"Partying Like It's 1999"

Market Commentary – July 2020

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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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 -5.0% in the first quarter of 2020. This is the same as the second estimate and lower than the advance reading of -4.8%. On June 10, the Federal Reserve revealed its first economic forecast since December 2019. In December, the Fed projected real GDP growth of 2.0% in 2020, 1.9% in 2021, 1.8% in 2022, and 1.9% in the "longer run" (beyond 2022). As of June 10, these values were revised to -6.5%, 5.0%, 3.5%, and 1.8%. GDP readings in 2020 are truly historic, and the 2020 Q2 result to be announced in late July will likely blow away the worst readings from the Great Depression.

While the economic numbers are scary, investors should remember the adage "don't fight the Fed". On June 10, the Fed announced its expectation to keep the federal funds rate at a rock-bottom range of 0% to 0.25% at least through 2022. Its balance sheet has ballooned from $4.2 trillion in February to an unprecedented $7.1 trillion today. The Fed is also considering "yield curve control", which differs from quantitative easing ("QE"). With QE, the Fed attempts to lower interest rates by buying bonds in a fixed dollar amount. With yield curve control, the Fed tries to drive bond yields to pre-determined levels by buying bonds of various maturities in variable dollar amounts (i.e., by buying as many bonds as needed whenever necessary to lower yields to their desired target). If Treasury rates start to rise by market forces, the Fed could use yield curve control to try to suppress them. One thing is clear: The Fed remains extremely accommodative. The next monetary policy announcement is scheduled for July 29.

The mega-cap technology stock bubble has been brewing for some time, with 2020 possibly being the "blow-off" top (a rapid rise followed by a rapid decline). On December 31, 1999, which was near the peak of the last technology stock bubble, the Technology and Telecommunication sectors combined made up 37% of the S&P 500. By October 2002, they had collapsed to less than 17% of the index. Over the next 14 years, Technology became 21.5% of the S&P 500 and Telecommunication was 2.5% (24% combined). In September 2018, S&P reconfigured the stodgy Telecommunication sector by reallocating some mega-cap tech stocks into it and renaming it "Communication Services". Investors who had maxed their allocation to technology suddenly had a "stealth" way to invest even more in technology – under the guise of "Communication Services". As of June 30, 2020, Technology is 27.5% and Communication Services is 10.8% (38.3% combined, which is eerily similar to the 1999 peak). The cult-like popularity of index investing is magnifying this bubble. Someone who buys an S&P 500 index fund blindly allocates 38% of their money to these two sectors *without considering their valuations*. Does that sound wise?

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) during 2021 is $161.51, which implies a price-to-earnings (P/E) ratio of 19.2 with the S&P 500 at 3,100. The earnings yield (E/P) of 5.21% represents attractive value relative to the 10-year U.S. Treasury note yield of 0.66%. With the five largest mega-cap companies (all technology) having P/E ratios ranging from 25 to 75, the overall P/E of the S&P 500 index is deceptively skewed higher. There are amazingly cheap value stocks available for savvy investors to buy.

After some consolidation in June, stocks may be poised for their next leg higher. The S&P 500 is resting near major support from the 50-day and 200-day moving averages (2,989 and 3,022, respectively). The biggest opportunities, however, rest with value stocks. In the first half of 2020, the value indexes were all down significantly for the year (S&P 500 Large Cap Value -16.8%, S&P 400 Mid Cap Value -22.0%, and S&P 600 Small Cap Value -25.3%, without dividends). Low valuations and juicy dividend yields make the situation even more appealing (subject to an investor's unique risk profile, of course). Investors in mutual funds should verify whether an undesirable over-allocation to technology lurks under the hood.