“Return Of Value”

Market Commentary – January 2018

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written December 31, 2017 – 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 3.2% in the third quarter of 2017. The advance and second estimates were 3.0% and 3.3%, respectively. On December 13, the Federal Open Market Committee (FOMC) released its revised economic projections. It sees GDP growth of 2.5% in 2017, 2.5% in 2018, 2.1% in 2019, 2.0% in 2020, and 1.8% in the “longer run” (beyond 2020). Forecasts for 2017 through 2020 were each bumped up from the FOMC’s September forecast, with the most dramatic increase for 2018 (from 2.1% in September to 2.5% in December).

The FOMC raised its benchmark federal funds rate by 0.25% to a range of 1.25% to 1.5% in its monetary policy announcement on December 13. This was the third interest rate hike of 2017, following 25 basis point increases in March and June of 2017. By the end of 2018, the FOMC projects a federal funds rate of 2.1%, which implies three more 25 basis point hikes to a range of 2.0% to 2.25%. The FOMC also announced plans to double the monthly reduction of its balance sheet ($4.5 trillion in Treasury and mortgage-backed securities) from $10 billion to $20 billion each month. Both of these moves continue the Fed’s plan to ween the economy off of accommodative monetary policy. The next FOMC decision on monetary policy is scheduled for January 31.

Strangely, the yield curve of U.S. Treasuries is flattening, with shorter-term interest rates rising and longer-term interest rates falling. As of December 31, 2016, yields on the 5-year, 10-year, and 30-year Treasuries were 1.93%, 2.45%, and 3.06%. Today, these yields stand at 2.21%, 2.41%, and 2.74%. Bond yields and prices move in opposite directions, so an increase in yield means falling bond prices and a decrease in yield means rising bond prices. Investors are bidding the price of long-term bonds higher in a search for long-term yield. Why? Are investors not confident in the long-term growth prospects of the U.S. economy? It is interesting to note from the FOMC’s economic projections that they forecast 1.8% GDP growth in the “longer run”. Is this a subtle psychological tool for the Fed to facilitate a fog of lower long-term interest rates while it raises short-term rates without crashing asset prices? While the reasons for the flattening yield curve are unclear, it is prudent to notice the pattern. When this eventually unwinds, higher long-term interest rates will hurt stock and real estate prices.

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 $141.19, which implies a price-to-earnings (P/E) ratio of 18.9 with the S&P 500 at 2,674. The earnings yield (E/P) of 5.28% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.41%. A huge change versus one month ago, however, is that we now know that tax reform has been passed into law. The U.S. corporate tax rate will drop from 35% to 21%. This news is so fresh that corporate earnings estimates still do not reflect the lower tax rates. Lower taxes do matter. For example, one bank stock analyzed by Banyan Asset Management had a fair value of about $14 per share with “old” tax rates, but fair value jumped to $18 with lower taxes. Therefore, the P/E on the S&P 500 is truly something materially lower than 18.9.

Speculation is alive and well in this bull market, which is concerning. Cryptocurrencies, led by bitcoin, are all the rage. Plus, large cap technology stocks have come to dominate the S&P 500, comprising 23.8% of the index. Index investors may not realize how heavily invested they are in expensive, overvalued technology stocks. With big stocks like Amazon, Facebook, and Google up 56%, 53%, and 33% respectively in 2017, index investors can easily fall victim to a sense of overconfidence. Previously forgotten value stocks started exhibiting some relative strength as 2017 came to a close. Remember that 2016 was a very strong year for value stocks, but growth curiously took over on the first trading day of 2017 and did not look back. Perhaps a major reversal favoring value stocks will occur in 2018.