"Don't Be Too Greedy"

Market Commentary – May 2019

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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 3.2% in the first quarter of 2019. This is higher than 2.2% in 2018 Q4. The components of the 2019 Q1 GDP number are: consumer spending +0.82 percentage point, investment +0.92 percentage point, net exports +1.03 percentage points, and government spending +0.41 percentage point. The sum of these numbers equals 3.18%. This reading is less impressive than it may appear on the surface. Consumer spending in the U.S. historically makes up about 70% of GDP, so it should have generated +2.2 or +2.3 percentage points. We can therefore conclude that consumer spending was weaker than normal. Investment's +0.92 percentage point gain was mostly due to the building of inventory (+0.65 percentage point), which is not sustainable. Businesses are seemingly timid about their investment plans. Residential spending (i.e., housing), another sub-component of investing, made its fifth consecutive quarterly loss. Net exports and government spending were both strong, but these categories are notoriously volatile and cyclical.

On May 1, the Federal Open Market Committee (FOMC) will announce its latest stance on monetary policy. Right now, the benchmark federal funds rate is in a range of 2.25% to 2.50%. Fed funds futures project that the Fed will *cut* interest rates by 0.25% by March 2020. Remember how at the end of October 2018 the Fed was projecting four 25 basis point rate hikes during 2019-2020? The Fed changed its tune in early January; notice how stock prices have skyrocketed since then. Investors are also curious whether there will be any changes to the Fed's projected path of shrinking its balance sheet. Overall, lower interest rates will likely be viewed as bullish for stocks.

According to the stock selection process of Banyan Asset Management, the next step after updating our universe is to perform in-depth research on individual stocks. This research centers on the fundamental and technical analysis of stocks to determine which ones we should buy. Our fundamental models rely heavily on a discount rate to discount future cash flows to present value in order to calculate the fair value of a stock. The higher the discount rate, the lower the fair value of a stock. For the current vintage of fundamental analysis, we have decided to maintain our risk-free rate at 3.5%, increase the equity risk premium from 5.84% to 5.96%, and keep the discount rate minimum at 8.0%. We are finding some excellent opportunities to capitalize on should the market pull back.

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 $170.62, which implies a price-to-earnings (P/E) ratio of 17.3 with the S&P 500 at 2,946. The earnings yield (E/P) of 5.79% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.51%. Note that the spread between the two yields has fallen to 3.28%, right in between 2.68% from October 2018 and 4.17% from January 2019. The higher the spread, the more attractive stocks are to own.

While it may seem obvious, the most bullish thing that a chart can do is "go higher". In April, the S&P 500 closed at an all-time high. Capital keeps pouring into stocks. In the spirit of Yogi Berra, this trend will continue until it stops. A chart breaking to new all-time highs has no technical resistance above. On the other hand, support levels should be around 2,840 (50-day moving average), 2,800 (old support/resistance prices from February/March 2019), and 2,770 (200-day moving average).

Capital in recent weeks has gravitated toward expensive technology stocks, which is concerning. Still, many of the relatively "boring" stocks in our portfolios are enjoying solid strength this year. Although they are less exciting, we are content owning stocks with low valuations, high dividends, low betas, and low debt. It is important to not be too greedy: keep emotion your friend, not your enemy.