# “Mega-Cap Tech Implosion”

## Market Commentary – November 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 2.6% in the third quarter of 2022.** This is much higher than the 2022 Q2 decrease of -0.6%. The components of the 2022 Q3 GDP number are: consumer spending +0.97 percentage point, investment -1.59 percentage points, net exports +2.77 percentage points, and government spending +0.42 percentage point. The sum of these numbers equals +2.57%. Net exports and government spending are historically volatile and hover around 0%. According to quarterly data from the U.S. Bureau of Economic Analysis, net exports contributed -0.08 percentage point to GDP each quarter over the past 20 years, while government spending contributed +0.16 percentage point. Therefore, the current high values for net exports and government spending are not sustainable. Consumer spending, which historically is 70% of GDP in the U.S., was weak once again. A major drag on investment was residential (i.e., housing), which reduced GDP by -1.37 percentage points. Overall, the economy is much weaker than the headline GDP number (+2.6%) would lead you to believe.

**The Federal Reserve’s war on inflation continues, with the next monetary policy announcement scheduled for November 2.** The benchmark federal funds rate currently stands at a target range of 3.0% to 3.25%. Futures markets, which are predicting a fourth consecutive 0.75% increase in the fed funds rate on November 2, see the rate peaking at 4.75% to 5.0% by April 2023. Meanwhile, the Fed’s balance sheet is shrinking, albeit at a slower rate than they threatened. Assets have contracted from $8.914 trillion on May 25 to $8.723 trillion on October 26 (down $191 billion). The Fed was supposed to reduce assets by $47.5 billion per month starting June 1, and $95 billion per month starting September 1. Therefore, assets should be $332.5 billion lower by now. While the parrots in the financial media are focused on the fed funds rate, the lighter-than-expected balance sheet reduction shows that the Fed is nervous. If they are nervous, they may blink at any time with their aggressive interest rate hike policy (bullish for stocks).

**The mega-cap tech bubble is imploding before our very eyes.** From 2017-2021 (5 years), a massive spread developed between the S&P 500 Large Cap Value (LCV) and Growth (LCG) indexes: LCV +54.7% vs. LCG +176.1% (both without dividends), for a difference of 121.4%. As of 10/31/2022, this spread has been halved to 58.0% in only 10 months (from 1/1/2017 to 10/31/2022, LCV +41.3% vs. LCG +99.3%). The following mega-cap technology stocks are off drastically from their all-time highs: Microsoft -34%, Alphabet (Google) -38%, Tesla -45%, Amazon.com -46%, and Meta Platforms (Facebook) -76%, while Apple is off “only” -16%. Valuations on these stocks are still stretched, and more downside risk awaits.

**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 $232.86, which implies a price-to-earnings (P/E) ratio of 16.6 with the S&P 500 at 3,872. The earnings yield (E/P) of 6.01% represents fair value relative to the 10-year U.S. Treasury note yield of 4.03%. (We assume a range of +2.0% to -2.0% as being “fairly valued”.) Keep in mind that a stock trading at a P/E of less than 10 implies an E/P greater than 10% (many of these stocks exist today). This is a very attractive risk-reward profile for investors and helps explain why money is pouring out of overpriced growth stocks and into cheaper value stocks.

**The S&P 500 has a bit of upward momentum, but resistance overhead should cap such gains for now.** The S&P 500 had an opportunity to capitulate to new lows in October, but it instead bounced from 3,492 intraday on October 13 and rallied in the second half of the month. A push higher to the 200-day moving average around 4,109 seems reasonable. Upside beyond that may be limited, however, as valuations get stretched. A continued rotation from growth into value is likely. Moreover, there is definitely headline risk with the Federal Reserve on November 2 and midterm elections on November 8. Straight from our 2008 financial crisis playbook, it is worth considering a tranche of buying (incremental and balanced).