"Valuations Matter"

Market Commentary – September 2021

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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 6.6% in the second quarter of 2021. This is higher than the advance estimate of 6.5%. While we normally assess GDP in terms of real growth percentages, it is helpful to also consider GDP in terms of real dollars. Using 2012 as a base year for calculating inflation, the U.S. Bureau of Economic Analysis reported that real GDP peaked at $19.202 trillion in 2019 Q4. It bottomed at $17.258 trillion in 2020 Q2, as COVID-19 lockdowns ravaged the U.S. economy. GDP finally poked its head above the 2019 Q4 peak to hit $19.361 trillion in 2021 Q2. The economy has officially gained back the output it lost due to the Great Cessation.

Investors are trying to gauge when the Federal Reserve will cut back on monetary stimulus. Minutes of the Federal Open Market Committee (FOMC) meeting on July 27-28 included some clues. "Looking ahead, most participants noted that, provided that the economy were to evolve broadly as they anticipated, they judged that it could be appropriate to start reducing the pace of asset purchases this year." The economy had reached its goal on inflation and was "close to being satisfied" with employment. Some FOMC members noted "upside risks to inflation" and wanted to start tapering "relatively soon". As of August 25, there were $8.38 trillion of assets on the Fed's balance sheet ($0.11 trillion higher than July 28). The Fed maintains that tapering will happen first, followed by interest rate hikes once the Fed's balance sheet is no longer growing. Fed funds futures are pricing in the first 0.25% hike by April 2023. The next FOMC announcement on monetary policy is scheduled for September 22.

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 $198.68, which implies a price-to-earnings (P/E) ratio of 22.8 with the S&P 500 at 4,523. The earnings yield (E/P) of 4.39% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.30%. The spread between E/P and the 10-year Treasury is holding steady at 3.09%. While stock prices have risen in recent weeks, so have earnings estimates.

The S&P 500 continues to motor ahead, hitting new all-time highs. Support should be near 4,390 (50-day moving average), 4,165 (April/May resistance and June support), and 4,050 (200-day moving average). There has not been a correction greater than 10% since September 2020 (and that correction was only 10.5%). When stock prices finally break, they will likely fall far in a short amount of time. It would be surprising, however, to see a collapse as severe as March 2020 (down 35% in one month).

An Achilles' heel for the S&P 500 is the ridiculously lopsided allocation of capital to the index's five largest companies. The S&P 500 currently has a total market cap of $39.2 trillion. The five largest companies in the S&P 500 are: Apple ($2.5 trillion market cap, 26.8 P/E), Microsoft ($2.3T, 34.4), Alphabet ($1.9T, 27.4), Amazon.com ($1.7T, 52.0), and Facebook ($1.1T, 23.7). With a combined total market cap of $9.5T, these five companies (only 1% of the companies in the S&P 500) make up 24.2% of the market cap of the index. The weighted average P/E of these five companies is a whopping 32.9, which is significantly higher than the overall S&P 500 P/E of 22.8. This is a ticking time bomb that could potentially implode the S&P 500. On a lighter note, the existence of such a spread implies that there are numerous companies trading at much more attractive valuations.

Valuations matter! When we analyze a stock to determine whether it should be purchased, we calculate the stock's "intrinsic value" (our estimate of what the stock should be worth). We strive to buy stocks trading at a discount to intrinsic value. This approach intuitively makes sense. Value investors hope to create a margin of safety with their portfolios, offering a degree of downside protection. Stocks can only get so cheap before they boomerang back up in price. This repeating saga is as old as investing itself.