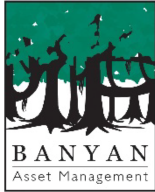

"Higher For Longer"

Market Commentary – October 2023

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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 2.1% in the second quarter of 2023. This is the same as the second estimate of 2.1% and slightly lower than the revised 2023 Q1 estimate of 2.2%. On September 20, the Federal Reserve revised its economic projections that were last released in June. It now sees GDP growth of 2.1% in 2023, 1.5% in 2024, 1.8% in 2025, 1.8% in 2026, and 1.8% in the "longer run" (beyond 2026). Note that the 2024 estimate was 1.1% in June, so 1.5% expresses the Fed's increasing optimism that the economy will avoid a recession.

On September 20, the Federal Open Market Committee (FOMC) maintained the federal funds rate at a target range of 5.25% to 5.5%. The Fed projects the federal funds rate at 5.6% in 2023 (implying one more 0.25% hike in the final three months of the year), 5.1% in 2024, 3.9% in 2025, 2.9% in 2026, and 2.5% in the longer run. In June, the 2024 projection was 4.6% and the 2025 forecast was 3.4%, so the current view is 0.5% higher for both 2024 and 2025. The general theme is that the Fed anticipates keeping its federal funds rate higher for longer in an attempt to put a lid on inflation. Meanwhile, the Fed's balance sheet stood at $8.002 trillion on September 27, down by $119 billion from August 30. The Fed is now making good on its promise to trim assets by $95 billion per month. The FOMC's next decision on monetary policy is scheduled for November 1.

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 $237.77, which implies a price-to-earnings (P/E) ratio of 18.0 with the S&P 500 at 4,288. The earnings yield (E/P) of 5.54% represents fair value relative to the 10-year U.S. Treasury note yield of 4.59%. The yield spread is 0.95%. The seven largest companies in the S&P 500 make up $10.6 trillion of the $37.8 trillion index market capitalization with a weighted P/E of 29.0. If 28.1% of the index has a P/E of 29.0, then 71.9% of the index has a P/E of 13.7 for the overall P/E to be 18.0. A P/E of 13.7 is an E/P of 7.28%, which is attractive compared to the 10-year Treasury note yield of 4.59% (a yield spread of 2.69%).

The correction in the S&P 500 continued into September, with the index forming its first "lower low" since October 2022. "Lower low" means that the index closed materially below 4,370 (August low). Moreover, the S&P 500's peak in early September of 4,515 was lower than the July high of 4,600 (i.e., a "lower high"). A series of lower highs and lower lows is the definition of a downtrend (hence our technical change to bearish for October). This does not, however, necessarily mean that the index is on the verge of collapse. Massive support should exist around 4,200 (February, April, and May 2023 highs and also the 200-day moving average). If 4,200 is breached, then the next support area would be the March 2023 low of 3,855 (a stiff, but normal 16% correction from 4,600). October is famous for scary declines, but it also tends to end downtrends. It would not be surprising for the first part of October to be choppy, with a reversal of the short-term downtrend later in the month.

Higher interest rates generally mean lower stock valuations. There are a few ways to look at this. Intuitively, when interest rates are high, there are alternatives to making money (e.g., owning stocks, bonds, or cash). When interest rates are low, bonds and cash do not yield much return and investment dollars are lured into risky assets (like stocks). Another intuitive explanation is that when interest rates are low, each dollar of earnings that a company generates is more valuable. On the contrary, earnings are not as valuable with high interest rates since profits can be made elsewhere. There is a mathematical explanation, as well, relative to the time value of money. We estimate the fair value of a stock based on the sum of future cash flows discounted to present value. Higher interest rates mean a higher discount rate, which equates to lower fair value estimates. Any way you slice it, higher interest rates for longer are pressuring stock valuations.