"The Achilles' Heel Of Investors"

Market Commentary – February 2024

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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 3.3% in the fourth quarter of 2023. This is lower than 4.9% growth in 2023 Q3. The components of the 2023 Q4 GDP number are: consumer spending +1.91 percentage points, investment +0.38 percentage point, net exports +0.43 percentage point, and government spending +0.56 percentage point. The sum of these numbers equals +3.28%. Overall, this is a decent reading. Consumer spending accounted for 58% of GDP; lighter than the typical 70%, but not awful. Investment figures were mildly positive, with the volatile change in private inventories only contributing +0.07 percentage point to GDP. With a recession commonly viewed as two consecutive quarters of negative GDP growth, the U.S. economy is seemingly chugging away. Recall that the National Bureau of Economic Research is officially in charge of "business cycle dating" (i.e., determining when the economy is in recession). The last recession in the U.S. was from February to April 2020, when the global economy became infected with COVID-19. Prior to that, the last recession spanned from December 2007 to June 2009 – a period some refer to as the "Great Recession".

This afternoon, the Federal Open Market Committee (FOMC) maintained its benchmark federal funds rate at a target range of 5.25% to 5.5%. In a press conference immediately following the monetary policy announcement, Fed Chair Jerome Powell said, "we believe that our policy rate is likely at its peak for this tightening cycle and that, if the economy evolves broadly as expected, it will likely be appropriate to begin dialing back policy restraint at some point this year." Fed funds futures markets see the first 0.25% cut by May. Moreover, futures predict the federal funds rate 1.75% lower by April 2025. Meanwhile, the Fed's balance sheet had $7.677 trillion in assets on January 24, down only $36 billion from $7.713 trillion on December 27. This is much less than the Fed's commitment of $95 billion per month. Will the Fed pick up the pace of its balance sheet reduction in February or is this a sign of a reduced commitment? The next FOMC announcement on monetary policy is scheduled for March 20.

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) through December 31, 2024 is $240.08, which implies a price-to-earnings (P/E) ratio of 20.2 with the S&P 500 at 4,846. The earnings yield (E/P) of 4.95% represents fair value relative to the 10-year U.S. Treasury note yield of 3.99%. The yield spread is 0.96%. Seven of the eight largest companies in the S&P 500 make up $12.3 trillion of the $42.7 trillion index market capitalization with a weighted P/E of 30.7. If 28.8% of the index has a P/E of 30.7, then 71.2% of the index has a P/E of 15.9 for the overall P/E to be 20.2. A P/E of 15.9 is an E/P of 6.28%, which is attractive compared to the 10-year Treasury note yield of 3.99% (a yield spread of 2.29%).

The S&P 500 closed at an all-time high of 4,927 on January 29, blasting past the old all-time high of 4,796 from January 2022. The tide, however, is not lifting all boats, as strength is once again very lopsided toward growth and mega-cap technology stocks. The S&P 500 dropped 1.6% on January 31, fueled by disappointment that the Fed is not cutting interest rates in March. While this could be a mere temper tantrum, stocks did close decisively lower on higher volume. Market technicians call this a *distribution day*, and it could be a sign of further weakness. Stocks are ripe for a correction. Support below should be found near 4,711 (50-day moving average), 4,590 (July 2023 high), and 4,434 (200-day moving average).

Market participants who bid certain stocks to sky-high valuations justify their "logic" with their love of particular stories. Growth stocks, especially mega-cap technology stocks, are infected with this malaise. The irony is that these investors are valuing emotion more than logic. Logic will tell you that a company cannot grow its revenue faster than GDP in perpetuity, but emotion may lead you to believe it can happen…especially "this time". Emotion is the Achilles' heel of investors.