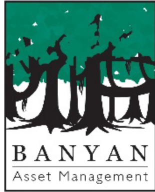

"Exuberant Optimism"

Market Commentary – April 2024

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written March 31, 2024 – www.banyan-asset.com

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 fourth quarter of 2023. This is higher than the advance estimate of 3.3% and the second estimate of 3.2%, but lower than the 2023 Q3 reading of 4.9%. On March 20, the Federal Reserve revised its economic projections that were last released in December. It now sees GDP growth of 2.1% in 2024, 2.0% in 2025, 2.0% in 2026, and 1.8% in the "longer run" (beyond 2026). As it explains in its periodic statements on monetary policy, the Federal Open Market Committee (FOMC) "seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run". The Fed currently projects unemployment in a stable range of 4.0% to 4.1% from 2024-2026 and beyond, and inflation peaking at 2.4% in 2024 and slowing to 2.0% by 2026. It seems that the Fed is succeeding in its hope for a "soft landing", where it calms the economy just enough to cool inflation without causing a recession.

On March 20, the FOMC pleased bulls on Wall Street by maintaining its projection of three 0.25% rate cuts during 2024. With the benchmark federal funds rate at a target range of 5.25% to 5.5%, futures markets see the first 0.25% cut by August 2024 and a new target range of 3.5% to 3.75% by February 2026 (1.75% in total cuts). Meanwhile, the Fed's balance sheet had $7.485 trillion in assets on March 27, down $97 billion from $7.582 trillion in assets on February 21 (in line with the Fed's commitment of $95 billion per month). The Fed must be pleased that it has cooled inflation and slashed $1.5 trillion from its bloated balance sheet without causing the economy (or stock market) to crash. The next FOMC announcement on monetary policy is scheduled for May 1.

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) through December 31, 2024 is $240.30, which implies a price-to-earnings (P/E) ratio of 21.9 with the S&P 500 at 5,254. The earnings yield (E/P) of 4.57% represents fair value relative to the 10-year U.S. Treasury note yield of 4.20%. The yield spread is 0.37%. Seven of the eight largest companies in the S&P 500 make up $13.8 trillion of the $46.3 trillion index market capitalization with a weighted P/E of 32.1. If 29.9% of the index has a P/E of 32.1, then 70.1% of the index has a P/E of 17.5 for the overall P/E to be 21.9. A P/E of 17.5 is an E/P of 5.72%, which is fairly priced compared to the 10-year Treasury note yield of 4.20% (a yield spread of 1.52%).

The S&P 500 continues to defy gravity as it motored higher to close March at an all-time high of 5,254. The S&P 500 has not closed below its 50-day moving average (currently 5,047) since November. Moreover, the 200-day moving average is at 4,618, which would take a 12.1% correction to reach. The S&P 500 is in a solid uptrend, characterized by higher highs and higher lows. All uptrends eventually come to an end, although it is unclear when that will happen. Reasonable downside targets would be around 4,800 from the January 2022 high and 4,600 from the July 2023 high. Despite the headline-grabbing highs of the S&P 500, there are many stocks seemingly being overlooked by bullish investors.

Having analyzed 9 of the 11 sectors in the annual update of our universe of stocks (only the utilities and real estate sectors remain), some general patterns have emerged. Some of the richest valuations are in the Information Technology, Health Care, and Industrials sectors, where P/E ratios in the 25 to 35+ range are common. Many of these companies pay paltry dividends of 1% or less, while buying back a trivial amount of stock or even *issuing* more stock. Companies with low-debt balance sheets and high *anticipated* earnings growth rates are being rewarded with sky-high valuations. Meanwhile, some of the most attractive valuations are in micro caps (<$1B market cap) and small caps ($1B to $5B), although there are interesting value stocks spanning all market caps. The biggest takeaway from our research at this point is that growth and index investors' exuberant optimism for the future is causing them to misprice risk.