"Reinflating The Mega-Cap Tech Bubble"

Market Commentary – June 2023

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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 2023. This is higher than the advance estimate of 1.1% and lower than the 2022 Q4 reading of 2.6%. In April, the Consumer Price Index (CPI), a measure of inflation experienced by consumers, rose 5.0% year-over-year. CPI peaked at 8.9% in June 2022 and has been trending lower since. Meanwhile, the Producer Price Index (PPI), a measure of inflation experienced by domestic "producers" of goods and services, increased 2.4% in April. PPI peaked at 11.6% in March 2022 and has steadily cooled since. Recall that the Federal Reserve prefers inflation to run about 2%. Overall, inflation seems to be coming under control. Unemployment is still a thorn in the side of the Federal Reserve, however. April unemployment came in at 3.4%, which is the same as January 2023. The last time unemployment was 3.4% was May 1969. If companies cannot find new employees, they will need to retain existing employees and attract new ones with higher wages. Higher wages would drive higher prices for products and services (i.e., inflation).

On May 3, the Federal Open Market Committee (FOMC) raised the target range on the federal funds rate by another 0.25% to a range of 5.0% to 5.25%. Futures markets predict a 62% probability of one final 0.25% hike by the end of August. Of course, this may or may not materialize. A 0.25% *cut* from current levels is priced in for February 2024, with the federal funds rate 1.25% lower by August 2024. What is clear is that we are very close to the end of this rate hike cycle. Meanwhile, the Fed's balance sheet has $8.436 trillion in assets as of May 24 (more than $8.340 trillion on March 1 when the recent banking turmoil started). Prior to the banking situation, the Fed was on pace to reduce assets by $95 billion per month. The Fed's next announcement on monetary policy is scheduled for June 14.

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) over the next 12 months is $222.21, which implies a price-to-earnings (P/E) ratio of 18.8 with the S&P 500 at 4,180. The earnings yield (E/P) of 5.32% represents fair value relative to the 10-year U.S. Treasury note yield of 3.64%. The yield spread is now 1.68%, which is the lowest month-end reading since October 2008.

Pressure continues to build in the S&P 500 for a breakout, which we still believe will be to the upside. The index poked its head above 4,200 for two days before settling back at 4,180. Support exists around 4,110 (50-day moving average), 3,975 (200-day moving average), and 3,800 (December 2022 and March 2023 lows). Resistance should be around 4,300 (August 2022 high), 4,600 (March 2022 high), and 4,800 (all-time closing high). Perhaps news of Congress lifting the debt ceiling will be the catalyst for the breakout to the upside. Of course, there is a chance that Congress fails to lift the debt ceiling, which would trigger a default of some sort by the U.S. Treasury (an unprecedented event) and would weigh heavily on stock prices. Hopefully this debt-ceiling event will pass with only the typical political headline shrapnel.

A tsunami of cash has rushed back to mega-cap technology stocks in 2023 to reinflate the bubble that deflated last year. The S&P 500 is a market cap-weighted index, meaning that companies with higher market caps count more toward the performance of the index. The S&P 500 has a $36.8 trillion market cap with the following five largest companies: Apple ($2.8T market cap, 27.0 P/E), Microsoft ($2.5T, 30.0 P/E), Alphabet ($1.6T, 23.0 P/E), Amazon.com ($1.3T, 76.8 P/E), and Nvidia ($1.0T, 48.8 P/E). With a combined total market cap of $9.1T, these five companies (only 1% of the companies in the S&P 500) make up 24.6% of the index's market cap. The weighted average P/E of these five companies is 36.4, which is much higher than the overall S&P 500 P/E of 18.8. If 24.6% of the index has a P/E of 36.4, then 75.4% of the index has a P/E of 13.1 for the overall P/E to be 18.8. Seen in this light, there are opportunities for value investors to quietly scoop up stocks being ignored by investors who are intoxicated by growth.