“Rotation To Value”

Market Commentary – October 2019

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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 2.0% in the second quarter of 2019. This is lower than the advance estimate of 2.1% and the same as the second estimate. On September 18, the Fed revised its economic projections that were last released in June 2019. It sees GDP growth of 2.2% in 2019, 2.0% in 2020, 1.9% in 2021, 1.8% in 2022, and 1.9% in the “longer run” (beyond 2022). While the Fed is not predicting a recession, it does see tepid economic growth on the horizon.

As expected, the Federal Open Market Committee (FOMC) lowered its benchmark federal funds rate another 0.25% on September 18 to a range of 1.75% to 2.0%. Based on its economic projections, the Fed expects to leave the federal funds rate alone for the rest of 2019 and 2020, with 0.25% hikes in 2021 and 2022, respectively. Moreover, it sees the “longer run” (beyond 2022) federal funds rate at 2.5%. Futures markets disagree, as they are betting on three more 0.25% rate cuts: by the end of December 2019, March 2020, and January 2021. One of the unstated goals of monetary easing is to correct the inverted yield curve, where short-term interest rates are higher than long-term interest rates. The following were U.S. Treasury yields as of September 30: 1.88% 3-month, 1.75% 1-year, 1.55% 5-year, 1.68% 10-year, and 2.12% 30-year. Two more 0.25% cuts in the federal funds rate, which is an ultra-short-term rate, should do the trick. The next FOMC decision on monetary policy is scheduled for October 30.

While we tend to not emphasize politics in our monthly market commentaries, a brief review of the effect of politics on financial markets is timely given the abundance of controversial news lately. The stock market likes companies to make money after taxes, especially with increasing profits each year. Fewer regulations help businesses operate and expand with less “red tape”. President Trump’s policies have supported business, and the stock market has rewarded this benign environment with a healthy increase since the 2016 election. Wall Street could accept a moderate Democrat as president from 2021 to 2024, but the anti-business socialist policies of Elizabeth Warren and Bernie Sanders are feared by many investors. While it is unlikely that either candidate would be elected, the election of Warren or Sanders would likely trigger a massive bear market for stocks. Investors need to be aware of this risk.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are bullish on the market. The Standard & Poor’s forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $169.02, which implies a price-to-earnings (P/E) ratio of 17.6 with the S&P 500 at 2,976. The earnings yield (E/P) of 5.68% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.68%.

The S&P 500 broke out of its August trading range and formed a new one in September. The index got within spitting distance of its all-time high of 3,026 (resistance), while finding support around 2,945. While October can be a scary month, it feels like this market wants to move higher. This would catch many market participants by surprise and fuel a powerful breakout to new all-time highs. Of course, we are mindful of downside risks, which could be exaggerated by algorithmic trading. Support should exist around 2,835 (200-day moving average) and 2,625.

The pendulum of popularity is swinging from growth to value. On September 6, the best major indexes for 2019 year-to-date (YTD) without dividends were the Russell 1000 Growth and Nasdaq 100 (+24.1% respectively), while the worst major index was the Russell 2000 Value (+7.4%). Fast forwarding to September 30, the Nasdaq 100 is up +22.4% YTD (it lost 1.7 percentage points of its 2019 YTD gain), while the Russell 2000 Value is up 11.0% (an increase of 3.6 percentage points). Money is shifting from growth to value, at least at the moment. Perhaps other investors are also interested in the kind of stocks we own (dollar-weighted average P/E of 12.4, dividend yield of 4.2%, and beta of 0.80).