"Oops!"
Market Commentary – January 2023

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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 3.2% in the third quarter of 2022. This is higher than the advance estimate of 2.6% and the second estimate of 2.9%. On December 14, the Federal Reserve revised its economic projections that were last released in September. It now sees GDP growth of 0.5% in 2022, 0.5% in 2023, 1.6% in 2024, 1.8% in 2025, and 1.8% in the "longer run" (beyond 2025). The Fed is expecting a weak 2023. They see inflation at 3.1% in 2023 (up from 2.8% projected in September), but this would be cooler than their 2022 forecast of 5.6%. Before we put too much faith in the Fed's forecasting abilities, however, note that in December 2021, they predicted 2022 GDP of 4.0% (currently projected at 0.5%) and inflation of 2.6% (currently projected at 5.6%). Oops!

On December 14, the Federal Open Market Committee (FOMC) raised its benchmark federal funds rate by 0.5% to a target range of 4.25% to 4.5%. This 0.5% hike broke a string of four consecutive 0.75% increases. Importantly, the Fed sees the fed funds rate peaking at 5.1% by the end of 2023 (up from 4.6% projected in September). Furthermore, it sees the key rate at 4.1% in 2024, 3.1% in 2025, and 2.5% in the longer run. In other words, rates are expected to be higher for a longer period of time. As for the Fed's balance sheet, assets continue to contract, albeit at a slower pace than telegraphed in May ($47.5 billion per month starting June 1 and $95 billion per month starting September 1). With assets at $8.914 trillion on May 25, they should be $522.5 billion lower by now. As of December 28, assets were $8.551 trillion, down only $363 billion. Moreover, the rate of reduction has slowed over the past month, with only $70 billion in assets disappearing (much less than the $95 billion promised). Interest rates get the headlines, but the balance sheet action hints at the Fed's hesitations. The next decision on monetary policy is scheduled to be announced on February 1, 2023.

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) over the next 12 months is $226.51, which implies a price-to-earnings (P/E) ratio of 17.0 with the S&P 500 at 3,840. The earnings yield (E/P) of 5.90% represents attractive value relative to the 10-year U.S. Treasury note yield of 3.88%. Note that the earnings estimate for 2023 has been declining as analysts have reined in their forecasts for various companies. On June 15, 2022, S&P expected 2023 EPS of $248.41 (vs. $226.51 today). The financial media is communicating a bearish tone for 2023, with frequent references to recession over the coming 12 months. One year ago, the Fed and many market participants botched their anticipated view of 2023. Could the same thing happen again, only this time with upside surprises? Bear markets give birth to bull markets.

Despite a rough December plagued by heavy tax loss selling, the S&P 500 remains well above its October intraday low of 3,492. With a couple brief teases above the 200-day moving average in late November and early December, the S&P has fallen to just below its 50-day moving average. An interesting technical scenario has developed. The 50-day moving average (3,898) is rising toward a gently declining 200-day moving average (4,008). They are approaching a pinch point, which is a sign of buying pressure building. At any moment, an explosive move up could launch. Should the market blast higher, technicians would come out of the woodwork with observations of a decisive close above the 200-day moving average and a bullish inverse head and shoulders pattern. Plus, a "golden cross" would occur when the 50-day moving average eventually surpasses the 200-day moving average. Technical analysis is far from an exact science, however. Extreme selling on high volume can foil the plans of the strongest bull. Given the current pattern, though, unless the October low is violated for the S&P 500, we remain in the bullish camp. An appealing recipe for navigating such a market condition remains simple: own undervalued stocks with strong balance sheets, low betas, and juicy dividends, along with a healthy cash position to allow for the purchase of more shares should stock prices go further on sale.