"Ready To Be Discovered"

Market Commentary – January 2020

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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 2.1% in the third quarter of 2019. This is slightly higher than the 2.0% annual rate in 2019 Q2. On December 11, the Federal Reserve revised its economic projections that were last released in September 2019. It sees GDP growth of 2.2% in 2019, 2.0% in 2020, 1.9% in 2021, 1.8% in 2022, and 1.9% in the "longer run" (beyond 2022). There were no changes in any of these values when compared to the September projections. The Fed has a statutory mandate to "foster maximum employment and price stability". It projects an unemployment rate of 3.6% in 2019 and 4.1% in the longer run (beyond 2022), while seeing inflation of 1.5% in 2019 and 2.0% in the longer run. The Fed is likely pleased with the current economy.

As expected, the Federal Open Market Committee (FOMC) left its benchmark federal funds rate in a range of 1.50% to 1.75% in its monetary policy statement on December 11. Remember one year ago how equity markets were reeling from interest rate hikes. The Fed realized its mistake and reversed course, cutting the federal funds rate by a total of 0.75% during 2019. It also quietly expanded its balance sheet, reminiscent of quantitative easing. Fed Chair Jerome Powell maintains that the balance sheet expansion was to facilitate liquidity in the repo market (a technical detail), but the favorable effect on stock prices cannot be denied. The Fed balance sheet stood at \$3.97 trillion as of October 23, 2019, up \$0.165 trillion from July 24, 2019, but down \$0.204 trillion from October 24, 2018. With the stock market screaming higher, GDP "as expected", unemployment low, and inflation tame, the Fed will likely sit on the sidelines in the months ahead. The next FOMC decision on monetary policy is scheduled for January 29.

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 \$175.65, which implies a price-to-earnings (P/E) ratio of 18.4 with the S&P 500 at 3,231. The earnings yield (E/P) of 5.44% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.92%. Higher earnings estimates have driven stock prices up in recent months. We need to keep a watchful eye on the 10-year U.S. Treasury note yield, which has been creeping higher since bottoming in September. The spread with the earnings yield is still a robust 3.52%, but further increases in the 10-year yield will create headwinds for stock prices.

The S&P 500 formed yet another all-time high in December, closing at 3,240 a few days ago. The stock market has seemingly been in a melt-up, climbing incrementally higher each day. The daily moves have not been drastic, but when added together, they have been very material. The S&P 500 traded as low as 2,855 in early October and has risen 13.2% since then. With the start of the new year, however, selling pressure may enter the picture. Investors realized plenty of gains in 2019 and had to postpone additional selling to avoid bumping up the 2019 tax bill even more. Plus, how nice it is to start the new year by banking some more realized gains for 2020! A fresh round of selling seems likely…in the short run. Once that is out of the system, however, the bull market should be ready to resume.

Valuations on popular large cap technology stocks are very concerning. For example, Apple (AAPL) was up 86% in 2019 and is now trading with a forward P/E of 22.5; Microsoft (MSFT), up 55% in 2019, trades at a P/E of 29.3. While money is flowing into stocks across the board, there are select companies, especially in large cap technology, that have attracted more than their fair share of capital. Market indexes are skewed by the performance of these few giant stocks. At Banyan Asset Management, we do not own these richly priced "hot" stocks. Our cumulative portfolio has the following dollar-weighted parameters: 13.3 P/E, 4.1% dividend yield, and 0.80 beta. Moreover, our stocks tend to have strong balance sheets relative to other companies in their industries. These opportunities are ready to be discovered by investors capable of trumping emotion with logic!