“Trick-Or-Treat”

Market Commentary – November 2023

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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 4.9% in the third quarter of 2023. This is much higher than 2.1% growth in 2023 Q2. The components of the 2023 Q3 GDP number are: consumer spending +2.69 percentage points, investment +1.47 percentage points, net exports -0.08 percentage point, and government spending +0.79 percentage point. The sum of these numbers equals +4.87%. While the financial media gushed over the headline number of 4.9%, a look under the hood reveals that GDP growth is not as robust as it seems. Inventory, which can fluctuate wildly from quarter-to-quarter without sustainable patterns, generated +1.32 percentage points of the overall GDP reading. Moreover, given that consumer spending is historically 70% of GDP in the U.S., consumer spending of +2.69 percentage points should accompany GDP growth of 3.8%, not 4.9%.

Strong economic growth is potentially unwelcome news for the Federal Reserve as they combat inflation. The Federal Open Market Committee (FOMC) is scheduled to make its next announcement on monetary policy on November 1. Futures markets project a 72% probability of one final 0.25% hike in the target federal funds rate, which currently sits in a range of 5.25% to 5.5%, by February 2024. Meanwhile, the Fed trimmed its bloated balance sheet from $8.002 trillion on September 27 to $7.908 trillion on October 25, down $94 billion (on pace with its commitment to reduce the balance sheet by $95 billion per month).

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly 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 $235.71, which implies a price-to-earnings (P/E) ratio of 17.8 with the S&P 500 at 4,194. The earnings yield (E/P) of 5.62% represents fair value relative to the 10-year U.S. Treasury note yield of 4.88%. The yield spread is 0.74%. Seven of the eight largest companies in the S&P 500 make up $10.6 trillion of the $36.9 trillion index market capitalization with a weighted P/E of 28.4. If 28.8% of the index has a P/E of 28.4, then 71.2% of the index has a P/E of 13.5 for the overall P/E to be 17.8. A P/E of 13.5 is an E/P of 7.40%, which is attractive compared to the 10-year Treasury note yield of 4.88% (a yield spread of 2.52%).

The technical pattern of the S&P 500 is growing increasingly ominous. In October, the index formed its second “lower low” since it peaked on July 31. Downtrends are defined by a series of lower lows and lower highs, and this has been the pattern of the S&P 500 since July. Moreover, the index decisively broke below the 200-day moving average on high volume. Finally, the 50-day moving average (4,353) is rapidly approaching the 200-day moving average (4,242). Should the 50-day cross below the 200-day, which it has not yet done, market technicians would call that a “death cross”. These bearish patterns, of course, do not guarantee that the downtrend will continue. In March 2023, the S&P 500 decisively broke the 200-day moving average, only to begin a rally from around 3,800 to nearly 4,600 by July. Plus, many investors acknowledge that the period from November to April is a historically bullish part of the calendar.

The period from January 1, 2022 to October 31, 2023 has not been kind to stock investors. The following returns are all *total returns* (including dividends) and span the same period of time. All market caps are down: S&P 500 Large Cap -9.4%, S&P 400 Mid Cap -14.2%, and S&P 600 Small Cap -20.3%. Value has outperformed growth, but nearly all value and growth indexes are down: Large Cap Value +0.2% vs. Growth -18.6%, Mid Cap Value -11.0% vs. Growth -17.6%, and Small Cap Value -17.3% vs. Growth -23.3%. The increase in interest rates is weighing on stock valuations. The real question, of course, is what happens going forward? Many value stocks are attractively priced and have high dividend yields, which can provide tasty “treats” for investors. However, it may be that the same value stocks turn out to be value traps, where cheap stocks “trick” investors and get even cheaper. Our approach remains consistent: keep a balance of stocks and cash, favoring undervalued stocks with strong balance sheets and juicy dividends.