"The Fed Blinked"

Market Commentary – February 2019

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Written January 31, 2019 – www.banyan-asset.com

The partial government shutdown forced the U.S. Bureau of Economic Analysis to delay the release date for the advance estimate of Gross Domestic Product (GDP) for the fourth quarter of 2018. While the exact release date has not yet been determined, it will likely be in the next week or two. Meanwhile, in its regularly scheduled announcement on monetary policy on January 30, the Federal Open Market Committee (FOMC) wrote that "economic activity has been rising at a solid rate". It added that "household spending has continued to grow strongly, while growth of business fixed investment has moderated from its rapid pace earlier last year." The FOMC expects "sustained expansion of economic activity, strong labor market conditions, and inflation near (its) 2 percent objective as the most likely outcomes."

A major clue that the Federal Reserve "blinked" (i.e., caved to stock market weakness) happened live on television on January 4 during an interview with Fed Chair Jerome Powell and past Fed Chairs Janet Yellen and Ben Bernanke. Powell stated "we're listening carefully to the message that markets are sending". Moments later the stock market took off like a rocket, with the S&P 500 rising more than 3% that day. The FOMC announcement on January 30 confirmed this dovish tone, leaving its federal funds rate alone and stating that "in light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate." Fed funds futures currently project that the Fed is done tightening interest rates for this cycle. The next FOMC announcement on monetary policy is scheduled for March 20.

Our hypothesis has been that the Federal Reserve's tightening monetary policy was holding back the stock market. President Trump had correctly identified this as well. As Federal Reserve Bank of Kansas City President and CEO Esther George hauntingly warned the Forum Club of Southwest Florida in February 2014, unwinding the unprecedented accommodative monetary policy will be a "turbulent process". She also admitted that we are in uncharted waters regarding economic policy. This is seemingly coming true. Fed Chair Jerome Powell's comments marked the peak of the stock market in October 2018 and they nearly marked the bottom of the recent sharp decline. While there are plenty of other legitimate concerns in the world economy, the biggest by far was the Federal Reserve raising interest rates. Time will likely prove to be an asset rather than a liability, allowing the Fed to gradually shrink its bloated balance sheet and ween society off low interest rates. Investors should brace for more volatility (both up and down).

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 $168.49, which implies a price-to-earnings (P/E) ratio of 16.0 with the S&P 500 at 2,704. The earnings yield (E/P) of 6.23% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.64%. Earnings estimates have been coming down, so that trend will need to be carefully observed in the coming months.

Having bounced higher in January as violently as they declined in December, stocks are more likely to consolidate recent gains and tread water going forward. The S&P 500 pierced through strong resistance around 2,580, so that should now act as an area of support. Overhead, the 200-day moving average (2,741) and the November highs (around 2,800) should be important resistance levels.

Once again, the concepts of "balanced" and "incremental" have proven to be valuable tools in our toolbox. When the market was collapsing in December, the fact that we had cash allowed us to press on the gas pedal. Not only did we have the cash to buy, but we also had the psychological willingness to buy while others were panicking and selling. This is a simple and effective way to gain an important competitive advantage over other market participants.