"Loving The Unloved"

Market Commentary – May 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 1.1% in the first quarter of 2023. While this headline value is lower than the 2022 Q4 reading of 2.6%, it is not as bad as it appears. The components of the 2023 Q1 GDP number are: consumer spending +2.48 percentage points, investment -2.34 percentage points, net exports +0.11 percentage point, and government spending +0.81 percentage point. Consumer spending was the strongest since 2021 Q2! Given that consumer spending is historically 70% of GDP in the U.S., +2.48 percentage points contribution of consumer spending corresponds to roughly 3.5% GDP growth (solid). On the other hand, the investment value shows that businesses are hesitant about the economy. Sales were greater than production in 2023 Q1, as a contraction of inventories weighed on GDP by -2.26 percentage points. Additionally, fixed investment hurt GDP by -0.07 percentage point. Overall, businesses are bracing for an economic slowdown while consumers continue to spend.

With the next Federal Open Market Committee (FOMC) decision on monetary policy scheduled for May 3, investors are questioning whether the federal funds rate will stay at a target range of 4.75% to 5.0% or increase by another 0.25% one more time. Futures markets predict a 62% probability of a 0.25% hike by the end of May and a 90% probability by the end of July. Therefore, it looks likely that one final 0.25% increase is in the cards. However, expectations change drastically by late 2023 and 2024. Futures markets see the federal funds rate 0.25% *lower* than current levels by December 2023 and 1.5% lower by September 2024. As of March 22, 2023, the Fed itself projected the federal funds rate to be 5.1% at the end of 2023, 4.3% at the end of 2024, 3.1% at the end of 2025, and 2.5% in the "longer run" (beyond 2025). Meanwhile, recent banking turmoil has thrown a curve ball at the Fed's plan to shrink its balance sheet. As of April 26, it had $8.563 trillion in assets, less than $8.734 trillion on March 22 but significantly more than $8.340 trillion on March 1.

Technical factors of the market are bullish (more demand than supply), while fundamentals are fairly 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 $223.18, which implies a price-to-earnings (P/E) ratio of 18.7 with the S&P 500 at 4,169. The earnings yield (E/P) of 5.35% represents fair value relative to the 10-year U.S. Treasury note yield of 3.44%. The recent surge in mega-cap technology stocks has driven the yield spread back below 2%. Meanwhile, small and mid-cap stocks have much better relative valuations, with S&P reporting their 2023 P/E ratios as 13.7 and 14.3, respectively.

Pressure is building in the S&P 500 for a breakout, which we believe will be to the upside. The index is poised to challenge the February high at 4,180. Meanwhile, it has exhibited a series of higher lows since bottoming intraday around 3,500 in October 2022. There continues to be plenty of support below, especially around 4,030 (50-day moving average), 3,965 (200-day moving average), and 3,800 (December 2022 and March 2023 lows). Resistance above should be around 4,300 (August 2022 high) and 4,600 (March 2022 high). The ultimate resistance should be around the all-time closing high near 4,800.

The annual update of our universe of stocks confirmed many of last year's picks and revealed some potential new opportunities. We analyzed a total of 1,593 companies with a cumulative market capitalization of $42.8 trillion. Our research identified "our universe", which is comprised of stocks we believe to have the best risk/reward prospects (based on a combination of low valuation, low beta, low debt to market cap, and high dividend yield). This year, 82 companies made the cut (versus 73 companies in 2022 and 65 in 2021). Our stocks have the following market cap ranges: <$1B (22 stocks), $1B to $5B (16 stocks), $5B to $20B (16 stocks), $20B to $100B (17 stocks), and >$100B (11 stocks). While growth and index investors chase mega-cap technology stocks back to stratospheric valuations, there are many unloved stocks spanning all market caps and sectors for active value investors to love.