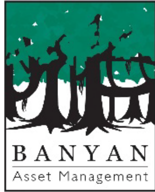

“Objectivity Over Subjectivity”
Market Commentary – September 2023

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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 2.1% in the second quarter of 2023. This is lower than the advance estimate of 2.4% and slightly higher than 2.0% growth in 2023 Q1. Inflation continues to cool down. According to the Consumer Price Index (CPI), the price of goods and services over the last 12 months rose by a seasonally-adjusted 3.3% in July. After peaking in June 2022 at 8.9%, the inflation fever broke and has been steadily trending lower. Meanwhile, the Producer Price Index (PPI), a measure of inflation experienced by *producers* of goods and services, shows that prices increased by only 0.8% in July year-over-year. PPI peaked at 11.6% in March 2022 and has fallen drastically in 2023. The Fed’s target for inflation is 2%, so inflation is approaching their target.

While we wait for the next Federal Open Market Committee (FOMC) announcement on monetary policy scheduled for September 20, the Federal Reserve continues to whittle down its bloated balance sheet. Prior to the 2008 financial crisis, the Fed had only $0.9 trillion on its balance sheet. In response to the financial crisis, the balance sheet expanded to $4.5 trillion by January 2015. It stayed flat for several years and then pared to $3.8 trillion by August 2019. When the economy stopped in March 2020 due to COVID-19, the balance sheet skyrocketed, peaking at $8.965 trillion in April 2022. As of August 23, 2023, the Fed had $8.139 trillion in assets on its balance sheet, down about $104 billion from July 26. Since the temporary spike in the Fed’s balance sheet in March due to a couple major bank failures, the Fed has resumed its commitment to reduce the balance sheet by $95 billion each month.

Technical factors of the market are bullish (more demand than supply), while fundamentals are fairly 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 $229.91, which implies a price-to-earnings (P/E) ratio of 19.6 with the S&P 500 at 4,508. The earnings yield (E/P) of 5.10% represents fair value relative to the 10-year U.S. Treasury note yield of 4.09%. The yield spread is 1.01%. The seven largest companies in the S&P 500 make up $11.3 trillion of the $39.7 trillion index market capitalization with a weighted P/E of 32.5. If 28.6% of the index has a P/E of 32.5, then 71.4% of the index has a P/E of 14.4 for the overall P/E to be 19.6. A P/E of 14.4 is an E/P of 6.93%, which is attractive compared to the 10-year Treasury note yield of 4.09% (a yield spread of 2.84%).

The S&P 500 finally encountered a healthy correction in August, although it has rebounded materially from those August lows. After closing July at 4,589, the index hit a closing low of 4,370 on August 18. It has since bounced back to 4,508. Going forward, resistance areas include 4,600 (July high) and 4,800 (all-time closing high), while support areas include 4,370 (August low), 4,200 (February, April, and May 2023 highs), and 4,157 (200-day moving average). Investors would be wise to remember that September and October can be shaky for the financial markets.

By definition, a company cannot grow sales faster than GDP in perpetuity. 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). To help justify the lofty valuations of the mega-cap technology stocks, growth investors like to tout the high growth rates of sales. What they are ignoring, however, is that growth will eventually migrate back to GDP. It is a matter of when, not if. When it does, sky-high valuations will come crashing down to reality. To quote Nelson Kjos in *The Money Manager and The Poet*, “Objectivity over subjectivity…if you can.”