"Planting Future Money Trees"
Market Commentary – May 2024

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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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 1.6% in the first quarter of 2024. The components of the 2024 Q1 GDP number are: consumer spending +1.68 percentage points, investment +0.56 percentage point, net exports -0.86 percentage point, and government spending +0.21 percentage point. The sum of these numbers equals +1.59%. The net exports value makes GDP look worse than it really is since -0.86 percentage point is not sustainable. Over the past 30 years, net exports has averaged -0.19 percentage point (it swings up and down with the strength of the U.S. dollar, although it overall weighs slightly on GDP over time due to Americans' love for imports). Given readings of 4.9% in 2023 Q3 and 3.4% in 2023 Q4, the trend in GDP indicates that economic growth is slowing.

The Federal Open Market Committee (FOMC) is expected to keep its benchmark federal funds rate at a target range of 5.25% to 5.5% when it announces monetary policy on May 1. Futures markets expect the first 0.25% cut by December 2024 and a new target range of 4.0% to 4.25% by February 2026 (1.25% in total cuts). This is 0.50% fewer total cuts than were expected one month ago. The Fed's balance sheet had $7.402 trillion in assets on April 24, down from $7.485 trillion in assets on March 27 (slightly slower than the Fed's commitment of $95 billion per month). Other than the March 2023 mini-banking crisis spike in the balance sheet, the Fed has remained credible on its commitment to slash its assets.

The annual update of our universe of stocks highlighted the extent to which market participants are being lured toward growth over value stocks. We analyzed a total of 1,501 companies with a cumulative market capitalization of $51.6 trillion. Our research identified "our universe", which is comprised of stocks we believe to have the best risk/reward prospects (based on a combination of low valuation, low beta, low debt to market cap, and high dividend yield). This year, 85 companies made the cut (versus 82 companies in 2023, 73 in 2022, and 65 in 2021). Our stocks have the following market cap ranges: <$1B (25 stocks), $1B to $5B (16 stocks), $5B to $20B (16 stocks), $20B to $100B (18 stocks), and >$100B (10 stocks). The majority of opportunities appear to be in the micro, small, and mid-cap spaces, while large and mega-cap stocks have generally had their prices bid to high levels relative to earnings.

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) through June 30, 2025 is $257.58, which implies a price-to-earnings (P/E) ratio of 19.6 with the S&P 500 at 5,036. The earnings yield (E/P) of 5.12% represents fair value relative to the 10-year U.S. Treasury note yield of 4.69%. The yield spread is 0.43%. Seven of the eight largest companies in the S&P 500 make up $13.4 trillion of the $44.3 trillion index market capitalization with a weighted P/E of 29.7. If 30.2% of the index has a P/E of 29.7, then 69.8% of the index has a P/E of 15.1 for the overall P/E to be 19.6. A P/E of 15.1 is an E/P of 6.61%, which is fairly priced compared to the 10-year Treasury note yield of 4.69% (a yield spread of 1.92%).

The rally in the S&P 500 is finally showing some fatigue as the index pulled back 5.5% from its record close at the end of March. The index pierced its 50-day moving average (currently 5,127), although it remains well above the 200-day moving average (4,696). The April low around 4,950 has become an area of support, with additional support levels around 4,800 (January 2022 high) and 4,600 (July 2023 high). At this point, the index is experiencing a normal correction.

We are in an opportunistic period for traditional value investors to selectively plant seeds for future money trees, but it will take time and patience for the seeds to grow. Index investor lemmings blindly invest money without doing any analysis. Meanwhile, many active investors are enamored of hyped growth stories and dream of unsustainable corporate profits. Opportunities exist where others are not looking.