# “Bullish, But…”
## Market Commentary – October 2017

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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 3.1% in the second quarter of 2017.** This is higher than the advance estimate of 2.6% and the second estimate of 3.0%. On September 20, the Federal Open Market Committee (FOMC) released its revised economic projections. It sees GDP growth of 2.4% in 2017, 2.1% in 2018, 2.0% in 2019, 1.8% in 2020, and 1.8% in the “longer run” (beyond 2020). The forecast for 2017 was increased by 0.2%, while 2019 was bumped up by 0.1%, compared with forecasts from June. This was also the first time projections for 2020 were introduced. The FOMC does not share the confidence of President Trump that GDP growth will exceed 3%.

**In its announcement on monetary policy on September 20, the FOMC revealed that effective October 2017, it will start reducing the size of its portfolio of bonds acquired in the aftermath of the 2008-2009 financial crisis with its “quantitative easing” stimulus program.** The Fed plans to reduce the size of its investments in Treasury and mortgage-backed securities by $10 billion each month. With a portfolio of $4.5 trillion in securities, the pace of this reduction is slow; but the important news is that the Fed has finally pulled the trigger on this long-anticipated direction. In terms of its benchmark federal funds rate, the FOMC left it alone in a target range of 1.0% to 1.25%, but hinted that it may be increased later this year. The next FOMC decision on monetary policy is scheduled for November 1.

**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 $136.86, which implies a price-to-earnings (P/E) ratio of 18.4 with the S&P 500 at 2,519. The earnings yield (E/P) of 5.43% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.33%. The spread between the earnings yield and 10-year Treasury has been trending lower, after reaching 7.29% in October 2011. The downtrend in this spread has been gradual, but it is also undeniable. Investors need longer-term interest rates to be this low in order to justify current stock prices.

**In September, capital finally began to be attracted into some beaten down stocks at the expense of the high-fliers.** As of 9/30/17, the year-to-date return spread between the Nasdaq 100 and S&P 600 Small Cap Value indexes fell from 25.2% to 16.9%. While this is still a sizeable difference, perhaps mean reversion is in progress. The S&P 500 index closed at an all-time high at the end of September, continuing its post-2016 election pattern of higher lows and higher highs (an uptrend). Support levels should be at the 50-day moving average (2,473), price consolidation around 2,420, and the 200-day moving average (2,389).

**While it is possible that the stock market can continue motoring higher (and hopefully it will), investors seem primed to be blindsided by a “black swan event”.** Black swan events are rare, hard-to-predict situations that come as a surprise and have a major effect. A possible black swan event relevant to recent headlines would be a military attack launched by North Korea on the U.S. or one of our allies. President Trump has made it clear that North Korea would be neutralized, to say it politely. If this happens, global financial markets would likely spiral down with amazing speed. Investors seem to have forgotten how quickly the stock market can turn violent and dangerous. Then again, there does not even need to be an obvious reason for a collapse. With the proliferation of Exchange Traded Funds (ETFs) and derivatives (what Warren Buffett has dubbed “financial weapons of mass destruction”), a wave of selling could tip the scale and cause a cascade of more selling. Unfortunately, this only becomes obvious after the fact. While at Banyan Asset Management we are believers in the economic policies of President Trump (especially the tax reform concepts being presented recently), it is very concerning how President Trump brags over Twitter nearly every time the S&P 500 hits an all-time high. What would he assign as the “cause” of a decline in stock prices (from mild to severe)? The stock market has a curious way of humbling investors.