"Hawkish Fed"
Market Commentary – February 2022

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The advance 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 6.9% in the fourth quarter of 2021. This is much higher than the 2.3% reading in 2021 Q3. The components of the 2021 Q4 GDP number are: consumer spending +2.25 percentage points, investment +5.15 percentage points, net exports +0.00 percentage point, and government spending -0.51 percentage point. The sum of these numbers equals +6.89%. The economy is nowhere near as hot as the headline GDP number would lead you to believe. The investment reading is misleading, as +4.90 percentage points was generated from inventory buildup. Given the bizarre product shortages being found throughout various sectors of the economy, this inventory rebuilding did not replenish the depleted supply chain. In addition to supply chain disruptions, the economy continues to battle labor shortages, inflation, and COVID-19 variants.

The Federal Open Market Committee (FOMC) has become more "hawkish" in monetary policy as it fights rampant inflation. "Hawks" want *tighter* monetary policy to cool inflation, while "doves" want *looser* monetary policy to support economic growth. The FOMC left its benchmark federal funds rate at a rock-bottom range of 0%-0.25% on January 26, but the future for interest rates is seemingly higher. The FOMC wrote "with inflation well above 2 percent and a strong labor market, …it will soon be appropriate to raise the target range for the federal funds rate." Fed funds futures see four 0.25% hikes in the federal funds rate in 2022 (starting in March), two in 2023, and one in 2024. This would put the federal funds rate in a range of 1.75%-2.0% in 2024. As for its bloated balance sheet ($8.86 trillion as of January 26), the FOMC decided to bring net asset purchases "to an end in early March". Expect the Fed to soon start telegraphing thoughts about *shrinking* the balance sheet. The era of ultra-easy monetary policy is coming to a screeching halt. The next FOMC monetary policy announcement is scheduled for March 16.

Financial markets are rattled by the Fed's newly found discipline toward inflation. Growth stocks were pummeled in January (all returns are without dividends): S&P 500 Large Cap Growth -8.4%, Nasdaq 100 -8.5%, S&P 600 Small Cap Growth -10.1%, and S&P 400 Mid Cap Growth -10.4%. Value stocks were down in January, but not nearly as much as growth: S&P 500 Large Cap Value -1.8%, S&P 400 Mid Cap Value -4.0%, and S&P 600 Small Cap Value -4.4%. Remember that higher interest rates mean sky-high valuations should come back down to earth. This is the logic behind the common saying that bull markets do not die of old age, but rather they are killed by the Fed.

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 $221.09, which implies a price-to-earnings (P/E) ratio of 20.4 with the S&P 500 at 4,516. The earnings yield (E/P) of 4.90% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.79%. The spread between the two yields is 3.11%, which is the same as last month (indicating that the decline in stocks was proportional to the rise in bond yields). The S&P 500 is hovering around its 200-day moving average (4,437), which is acting as support thus far. January was so weak that odds favor a bounce from here, at least to the 50-day moving average (4,632). However, should the January lows fail, it could get bumpy for the S&P 500. The next major support level is around 4,060 (May 2021 support), followed by 3,975 (March 2021 resistance).

The S&P 500 Large Cap Value and Growth index returns have begun the process of converging. From January 1, 2017 to January 31, 2022, the value index is up +52.0%, while the growth index is up +152.9% (without dividends). Note how the spread has compressed to 100.9% from 121.4% last month. The mega-cap technology bubble took a beating in January, but there is still much more excess to be unwound. In the meantime, the overall portfolio at Banyan Asset Management has an 11.9 P/E on 2022 EPS, 1.0 beta, and 4.6% dividend yield. A margin of safety should help smooth out market turbulence.