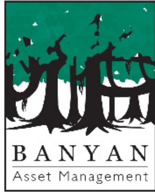

"Uncharted Waters"

Market Commentary – June 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 1.3% in the first quarter of 2024. This is lower than the advance estimate of 1.6% and the 2023 Q4 reading of 3.4%. Given the Federal Reserve's projection of 2.1% for 2024 GDP released on March 20, the Fed sees GDP improving slightly as the year progresses. Meanwhile, inflation and unemployment have bounced off of their lows for this economic cycle. The Consumer Price Index (CPI), which measures inflation in consumer prices, has been rangebound from 3.1% to 3.7% between June 2023 and April 2024 (currently 3.4%). This is stubbornly higher than the Fed's target of 2%. Unemployment has been stable, ranging between 3.4% and 4.0% since December 2021 (currently 3.9%). While the Fed seeks to achieve "maximum employment", extremely low unemployment can fuel inflation as businesses raise wages to attract scarce labor (wage inflation). The Fed therefore welcomes *some* unemployment.

On May 1, the Federal Open Market Committee (FOMC) kept its benchmark federal funds rate at a target range of 5.25% to 5.5%. The federal funds rate has been at this level since July 26, 2023, making good on the FOMC's promise to keep interest rates higher for a longer period of time. Futures markets anticipate the first 0.25% rate cut by December 2024, with a new target range of 4.0% to 4.25% by February 2026 (1.25% in total cuts). Meanwhile, the big news from the FOMC on May 1 was a reduction in the pace of "quantitative tightening" (i.e., shrinking the Fed's balance sheet). The reduction rate of $95 billion per month, in place since September 1, 2022, will be cut to $60 billion per month effective June 1, 2024. Total assets on the Fed's balance sheet peaked at $8.965 trillion in April 2022 and have been slashed by $1.681 trillion to $7.284 trillion on May 29, 2024. Recall that the Fed's balance sheet was only $0.9 trillion prior to the 2008 financial crisis. The next FOMC announcement on monetary policy is scheduled for June 12.

Technical factors of the market are bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) through June 30, 2025 is $258.18, which implies a price-to-earnings (P/E) ratio of 20.4 with the S&P 500 at 5,278. The earnings yield (E/P) of 4.89% represents fair value relative to the 10-year U.S. Treasury note yield of 4.51%. The yield spread is 0.38%. Seven of the eight largest companies in the S&P 500 make up $14.7 trillion of the $46.5 trillion index market capitalization with a weighted P/E of 30.9. If 31.6% of the index has a P/E of 30.9, then 68.4% of the index has a P/E of 15.6 for the overall P/E to be 20.4. A P/E of 15.6 is an E/P of 6.41%, which is fairly priced compared to the 10-year Treasury note yield of 4.51% (a yield spread of 1.90%).

The April drawdown in the S&P was only -5.5% before buyers came out of the woodwork to propel the index to new highs in May. The index closed at an all-time high of 5,321 on May 21, beating the former all-time high of 5,254 on March 28. A pattern of higher highs is back in place, which, by definition, is an uptrend. Support areas should be found around 5,180 (50-day moving average), 4,970 (April 2024 low), 4,800 (January 2022 high and 200-day moving average), and 4,600 (July 2023 high).

A model by Professor Robert Shiller of Yale University shows that stock valuations are in uncharted waters. Shiller maintains a fascinating data set that tracks monthly stock price (S&P 500), dividends, earnings, and CPI data. He values the S&P 500 using the CAPE (Cyclically Adjusted PE) ratio. High CAPE means the S&P 500 is expensive. In a chart spanning from 1881 to 2024, CAPE has fluctuated from a low of 5 (1921) to 44 (1999). CAPE has generally ranged between 10 and 25, with exponential spikes for bubbles (e.g., 33 in 1929 before the stock market crash and Great Depression). Alarmingly, CAPE has been historically high from 2014 to 2024, never falling below 25 and hitting 39 in 2021. CAPE is 33 as of today (similar to 1929, by the way). While Shiller's model is one take on the situation, it is critical to note that the mega-cap technology stock bubble is of historic proportions…caution!