"Opportunities Abound"

Market Commentary – December 2023

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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 5.2% in the third quarter of 2023. Even though this is greater than the advance estimate of 4.9%, a mix of strengths and weaknesses drove the 0.3% increase between estimates. A sign of strength is that investment contributed +1.82 percentage points in the second estimate, up from +1.47 percentage points in the advance estimate. Moreover, inventories only contributed +0.08 percentage point of this increase from +1.47 to +1.82. On the other hand, consumer spending only generated +2.44 percentage points in the second estimate, down from +2.69 percentage points in the advance estimate. Given that consumer spending is historically 70% of GDP in the U.S., +2.44 percentage points corresponds to GDP growth of only 3.5% (not 5.2%).

On November 1, the Federal Open Market Committee (FOMC) maintained its benchmark federal funds rate at a target range of 5.25% to 5.5%. It is becoming increasingly clear that the Fed is done with this rate hike campaign. In fact, futures markets are pricing in a 0.25% *cut* in the federal funds rate by May 2024 and 1.25% in cuts by February 2025. Of course, futures markets may have an incorrect read of the situation, but at a minimum they telegraph market expectations. As for the Fed's balance sheet, assets were trimmed from $7.908 trillion on October 25 to $7.811 trillion on November 22, down $97 billion (true to the Fed's commitment to reduce the balance sheet by $95 billion per month). Still, there is a long way to go to get to the pre-COVID-19 low of $3.76 trillion from September 2019. The next FOMC announcement on monetary policy is scheduled for December 13.

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 $242.54, which implies a price-to-earnings (P/E) ratio of 18.8 with the S&P 500 at 4,568. The earnings yield (E/P) of 5.31% represents fair value relative to the 10-year U.S. Treasury note yield of 4.37%. The yield spread is 0.94%. The seven largest companies in the S&P 500 make up $11.7 trillion of the $40.3 trillion index market capitalization with a weighted P/E of 30.8. If 29.1% of the index has a P/E of 30.8, then 70.9% of the index has a P/E of 13.9 for the overall P/E to be 18.8. A P/E of 13.9 is an E/P of 7.17%, which is attractive compared to the 10-year Treasury note yield of 4.37% (a yield spread of 2.80%).

As the S&P 500 technical pattern was on the verge of breaking down, along came a strong November rally from out of nowhere. While technical analysis is helpful for modeling the cumulative behavior of market participants, it is far from being a flawless prediction tool. The November rally shows that market sentiment changed dramatically. The S&P 500 launched from a low of 4,103 on October 27 (old resistance from February and April 2023 became new support) to a high of 4,568 on November 30 (near resistance from July 2023). If the index can punch through this resistance level, a move to the all-time high near 4,800 from the beginning of 2022 is likely. On the downside, support should exist near the 50-day moving average (4,354), the 200-day moving average (4,284), and at 4,100 (October 2023 low).

Seasonal factors are at play during this part of the calendar year. It is common to see tax-loss selling in December in stocks that have been weak in 2023. There may also be some profit-taking in the strongest stocks to offset some of those losses. Valuation models flip from focusing on 2023 earnings to higher 2024 earnings, which drives bullish sentiment. Wall Street is perpetually optimistic on this front, commonly projecting growth for the coming year. For example, S&P projects 2023 S&P 500 EPS of $214.33, while it sees $242.54 in 2024 (13% growth). The forecast of higher earnings going forward helps propel the bulls. A visit to Wall Street from jolly old St. Nicholas does not hurt, either (positive sentiment). In recent years, we have seen investment style popularity change in December and January. Perhaps this will be a catalyst to switch from overvalued mega-cap tech stocks to multi-cap value, where opportunities abound.