"All About The Fed"

Market Commentary – July 2019

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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 3.1% in the first quarter of 2019. This is lower than the advance estimate of 3.2% and the same as the second estimate. On June 19, the Fed revised its economic projections that were last released in March 2019. It sees GDP growth of 2.1% in 2019, 2.0% in 2020, 1.8% in 2021, and 1.9% in the "longer run" (beyond 2021). Since President Trump took office GDP has averaged 2.8%. Moreover, since the tax cuts were implemented in January 2018, GDP has averaged 3.0%. Looking back to our market commentary in April 2017, the Fed saw GDP growth of 2.1% in 2017, 2.1% in 2018, 1.9% in 2019, and 1.8% in the "longer run" (beyond 2019). They have historically been conservative with their estimates and perhaps that is the trend continuing today.

On June 19, the Federal Open Market Committee (FOMC) opened the door to a future rate cut in its statement on monetary policy. While the Fed left the benchmark federal funds rate in a range of 2.25% to 2.50%, it changed the language surrounding that. In recent announcements prior to June 19, the Fed said it "will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate." On June 19, however, it cited "in light of these uncertainties and muted inflation pressures, (the Fed) will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion." In other words, a rate cut is on the table. Futures markets are predicting a 25 basis point cut at the next meeting (July 30-31) and a second cut before the December 2019 meeting. This is quite a change from December 2018, when the Fed projected two 25 basis point hikes in 2019 and a third increase in 2020. Note how well stocks have performed since that change.

While there has been no shortage of controversial headlines, President Trump has been very helpful for the stock market. When Donald Trump won the presidential election on November 8, 2016, the S&P 500 had closed that day at 2,139.56. It closed on Friday, June 28, 2019 at 2,941.76 (up 37.5% plus dividends). When Barack Obama won his first presidential election on November 4, 2008, the S&P 500 closed at 1,005.75. From that date to the election of President Trump, the S&P 500 rose 112.7% (plus dividends). Two things to remember: 1) Obama's increase was over 8 years while Trump's increase has only had 2.5 years so far; 2) the S&P 500 had dropped 35.7% from the peak on October 9, 2007 until the date of Obama's first election (it is much easier to rally from a major market bottom like that).

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 $169.14, which implies a price-to-earnings (P/E) ratio of 17.4 with the S&P 500 at 2,942. The earnings yield (E/P) of 5.75% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.00%. The spread between the two yields is still a healthy 3.75%, even though the stock market rallied big in June. Lower interest rates pave the way for higher stock prices.

The S&P 500 is on the doorstep of resistance from its all-time closing high of 2,954 and is poised to break through. Should the market punch through this final level of resistance, we would need to wait for that rally to fizzle before identifying a new level of resistance. Support levels below should exist around 2,880 (50-day moving average), 2,777 (200-day moving average), and 2,740 (March and June 2019 lows). A break below 2,740 could be followed by a test of the December 2018 low around 2,350.

While most major indexes are enjoying healthy upside this year, the level of enjoyment is not being shared equally. For example, large cap tech stocks (Nasdaq 100) are outperforming small/mid cap value stocks (Russell 2000 Value) by 9% this year. We continue to sell overvalued stocks and replace them with "unloved" stocks from the bargain bin (low P/E, low beta, high dividend yield, and strong balance sheet).