"Fearmongering"

Market Commentary – December 2021

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written November 30, 2021 – www.banyan-asset.com

The second 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 third quarter of 2021. This is higher than the advance estimate of 2.0%, but still drastically lower than the second quarter reading of 6.7%. Unemployment measured 4.6% in October, which is the lowest number since it spiked to 14.8% in April 2020. In February 2020, unemployment was 3.5%, so it is still higher than before COVID-19 caused the Great Cessation. The spotlight, however, is on inflation. The Consumer Price Index, a measure of inflation on consumers, jumped a scorching 6.2% year-over-year in October (the largest increase since November 1990). Without food and energy (typically volatile in terms of inflation), CPI still rose a red-hot 4.6% year-over-year (the largest increase since August 1991). Earlier today, Federal Reserve Chair Jerome Powell said "it's probably a good time to retire" the word "transitory" with respect to inflation. This is a noteworthy change in position for the Fed Chair, and stocks sold off in response.

The Federal Open Market Committee (FOMC) finally announced its long-anticipated tapering of bond purchases on November 3. Before the announcement, the Federal Reserve was increasing its balance sheet by $120 billion each month ($80 billion in Treasury securities and $40 billion in agency mortgage-backed securities). In November, the Fed reduced this to $105 billion for the month ($70 billion + $35 billion). In December, the Fed projects $90 billion in purchases ($60 billion + $30 billion). According to the FOMC announcement, "similar reductions in the pace of net asset purchases will likely be appropriate each month, but it is prepared to adjust the pace of purchases if warranted by changes in the economic outlook." Quantitative easing ("QE") may therefore end by June 2022. Earlier today, however, Jerome Powell said that in response to inflation, QE may need to end a few months *earlier* than expected. As of November 22, the Fed had a record $8.68 trillion of assets on its balance sheet. While the tapering program has begun, the FOMC kept the federal funds rate at a rock-bottom target range of 0%-0.25%. The next FOMC announcement on monetary policy is scheduled for December 15.

News of the "omicron" variant of COVID-19 in late November has caused panic in the media and rattled financial markets. This new variant was allegedly discovered in South Africa and is spreading globally. Curiously absent from the media blitz, however, is the *deadliness* of the new variant. Some sources are reporting that symptoms are very mild, which would align with expectations for a mutating virus. If that is true, then why does society treat COVID-19 as a death sentence? There seem to be incentives for the media and politicians to promote fearmongering. The media captivates viewers (their goal) and politicians are intoxicated by their *perceived* power and ability to control lives (travel limitations, vaccine passports, masks, etc.). It is most certainly a financial boon for pharmaceutical companies. Our hypothesis is that financial markets will soon conclude that omicron is less lethal than feared.

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 $219.77, which implies a price-to-earnings (P/E) ratio of 20.8 with the S&P 500 at 4,567. The earnings yield (E/P) of 4.81% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.43%. Earnings expectations are continuing to jump, which makes stocks more attractive.

The S&P 500 peaked at a closing high of 4,704 on November 18 and has begun to correct on news of the omicron variant of COVID-19. Support levels should exist around 4,540 (50-day moving average and early September peak) and 4,300 (200-day moving average). Corrections are normal and healthy. Investors also know that once tax loss selling and capital gain harvesting have waned, the Santa Claus rally in late December is usually bullish. Tech stocks are once again driving investment dollars away from value stocks, which is creating interesting opportunities for value investors. Dividends add up!