"GDP Growth Is Key"

Market Commentary – March 2017

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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 1.9% in the fourth quarter of 2016. This is the same as the advance estimate and lower than the Q3 reading of 3.5%. In its monetary policy press release on February 1, the Federal Open Market Committee (FOMC) stated that "the labor market has continued to strengthen and…economic activity has continued to expand at a moderate pace." The FOMC noted that unemployment remains low (4.8% in January 2017), while inflation is below the FOMC's 2% longer-run objective (Consumer Price Index was +0.6% in January). They added that "household spending has continued to rise moderately while business fixed investment has remained soft", but seemed encouraged that "measures of consumer and business sentiment have improved of late".

The FOMC left its benchmark federal funds rate at a range of 0.50% to 0.75% in its announcement on February 1, but paved the way for future rate hikes. According to minutes from the FOMC meeting, "it might be appropriate to raise the federal funds rate again fairly soon if incoming information on the labor market and inflation was in line with or stronger than their current expectations or if the risks of overshooting the Committee's maximum-employment and inflation objectives increased." While the focus continues to be on interest rates, there is still no indication when the Federal Reserve will begin the process of trimming its bloated balance sheet of about $4.5 trillion in various debt securities.

GDP growth has a direct impact on stock valuations and could help launch the stock market higher. In the fundamental model we use to value stocks, one of the most critical input parameters is the terminal sales growth rate (the rate at which a company can grow its sales in perpetuity). A company cannot logically grow its sales in excess of nominal GDP (inflation plus real GDP) in perpetuity, otherwise it would literally take over the world. We use 4% as a terminal sales growth rate in our models, keeping in mind that this is a nominal rate. If you assume inflation is 2%, 4% nominal GDP implies 2% real GDP. The GDP values in the first paragraph of our market commentaries always reflect real GDP (without inflation). If real GDP could sustainably get up to 3%, we could use 5% terminal sales growth in our models and thus justify higher stock valuations.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $130.68, which implies a price-to-earnings (P/E) ratio of 18.1 with the S&P 500 at 2,364. The earnings yield (E/P) of 5.53% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.36%. In a television interview on February 27, Warren Buffett commented that the stock market is not currently in a bubble because interest rates are so low. However, if interest rates were to go to 5% or 6%, it would be difficult to justify current stock valuations. Buffett's logic mirrors what we try to highlight in this paragraph each month.

The higher the stock market moves without corresponding increases in earnings, the more concerned we become. The tide is not raising all boats equally, as large cap stocks are now being favored to small and mid-cap stocks, and growth is being favored to value. Capital is being lured into emotionally exciting industries, leaving others decimated. The industries that are struggling represent some great buying opportunities, but it will require investors to be patient for the rotation of money to play out. (Stocks that are out of favor can remain that way for quite a while before they snap back.) The progress made by President Trump since his inauguration on January 20 is impressive and is making a difference. At Banyan Asset Management, we believe that the policies of the Trump administration will be helpful for consumer and business confidence, and hence economic growth. Having added nearly $3 trillion in market capitalization since President Trump was elected, the stock market seemingly agrees. We are mindful, however, of the market's ability to bake in the good news upfront before that news becomes reality.