“Avoid Value Investing Fatigue”

Market Commentary – October 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. decreased at an annual rate of -31.4% in the second quarter of 2020. This is better than the advance estimate of -32.9% and the second estimate of -31.7%. On September 16, the Federal Reserve revised its economic projections that were last released in June 2020. It now sees GDP growth of -3.7% in 2020, 4.0% in 2021, 3.0% in 2022, 2.5% in 2023, and 1.9% in the “longer run” (beyond 2023). Note that in June 2020, the Fed projected 2020 GDP to contract by -6.5%, so a contraction of -3.7% is much shallower than feared only three months ago. The economic recovery does indeed appear to be “V-shaped”, as touted by President Trump.

On September 16, the Federal Open Market Committee (FOMC) announced that monetary policy will remain accommodative through 2023, well into the economic recovery. It projects the federal funds rate to remain in a range of 0% to 0.25% through the end of 2023 (extended one year into the future than prior FOMC guidance). With respect to quantitative easing, the Fed expects to buy $80 billion of Treasury securities and $40 billion of mortgage-backed securities *each month*. As of September 23, 2020, the Fed’s balance sheet had expanded to include total assets of $7.1 trillion (and growing). The Fed is clearly worried about economic shockwaves from the Great Cessation and they have unleashed powerful tools in response. The next FOMC announcement on monetary policy is scheduled for November 5.

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) during 2021 is $164.30, which implies a price-to-earnings (P/E) ratio of 20.5 with the S&P 500 at 3,363. The earnings yield (E/P) of 4.89% represents attractive value relative to the 10-year U.S. Treasury note yield of 0.68%. The P/E ratio of the Banyan Asset Management, Inc. overall portfolio is 12.9, however, which translates into an E/P of 7.75%. Value stocks present an incredible opportunity, even more attractive than at the depths of the financial crisis of 2008-2009.

September saw the S&P 500 take a healthy pullback, and the uptrend seems to be resuming. There should be resistance at the September high (3,580) and plenty of support by the 50-day moving average (3,357), the September low (3,237), and the 200-day moving average (3,110). Investors who overemphasize the importance of the S&P 500 run the risk of exposure to the mega-cap technology bubble we have analyzed for months. In 2020 year-to-date, the Nasdaq 100 is up 30.8% (without dividends). In comparison, the value indexes lag (S&P 500 Large Cap Value -13.4%, S&P 500 Mid Cap Value -20.9%, and S&P 600 Small Cap Value -24.1%). The capitalization-weighted S&P 500 is up 4.1% (without dividends), while the equal-weighted S&P 500 is down -6.3% (the same 500 companies!). Even the historically stodgy Dow Jones Industrial Average has been infected by the mega-cap technology bubble. It already contained Microsoft (33 P/E) and Apple (30 P/E), but then S&P (which now owns the Dow Jones indexes) decided in August 2020 to add Salesforce.com (CRM), an enterprise cloud computing company which focuses on customer relationship management software. CRM sports a nosebleed P/E of 67.

Investors who are experiencing fatigue with value investing and want to cave in to growth investing should avoid this temptation. A quick look at history provides a sobering reality of what happens when bubbles burst. The technology bubble of the late 1990s peaked for the Nasdaq 100 on March 27, 2000. A bear market ravaged the Nasdaq 100 over the next 18 months, causing it to crash by 82.9%! Consider how devastating that loss was: an investor who owned 100% Nasdaq 100 with $1 million on March 27, 2000 had only $170,000 18 months later. The next dilemma becomes growing $170,000 to $1 million, which requires a gain of $830,000 (488%). Many investors are blind to the presence of bubbles until after they burst. The mega-cap technology bubble is staring us directly in the eyes. Do you see it too? What we do not know is when the bubble will burst. When it does burst, however, it will likely be devastating.