“Importance Of Defense”

Market Commentary – September 2024

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The second 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 3.0% in the second quarter of 2024. This is stronger than the advance estimate of 2.8% and 1.4% in 2024 Q1. The Federal Reserve has a dual mandate, according to the Federal Reserve Reform Act of 1977, to promote stable prices and maximum employment. The current Fed quantifies “stable prices” as “inflation at the rate of 2% over the longer run”. The Consumer Price Index (CPI), which measures inflation in consumer prices, was 2.9% in July. While greater than 2%, this is the lowest value since peaking at 9.0% in June 2022. The trend is down. Unemployment, on the other hand, has been trending higher. It measured 4.3% in July, greater than the trough reading of 3.4% in April 2023. During a speech on August 23 in Jackson Hole, Wyoming, Fed Chair Jerome Powell stated, “We do not seek or welcome further cooling in labor market conditions.” The Fed’s primary focus has shifted from reducing inflation to preventing a further spike in unemployment.

The Fed is on the cusp of a new campaign to slash the federal funds rate, which is being celebrated by the stock market. In his speech on August 23, Powell said that “The time has come for policy to adjust. The direction of travel is clear, and the timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks.” Futures markets have priced in a 0.25% cut at the next Federal Open Market Committee (FOMC) announcement on monetary policy scheduled for September 18, followed by two more 0.25% cuts by the end of 2024 (0.75% total). Interestingly, futures markets now expect a series of cuts totaling 2.25% by January 2026 (0.5% more than one month ago). The Fed’s balance sheet had $7.123 trillion in assets on August 28, down $82 billion from July 24 (more than the Fed’s reduction commitment of $60 billion per month).

The U.S. Treasury yield curve, which has been inverted since early 2022, indicates that the Fed is “too tight” on monetary policy. The following were U.S. Treasury yield curve rates as of August 30: 5.21% 3-month, 4.38% 1-year, 3.91% 2-year, 3.71% 5-year, 3.91% 10-year, and 4.20% 30-year. The yield curve “inverts” when short-term interest rates are higher than long-term interest rates. Subtracting 2.25% from the 3-month Treasury would drop the yield to 2.96%, possibly curing the inversion. While yield curve inversions are often observed prior to recessions, the inversion over the past two years was seemingly a shockwave from COVID-19 fiscal and monetary stimulus (stimulus caused inflation, thus requiring higher interest rates to cool inflation). Years after COVID-19, we are still seeking “normal”.

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 September 30, 2025 is $267.03, which implies a price-to-earnings (P/E) ratio of 21.2 with the S&P 500 at 5,648. The earnings yield (E/P) of 4.73% represents fair value relative to the 10-year U.S. Treasury note yield of 3.91%. The yield spread is 0.82%. Seven of the eight largest companies in the S&P 500 make up $15.7 trillion of the $49.9 trillion index market capitalization with a weighted P/E of 30.5. If 31.4% of the index has a P/E of 30.5, then 68.6% of the index has a P/E of 16.9 for the overall P/E to be 21.2. A P/E of 16.9 is an E/P of 5.92%, which is attractively priced compared to the 10-year Treasury note yield of 3.91% (a yield spread of 2.01%).

After pulling back 9.1% from July 16 to August 5 on high volume, the S&P 500 rallied back to near its high…but on lighter volume. Market technicians view volume as giving credibility to the strength of a price move (up or down). If market internals were healthy, the bounce up from August 5 to August 30 would have been on higher volume than the preceding decline. It was not. Moreover, the index would have pushed to new highs. The market seems ripe for another sell-off. September and October are dicey months for the stock market. In general, our portfolios are heavier than usual with cash. As football season ramps up again, it is critical to acknowledge the importance of defense in winning games.