“Economic Crosscurrents”

Market Commentary – November 2021

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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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 2.0% in the third quarter of 2021. This is significantly lower than the second quarter reading of 6.7%. The components of the 2021 Q3 GDP number are: consumer spending +1.09 percentage points, investment +1.94 percentage points, net exports -1.14 percentage points, and government spending +0.14 percentage point. The sum of these numbers equals +2.03%. In 2021 Q2, consumer spending fueled GDP by +7.92 percentage points, so a drop to +1.09 percentage points is very significant. Digging deeper into this collapse, consumer spending on goods (durable and nondurable) hit a brick wall, weighing on GDP by -2.32 percentage points (the worst showing since 2008 Q4). Investment was helped by the change in private inventories, adding +2.07 percentage points to GDP. Intuitively it makes sense that inventories would build if companies continued producing while consumer spending on goods plummeted. The economy is battling a variety of crosscurrents, including supply chain disruptions, labor shortages, inflation, COVID-19 variants, and more.

Will the Federal Open Market Committee (FOMC) finally announce its long-anticipated tapering of bond purchases in its monetary policy statement scheduled for November 3? Growing by $120 billion per month, the Fed’s balance sheet has ballooned to a whopping $8.56 trillion in assets (as of October 25). This is in addition to keeping the federal funds rate at a rock-bottom target range of 0%-0.25%. Comments in recent weeks about the Fed tapering its future bond purchases have been exploratory in nature, but November could be when tapering plans are finally announced. The pace of tapering will be crucial, as well as expectations about the timing of future hikes in the federal funds rate. Fed funds futures are pricing in a 0.25% rate increase by September 2022, followed by three more 0.25% hikes in 2023. In its September projections, the Fed itself predicted a median federal funds rate of 1.0% by 2023, 1.8% by 2024, and 2.5% in the “longer run” (beyond 2024). We are closer to the end of this loose monetary policy period.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively 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 $212.15, which implies a price-to-earnings (P/E) ratio of 21.7 with the S&P 500 at 4,605. The earnings yield (E/P) of 4.61% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.55%. Stocks have become relatively less attractive over the past month, as the spread between the E/P and the 10-year Treasury fell from 3.38% to 3.06%. This happened because stock prices rose while Treasury yields stayed approximately flat.

The S&P 500 resumed its uptrend as it pushed to a new all-time high in October. The technical position of the S&P 500 was looking shaky at the end of September. The index was trading below its 50-day moving average (albeit above the 200-day moving average). This would have been a logical place for the index to break down technically. Instead, a strong rally in October pushed the index to new all-time highs. It seems like the moment we get a modest pullback in stock prices, investors rush back in to buy stocks. Since the S&P 500 is currently sitting at an all-time high, there is no technical resistance above. The index should find support around 4,540 (early September peak), 4,460 (50-day moving average), and 4,210 (200-day moving average).

Large cap growth stocks have gained momentum as 2021 has progressed as many investors believe the rich valuations of growth stocks are justified. There is reason for caution on this front. From January 1, 2017 through October 29, 2021, the S&P 500 Large Cap Value index has returned +50.0% (without dividends). In contrast, the S&P 500 Large Cap Growth index has returned +166.0% (without dividends). This spread of 116% highlights how lopsided the stock market has become in recent years. There is room for value stocks to rise, and/or growth to fall, in price. We are staying true to our investment style of focusing on attractive valuations, juicy dividends, and strong corporate balance sheets (low debt).