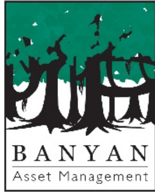

"Investment Zen"

Market Commentary – September 2022

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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. decreased at an annual rate of -0.6% in the second quarter of 2022. This is better than the advance estimate of -0.9% and the 2022 Q1 reading of -1.6%, but it is still negative. The components of the 2022 Q2 GDP number are: consumer spending +0.99 percentage point, investment -2.67 percentage points, net exports +1.42 percentage points, and government spending -0.32 percentage point. The sum of these numbers equals -0.58%. Consumer spending, which historically is 70% of GDP in the U.S., was weak. (If a decent GDP reading is 3%, then consumer spending should be about 2.1%.) While the volatile measurement of inventory weighed on investment by -1.83 percentage points, investment ex-inventory was still terrible. Inflation continues to roar, with the July Consumer Price Index coming in at a scorching 8.5% year-over-year and the July Producer Price Index even hotter at 9.8% year-over-year. The hangover from the debt binge of historic accommodative fiscal and monetary policies has stoked inflation and brought the U.S. economy to a screeching halt.

The Federal Reserve is no longer friendly to the stock market as it remains focused on tackling inflation. On August 26 in a speech at Jackson Hole, Wyoming, Fed Chairman Jerome Powell said the Fed will "use our tools forcefully" to attack inflation and warned of pain ahead for households and businesses due to higher interest rates, slower growth, and softer labor market conditions. Futures markets now see the federal funds rate peaking in May 2023 at a range of 3.75% to 4.0%, up 0.75% from the peak predicted last month. Meanwhile, the Fed's balance sheet is contracting, but the rate seems slower than announced. The Fed had $8.914 trillion in assets on May 25 and it had $8.851 trillion as of August 24 (down $63 billion). The Fed was supposed to reduce assets by $47.5 billion *per month* starting June 1, ramping up to $95 billion per month starting September 1. The next announcement on monetary policy is scheduled for September 21. Investors should expect a more hostile Fed in the coming months.

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 $235.64, which implies a price-to-earnings (P/E) ratio of 16.8 with the S&P 500 at 3,955. The earnings yield (E/P) of 5.96% represents attractive value relative to the 10-year U.S. Treasury note yield of 3.15%. The spread between the earnings yield and 10-year Treasury has shrunk to only 2.81%. Earnings estimates dropped slightly over the past month while the 10-year Treasury yield jumped higher by 0.48%. The yield curve has decisively inverted, with the 2-year Treasury yielding 3.45% versus the 10-year yield of 3.15%. Despite the recent increase in the 10-year yield, Treasury markets are still not convinced that rates will stay high for long.

The S&P 500 chart seems to be in a trading range as investors digest recent economic data. The index rose to its 200-day moving average in mid-August and has been falling on light volume ever since. This does not indicate panic in the stock market, but rather a trading range. We are assuming that the June low around 3,670 will hold as support. Should that be breached, however, a severe wave of selling on high volume would likely follow. We are aware of the risk of bearish headlines that seem to be associated with the months of September and October.

In a noisy and volatile world for investors, it helps to maintain a sense of calm. Squelching emotion keeps us logical when other investors are falling victim to their own psychological biases. Maintaining a balance in a portfolio between stocks and cash helps keep emotions in check. There is a plan for the market rising, falling, and staying flat. Still, we must deal with a constant barrage of information. Much of it is noise and should be ignored. Financial news channels are among the worst offenders, with their use of bright colors and loud sounds to animate their programs. A growling red bear or a jubilant green bull are boldly displayed on the screen to highlight the theme of the day. Sometimes it is best to turn the TV off.