“Fed-Induced Turbulence”
Market Commentary – July 2022

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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. decreased at an annual rate of -1.6% in the first quarter of 2022. This is lower than the advance estimate of -1.4% and the second estimate of -1.5%. On June 15, the Federal Reserve revised its economic projections that were last released in March. It now sees GDP growth of 1.7% in 2022, 1.7% in 2023, 1.9% in 2024, and 1.8% in the “longer run” (beyond 2024). The 2022 estimate plummeted from 4.0% in December to 1.7% in June, an unusually large drop in only six months. The economy is falling off the track rather quickly, and Wall Street is worried that the economy is already in recession. As a refresher, the National Bureau of Economic Research (NBER) officially decides the start and stop dates for business cycles in the United States. Historically, the NBER is notorious for calling economic cycles using their rearview mirror, rather their windshield.

The Federal Reserve is determined to wreck inflation, but they may wreck the U.S. economy in the process. On June 15, the Federal Open Market Committee (FOMC) raised its benchmark federal funds rate by a whopping 0.75%, the largest increase since 1994. The rate now sits in a target range of 1.5% to 1.75%. Futures markets predict the federal funds rate will peak at a range of 3.25% to 3.5% by January. This means another 1.75% in rate hikes awaits. The Fed itself projects the federal funds rate at 3.4% by the end of 2022 and 3.8% by the end of 2023. Futures markets disagree with the 2023 assessment, forecasting the rate around 3.0% by the end of 2023. All of the Fed’s action seems to be with interest rates thus far. As of June 22, the Fed’s balance sheet curiously had $8.934 trillion in assets (*higher* than $8.914 trillion on May 25). What happened to the balance sheet reductions they promised?

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 $239.33, which implies a price-to-earnings (P/E) ratio of 15.8 with the S&P 500 at 3,785. The earnings yield (E/P) of 6.32% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.98%. The spread between the earnings yield and 10-year Treasury has jumped up to 3.34%, thanks to higher earnings estimates and falling stock prices. If the economy is in a recession (or about to enter one), the higher earnings estimates may be overly optimistic. Still, it is amazing how almost mechanical it is that higher interest rates cause lower valuations.

Financial news cited at today’s market close that the first half of 2022 was the worst for the S&P 500 since 1970, as the index has plummeted -20.6% year-to-date (without dividends). The S&P 500 is firmly in a downtrend, marked by lower highs and lower lows. Indeed, the S&P 500 did peter out around 4,170 (March low) and decisively sliced through the May closing low of 3,900 to bottom around 3,670 in June. The index then rallied in June to just above 3,900 and currently sits at 3,785. Technicians will be watching for whether support at the 3,670 low will hold in the coming weeks. Many companies will be announcing 2022 Q2 earnings in July, so there will be catalysts for exaggerated stock market movements. The Fed’s continued aggressive rate hikes are not helping bullish stock investors.

The outperformance gap that growth stocks (led by mega-cap technology) enjoyed over value stocks from 2017-2021 continues to erode. To illustrate this pattern, we have been comparing the cumulative returns of the S&P 500 Large Cap Growth index with the S&P 500 Large Cap Value index (both without dividends). From January 1, 2017 to December 31, 2021, the growth index was up +176.1% versus +54.7% for the value index, for a spread of +121.4%. From January 1, 2017 to June 30, 2022, this spread has collapsed from +121.4% to +63.5%. We maintain that the future for growth stocks is bleak in the face of an aggressive Fed, although value stocks were not spared from pain in June. The overall portfolio at Banyan Asset Management has a 10.4 P/E on 2022 EPS, 1.0 beta, and 5.4% dividend yield. The dividend yield helps somewhat smooth the Fed-induced turbulence, which is expected for a few more months.