"Value Is Valued Again"

Market Commentary – March 2022

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The second 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 7.0% in the fourth quarter of 2021. This is higher than the advance estimate of 6.9%. Inflation is scorching hot, with various metrics running at 40-year highs. The Consumer Price Index (CPI), a measure of overall inflation faced by consumers, jumped 7.5% for the 12 months ending January 2022 (largest increase since February 1982). Factoring out the volatile food and energy sectors does not help much, as that modified CPI rose 6.0% (largest increase since August 1982). Meanwhile, unemployment measured 4.0% in January 2022, ticking up from 3.9% in December 2021. The reading of 4.0% is above the pre-COVID level of 3.5% in February 2020, but it is well-below the high of 14.7% hit in April 2020. With unemployment tame and inflation rampant, market participants are looking to the Federal Reserve for answers.

One of the most anticipated Federal Open Market Committee (FOMC) announcements on monetary policy is scheduled for March 16, as the Fed attempts to cool inflation. The federal funds rate is currently in a range of 0%-0.25%. With the recent geopolitical tensions between Russia and Ukraine, fed funds futures predict a 38% probability of a 25-basis point hike on March 16 (a rumored 50-basis point hike is seemingly off the table). Assuming the Russian/Ukrainian smoke clears, however, the Fed is expected to refocus on inflation with a steady rate hike campaign. The federal funds rate is projected to be 1.0% higher by October 2022 and 2.0% higher by December 2023 (for a new range of 2.0%-2.25%). In terms of the Fed's balance sheet, total assets stood at a record $8.93 trillion on February 21. The Fed will likely stop growing the balance sheet in March, and investors will look for clues about plans to shrink the balance sheet. It will be difficult for the Fed to remain so accommodative in the face of inflation.

Investors should plan for the three possible scenarios for stock prices looking forward: rise, trading range, and decline. The plan for rising stocks includes a diversified portfolio of undervalued stocks with strong balance sheets, high dividend yields, and low betas. For a trading range, where stock prices essentially move up and down in a sideways manner, investors can profit by collecting dividends and covered call premiums. For falling stock prices, an important tool for investors is cash in the portfolio. Cash provides three clear benefits for investors in a declining market. First, cash is not subject to stock market risk. Second, the availability of cash allows for the ability to buy additional stocks when they are "on sale". Third, cash allows investors to psychologically be able to "hit the buy button" when other investors are panicking and selling. When you have cash in a declining market, you are less likely be crippled by fear (thus giving you an edge over others who are falling victim to their emotions).

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 $223.27, which implies a price-to-earnings (P/E) ratio of 19.6 with the S&P 500 at 4,374. The earnings yield (E/P) of 5.10% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.83%. The rise in interest rates over the past month accompanied an almost mechanical corresponding decline in stock prices. The S&P 500 is behaving within expectations for technical analysis. The 50-day moving average did indeed act as resistance in February and the S&P 500 now rests below both its 50-day and 200-day moving averages (4,552 and 4,462). The February closing low of 4,225 is a critical support level, followed by 4,060 (May 2021 support) and 3,975 (March 2021 resistance).

Growth stocks are taking it on the chin while value stocks are enjoying strong outperformance in 2022. The S&P value indexes (large, mid, and small cap) are down about -2% to -3%, while their growth counterparts have fallen about -10% to -12% (all with dividends). Higher interest rates are devastating the mega-cap technology stocks. Value stocks are once again being valued by investors.