"Distorted"

Market Commentary – August 2018

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Written July 31, 2018 – www.banyan-asset.com

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 4.1% in the second quarter of 2018. This is up from 2.2% in 2018 Q1 (revised reading) and is the highest since 2014 Q3 (4.9%). The components of the 2018 Q2 GDP number are: consumer spending +2.69 percentage points, investment -0.06 percentage point, net exports +1.06 percentage points, and government spending +0.37 percentage point. The sum of these numbers equals 4.06%. In addition to a robust consumer spending number, investment was much stronger than it appears at first. Non-residential fixed investment generated +0.98 percentage point of GDP growth, while inventory depletion weighed on GDP by -1.00 percentage point (likely to reverse in future quarters). The big question is whether economic growth has peaked or whether this level of growth is sustainable. Time will tell.

The next Federal Open Market Committee (FOMC) decision on monetary policy is scheduled for August 1. In mid-July, Federal Reserve Chairman Jerome Powell told Congress that "incoming data show that, alongside the strong job market, the U.S. economy has grown at a solid pace so far this year." He added that "the best way forward is to keep gradually raising" rates. With the target for the federal funds rate at 1.75% to 2.0%, the FOMC projects a federal funds rate of 2.4% by the end of 2018. This implies two more 25 basis point hikes to a range of 2.25% to 2.5%. There are four scheduled FOMC decisions on monetary policy left in 2018, including the decision on August 1. Investors would be wise to recognize that they are swimming against the current with the Fed and other global central banks, as monetary policy is becoming less accommodative.

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 $162.66, which implies a price-to-earnings (P/E) ratio of 17.3 with the S&P 500 at 2,816. The earnings yield (E/P) of 5.78% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.96%. The spread between these two rates has compressed to the lowest level since February 2018, which had not been seen since early 2010. In early 2010, earnings exploded as the economy came out of a deep recession, so the low spread corrected itself with higher earnings. This time, earnings are arguably at or near a cyclical peak, so a higher E/P would more likely be generated by lower stock prices.

The S&P 500 has continued its gentle upward sloping trading range since March, but major resistance is hovering overhead. While the index popped through resistance at 2,787, it has yet to take out the all-time high from January (2,872). Strong support should be seen around 2,700 due to the 200-day moving average (2,698) and the June lows, with more solid support around 2,600 due to the lows in February, March, and May. With the S&P 500 index near major resistance, the burden of proof is on the bulls to march the stock market higher. The problem, however, is with the distorted performance of components within the index.

The S&P 500 has been led by a handful of technology stocks, but cracks in their pricy valuations are unfolding. Facebook, for example, dropped 21% over the past four days, and Netflix is down 20% from its peak in early July. Amazon, which is one of the most expensive stocks, has only started to show weakness, dropping 5% since earnings three days ago. Mutual funds and hedge funds are hiding in a few "key" technology stocks (those mentioned, plus Google and Microsoft), which has caused massive distortions in the major market indexes. These investment professionals should know that while stock prices ascend by escalator, they descend by elevator. Index and hedge fund investors who have focused on growth stocks at the expense of value stocks may soon regret their reckless bias. Value stocks have been quietly waiting in the background to be rediscovered – they eventually will.