"Great Cessation Shockwaves"

Market Commentary – August 2022

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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. decreased at an annual rate of -0.9% in the second quarter of 2022. Following the decline of -1.6% in 2022 Q1, this is now the second consecutive quarter of negative GDP growth. Economists commonly use the metric of two consecutive quarters of GDP contraction to define a recession. The official calling of a recession is decided by the National Bureau of Economic Research (NBER). Curiously, the recession may be over by the time the NBER identifies it. While the economy is in a slowdown, inflation is running hot. The U.S. Bureau of Labor Statistics reported that the Consumer Price Index (consumer inflation) jumped 9.1% in June year-over-year (largest since November 1981). The Producer Price Index (producer inflation) skyrocketed by 11.3% in June year-over-year (largest since record 11.6% in March 2022). Meanwhile, unemployment in June was locked in for a fourth consecutive month at 3.6% (low by historical standards). The unprecedented monetary and fiscal stimulus injected for the COVID-19 Great Cessation was destined to create unusual shockwaves.

The Federal Reserve is tightening monetary policy to attack inflation, but they are also using optics as a tool. On July 27, the Federal Open Market Committee (FOMC) raised its benchmark federal funds rate by yet another 0.75%, matching the increase on June 15. The rate is now in a target range of 2.25% to 2.5%. Futures markets predict additional 50 basis point and 25 basis point hikes in September and December, but then the federal funds rate should peak at a range of 3.0% to 3.25%. The rate hikes are real and are intended to cool inflation. The Fed's chatter about the reducing the bloated $8.9 trillion balance sheet seems to be optics thus far. In May, they announced plans to reduce assets by $47.5 billion per month starting June 1 and increasing to $95 billion per month after three months. The Fed had $8.914 trillion on its books on May 25 and $8.890 trillion on July 27. Where are the reductions? Why are financial news outlets not reporting this? The next announcement on monetary policy is scheduled for September 21.

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 $237.19, which implies a price-to-earnings (P/E) ratio of 17.4 with the S&P 500 at 4,130. The earnings yield (E/P) of 5.74% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.67%. The spread between the earnings yield and 10-year Treasury has compressed to 3.07% (the average over the past 12 months is 3.08%). The Treasury market is clearly not convinced that long-term interest rates will follow short-term interest rates. If long-term Treasury prices collapse and yields skyrocket, stocks will tank (not our reality at this point). There is also the risk that overly optimistic earnings estimates could be cut should the recession deepen.

The S&P 500 chart made two bullish moves in July. First, the index failed to violate its June closing low of around 3,670. This can now be viewed as an area of support. Second, after that successful test of the June low, the index closed decisively above its 50-day moving average for the first time since early April. Formidable resistance is ahead, particularly from the late-May peak of 4,175 and the 200-day moving average at 4,350. A further bullish development would be the index blasting through resistance levels on high volume, or the next correction occurring on low volume relative to the recent rally.

Portfolio management is less about predicting the future and more about planning for it. There are three things that the stock market can do: go up, go down, or stay flat. Most investors have a strategy for the market going up: own stocks. Where investors tend to fail, however, is with the other two scenarios. At Banyan Asset Management, our plan for a falling stock market is to utilize cash as a conservative way to short stocks. Cash can help *incrementally* buy stocks while they are on sale. In a sideways market, a juicy dividend yield generates an attractive income stream while also providing a degree of downside protection. Covered calls can augment portfolio income, while creating a disciplined way to "sell high".