"Buckle Up!"

Market Commentary – October 2022

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written September 30, 2022 – www.banyan-asset.com

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 -0.6% in the second quarter of 2022. In comparison, the 2022 Q2 advance estimate was -0.9%, the second estimate was -0.6%, and the 2022 Q1 reading was -1.6%. On September 21, the Federal Reserve revised its economic projections that were last released in June. It now sees GDP growth of 0.2% in 2022, 1.2% in 2023, 1.7% in 2024, 1.8% in 2025, and 1.8% in the "longer run" (beyond 2025). In December 2021, the Fed forecasted 2022 GDP at 4.0%. Despite having a staff of talented economists, the Fed was drastically wrong.

The Federal Reserve is aggressively using monetary policy to try to tame inflation. On September 21, the Federal Open Market Committee (FOMC) raised its benchmark federal funds rate by 0.75% for the third time since June, to a target range of 3.0% to 3.25% (the highest since January 2008). Looking forward, the Fed "anticipates that ongoing increases in the target range will be appropriate." Futures markets see the fed funds rate peaking in April 2023 at 4.5% to 4.75%, 1.75% higher than a peak of 2.75% to 3.0% predicted on May 31. As for the Fed's balance sheet, assets have contracted from $8.914 trillion on May 25 to $8.796 trillion on September 28 (down $118 billion). The Fed was supposed to reduce assets by $47.5 billion per month starting June 1, and $95 billion per month starting September 1. In other words, assets should be $237.5 billion lower by now, nearly twice the actual reduction of $118 billion. This slower pace does not receive any attention by the financial media (or explanation by the Fed). The next announcement on monetary policy is scheduled for November 2.

Higher interest rates are generating only *temporary* relief from high commodity prices, including energy. Investors worldwide want to earn the highest interest rates possible with the least amount of risk. U.S. Treasuries, considered in financial theory to be "risk-free" (i.e., it is extremely unlikely that the U.S. would ever default), are now generating attractive yields (e.g., 4.05% for one year). To buy U.S. Treasuries, however, investors first need to buy U.S. dollars. High demand makes the U.S. dollar strong relative to other currencies (lots of buyers of dollars and sellers of other currencies). When the U.S. dollar is *strong*, it takes *fewer* dollars to buy commodities (e.g., a barrel of oil). Note how oil peaked around $120/barrel and it is now about $80/barrel. Short-term, this feels good for consumers. However, once interest rates rise in other parts of the world, the U.S. dollar will weaken and commodity prices will shoot back up. The long-term solution to lowering oil prices, although politically unpopular, is to drill more oil (boost supply).

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are bearish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $233.98, which implies a price-to-earnings (P/E) ratio of 15.3 with the S&P 500 at 3,586. The earnings yield (E/P) of 6.53% represents attractive value relative to the 10-year U.S. Treasury note yield of 3.83%. Despite the weak performance of stocks in September, the spread between the earnings yield and 10-year Treasury actually contracted to 2.70%. Should 2023 earnings estimates get cut, stock prices would likely follow suit.

The S&P 500 broke the June low of 3,670, which increases the chance of another leg down for stock prices. Additional support levels will likely be found around 3,530 (October 2020 high), 3380 (February 2020 high), and 3,240 (September and October 2020 lows). With the 50-day and 200-day moving averages at 4,012 and 4,213 respectively, stocks are in a serious downtrend. October is famous for "capitulation lows", and 2022 is setting up for that possibility (which creates huge opportunities for investors with cash). Meanwhile the technology bubble continues to burst. From 2017 to 2021, the S&P 500 Large Cap Growth index earned 121.4% more percentage points than the S&P 500 Large Cap Value index (without dividends). Adding the first nine months of 2022 to this 5-year period, the spread has collapsed to +64.0%. Amazingly, there is still tremendous relative overvaluation in tech stocks to unwind. Buckle up!