"The Fed's Conundrum"

Market Commentary – October 2021

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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. grew at an annual rate of 6.7% in the second quarter of 2021. This is higher than the advance estimate of 6.5% and the second estimate of 6.6%. On September 22, the Federal Reserve revised its economic projections that were last released in June. It now sees GDP growth of 5.9% in 2021, 3.8% in 2022, 2.5% in 2023, 2.0% in 2024, and 1.8% in the "longer run" (beyond 2024). Note that the 2021 estimate dropped from 7.0% to 5.9%, while the 2022 estimate was nudged up from 3.3% to 3.8%. Overall, economic growth is robust.

On September 22, the Federal Open Market Committee (FOMC) maintained its ultra-accommodative monetary policy with the federal funds rate at a target range of 0%-0.25% and the Fed's balance sheet growing by $120 billion per month. As of September 29, there were $8.45 trillion of assets on the Fed's balance sheet ($0.12 trillion higher than August 25). For purposes of historical comparison, the Fed expanded its balance sheet from $0.9 trillion in mid-2008 before the 2008-2009 financial crisis to about $4.5 trillion in late 2014. Since the economy had recovered, the balance sheet was allowed to decay to $3.8 trillion by mid-2019. Facing an inverted yield curve and economic headwinds, the Fed's balance sheet slowly expanded to $4.2 trillion by February 2020. The Great Cessation, courtesy of COVID-19, caused the balance sheet to explode to its current level of $8.45 trillion (an all-time high).

The Fed has a growing conundrum: continue with massive monetary stimulus given economic uncertainty and shockwaves from COVID-19 or cut back on monetary stimulus to tame inflation. The Fed seeks to achieve maximum employment and inflation of 2% in the long run. Unemployment was 5.2% in August 2021, which is significantly higher than the pre-COVID level of 3.5% in February 2020. This augurs for more monetary stimulus. Inflation is presenting a problem, though. In June, the Fed projected Personal Consumption Expenditures "PCE" inflation at 3.4% in 2021 and 2.1% in 2022. In September, the Fed raised its forecasts to 4.2% in 2021 and 2.2% in 2022. Fed officials have maintained that inflation pressures in recent months would be transitory, but inflation has proven to be more stubborn than expected. Financial markets will eventually need to be weened off of Federal Reserve support. The next announcement on monetary policy is scheduled for November 3.

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 $211.17, which implies a price-to-earnings (P/E) ratio of 20.4 with the S&P 500 at 4,308. The earnings yield (E/P) of 4.90% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.52%. Earnings have normalized since the Great Cessation, so we are reverting back to our traditional process of looking at EPS over the next 12 months. Higher earnings and lower stock prices in September have caused the spread between E/P and the 10-year Treasury to jump from 3.09% to 3.38% (making stocks more attractive).

The technology-heavy S&P 500 hit a stumbling block in September and stopped its pattern of higher highs and higher lows. After peaking at 4,537 on September 2, the S&P 500 breached its 50-day moving average on September 20. It rallied back to the 50-day moving average and fell from there (old support became new resistance). It remains to be seen whether this is a blip or the start of something nastier. Future resistance should be near 4,440 (50-day moving average) and 4,537 (all-time closing high), while future support should be near 4,165 (April/May resistance and June support) and 4,135 (200-day moving average). A breach of the 200-day moving average would represent significant psychological damage to investors and could lead to a violent wave of technical selling. In the meantime, we are comfortable owning our value stocks. The overall portfolio at Banyan Asset Management has a 11.4 P/E on 2022 EPS, 1.0 beta, and 4.3% dividend yield. These fundamental factors should become increasingly valuable in a selloff.