"The Elephant In The Room"

Market Commentary – January 2022

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Written December 31, 2021 – 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. grew at an annual rate of 2.3% in the third quarter of 2021. This is higher the advance estimate of 2.0% and the second estimate of 2.1%, but materially lower than the second quarter reading of 6.7%. On December 15, the Federal Reserve revised its economic projections that were last released in September. It now sees GDP growth of 5.5% in 2021, 4.0% in 2022, 2.2% in 2023, 2.0% in 2024, and 1.8% in the "longer run" (beyond 2024). The 2022 estimate has risen from 3.3% in June to 4.0% in December; the Fed sees robust growth in 2022. Inflation is the fly in the ointment, as it continues to run hot. The Consumer Price Index (CPI), a measure of inflation on consumers, jumped 6.8% year-over-year in November (the largest increase since June 1982).

The Fed has been forced to address the elephant in the room: inflation. Many economists blame the Fed's ultra-easy monetary policy for causing the historic spike in inflation and they believe the Fed should put the brakes on monetary policy quickly. In its monetary policy announcement on December 15, the Federal Open Market Committee (FOMC) announced the acceleration of their tapering of bond purchases. Since COVID-19 crashed the global economy in early 2020, the FOMC has been increasing its balance sheet by $120 billion each month. The Fed reduced this to $105 billion in November 2021 and $90 billion in December. It now projects bond purchases of $60 billion in January, $30 billion in February, and none in March (doubling the monthly reduction pace from $15 billion to $30 billion). Still, the FOMC "is prepared to adjust the pace of purchases if warranted by changes in the economic outlook". The Fed's balance sheet contained a record $8.79 trillion in assets as of December 22. Moreover, the Fed is now projecting its federal funds rate will jump from a range of 0%-0.25% to 0.75%-1.0% during 2022 and to 1.5%-1.75% during 2023. It sees the federal funds rate at 2.5% beyond 2024. These moves would hopefully cool inflation. The next FOMC monetary policy announcement is scheduled for January 26.

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 $220.46, which implies a price-to-earnings (P/E) ratio of 21.6 with the S&P 500 at 4,766. The earnings yield (E/P) of 4.63% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.52%. Tax loss selling in December was followed by a stronger-than-expected Santa Claus rally, pushing the S&P 500 to a new all-time closing high of 4,793 on December 29. Support levels should exist around 4,650 (50-day moving average), 4,540 (September peak), and 4,380 (200-day moving average).

Comparing returns of the S&P 500 Large Cap Value and Growth indexes helps illustrate the tremendous opportunities in value stocks. From 2017-2021 (5 years), the S&P 500 Large Cap Value index was up +54.7%, while the corresponding S&P 500 Large Cap Growth index was up +176.1% (both without dividends). This spread of 121.4% suggests a potential bubble in growth stocks. Valuations of the largest growth stocks confirm this bubble. The S&P 500 currently has a total market cap of $42.3 trillion. The five largest companies in the S&P 500 are: Apple ($2.9 trillion market cap, 30.9 P/E), Microsoft ($2.5T, 36.5), Alphabet ($1.9T, 25.8), Amazon.com ($1.7T, 64.6), and Tesla ($1.1T, 125.1). With a combined total market cap of $10.1T, these five companies (only 1% of the companies in the S&P 500) make up 23.9% of the market cap of the index. The weighted average P/E of these five companies is a whopping 47.3, which is significantly higher than the overall S&P 500 P/E of 21.6. If nearly one quarter of the S&P 500 is trading at such rich valuations, there must be companies trading at very attractive valuations. Indeed, the overall portfolio at Banyan Asset Management has a 12.1 P/E on 2022 EPS, 1.0 beta, and 4.5% dividend yield. The question we ask is whether the popping of the mega-cap technology bubble would tank the entire stock market, or cause money to flow to cheaper value stocks. While certainly not immune from downside risk, value stocks can provide a degree of downside protection.