“Eyes On The Fed”

Market Commentary – July 2021

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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 6.4% in the first quarter of 2021. This is the same as the advance and second estimates. On June 16, the Federal Reserve revised its economic projections that were last released in March 2021. It now sees GDP growth of 7.0% in 2021, 3.3% in 2022, 2.4% in 2023, and 1.8% in the “longer run” (beyond 2023). Note how the first quarter GDP reading of 6.4% is less than the full year estimate of 7.0%. This implies that growth will be even stronger in Q2-Q4. Recall that in December 2020, the Fed predicted 2021 GDP at 4.2% (which itself is a strong number). Still, the difference between 4.2% and 7.0% is the economic equivalent of a football field. It is important to recognize how fluid these projections really are.

With economic growth on fire, inflation is on investors’ radar screens. The U.S. Department of Labor announced on June 15 that the Producer Price Index (PPI) for May 2021 jumped 6.6% year-over-year (the fastest increase on record, although this only dates back to 2010). The Consumer Price Index (CPI) in May rose by 5.4%, the largest increase since August 2008. The rise in CPI indicates that companies are successfully passing along most of their higher input costs to consumers. However, PPI did grow faster than CPI in May, suggesting that corporate profit margins may have contracted (bearish for stocks).

The ultimate question is whether the Federal Reserve will ease its monetary stimulus to help calm inflationary pressures. In its monetary policy announcement on June 16, the Federal Open Market Committee (FOMC) increased its projection for inflation in 2021 from 2.4% to 3.4%. The FOMC continues to write that such inflation reflects “transitory factors”. Monetary policy remains ultra-accommodative, with the federal funds rate at a target range of 0%-0.25% and the Fed’s balance sheet increasing by $120 billion per month. As of June 23, there were $8.15 trillion of assets on the Fed’s balance sheet (versus $4.17 trillion in January 2020, before COVID-19). There is no doubt that monetary policy has fueled the meteoric rise in stock prices since the Great Cessation of 2020. Investors may have a fit when they finally accept the Fed’s party is over. The next announcement on monetary policy is scheduled for July 28.

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 $187.30, which implies a price-to-earnings (P/E) ratio of 22.9 with the S&P 500 at 4,298. The earnings yield (E/P) of 4.36% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.45%. Since we are halfway through 2021, it is reasonable to start looking at estimates for 2022. S&P projects S&P 500 operating EPS at $210.43 for 2022 (20.4 P/E, 4.90% E/P). Seen in this light, stocks are not as expensive as some investors fear.

The S&P 500 is meandering higher, although the pace of the increase has seemingly cooled. The index is sitting at an all-time high, so there is no technical resistance overhead. The 50-day moving average has acted as strong support since November 2020. In the spirit of witty baseball legend Yogi Berra, technicians believe in particular chart patterns until they no longer work. Therefore, 4,200 (50-day moving average) should be a level of support, as well as 3,830 (200-day moving average) and 3,750 (near March 2021 low).

Growth stocks had a decent June relative to value stocks, but the first half of 2021 belonged to multi-cap value stocks. Consider the following index returns for 2021 with dividends: S&P 500 Large Cap (Value +16.3%, Growth +14.3%); S&P 400 Mid Cap (Value +23.0%, Growth +12.3%); S&P 600 Small Cap (Value +30.6%, Growth +16.5%). Value is consistently outperforming growth, although the spread is greater for small caps than large caps. Also, mid cap stocks are outperforming large cap stocks, and small cap stocks are outperforming mid cap stocks. At Banyan Asset Management, our overall portfolio is trading with a 12.5 P/E on 2022 EPS, 1.0 beta, and 4.0% dividend yield. Tremendous opportunities remain!