q3, respectively. Investment was weighed down by inventory depletion (-1.09 percentage points), which will likely reverse in future quarters as inventory is rebuilt. Business spending was soft, but it was offset by strength in residential spending. Net exports contributed the most to GDP since 2009 Q2! While this is not likely sustainable, it is impressive.

The Federal Open Market Committee (FOMC) left its benchmark federal funds rate in a range of 1.50% to 1.75% in its monetary policy statement on January 29. In the meantime, the Fed continues to expand its balance sheet in a program the Fed declines to call Quantitative Easing. Balance sheet assets have increased from $3.77 trillion in September 2019 to $4.17 trillion by the end of December (an increase of $400 billion in only 4 months). Is it a coincidence that this rapid expansion accompanied the stock market racing to new highs? It is also interesting that the balance sheet remained level in January 2020, closing the month with $4.15 trillion in assets. Note how the stock market has stopped rising. It is no secret that monetary policy helps inflate equity prices.

Financial markets are being rattled by the latest "black swan" event, the coronavirus originating from Wuhan in China. As we have reviewed before, black swan events are unexpected situations that tend to blindside investors. At the beginning of January, who would have predicted that a deadly virus would cause the largest human quarantine in history? While the disease spreads, financial markets have become infected by the coronavirus as the economic effects of China's economy shutting down are starting to be felt. The Federal Reserve will probably be forced to cut interest rates to stimulate the U.S. economy. Fed funds futures are already pricing in two 0.25% cuts in the federal funds rate (by July and December). Once the epidemiological aspects are better understood and assuming the situation does not spiral out of control, the stock market will likely be free to resume its rally.

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 $175.09, which implies a price-to-earnings (P/E) ratio of 18.4 with the S&P 500 at 3,226. The earnings yield (E/P) of 5.43% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.52%. Note how the 10-year yield plummeted from 1.92% to 1.52% over the past month, boosting the spread over the earnings yield to 3.91%. The high spread gives equity prices a degree of downside protection (especially when coupled with the increased likelihood of Fed interest rate easing).

After essentially a straight shot up from around 2,900 in October 2019 to a high of 3,330 in mid-January 2020, the S&P 500 was long overdue for a pullback. Corrections are usually associated with "scary" situations, and the coronavirus situation is no exception. What is scarier, however, is how speculation is running rampant in technology stocks. This speculation has been going on since the beginning of 2017, but it has reached euphoric levels. From January 1, 2017 to January 31, 2020, the Russell 2000 Value index is up a mere +2.3% (not including dividends). In contrast, the Nasdaq 100 index, stuffed with bubbly priced tech stocks, is up +84.9%! While growth has trounced value in the short run, it is important to remember that value is well-known as a superior long-term strategy. We can patiently wait with our portfolio of low P/E, high dividend yield, low beta stocks with strong balance sheets.