“Will The Fed Blink?”

Market Commentary – December 2018

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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 3.5% in the third quarter of 2018. This is the same as the advance estimate and down from 4.2% in 2018 Q2. Unemployment measured 3.7% in October, which is the lowest level since 1969. While this may seem like outstanding news, there are concerns that this could potentially stoke inflation (low employment can cause wages to spike as companies try to attract and retain workers). The consumer price index, a measure of inflation, rose 2.5% over the last 12 months as of October. This is slightly higher than the Federal Reserve’s target of 2%. Recall that per its statutory mandate, the Federal Open Market Committee (FOMC) “seeks to foster maximum employment and price stability”. Overall, the economy is humming along with good growth, low unemployment, and reasonable inflation…for now.

The Federal Reserve may blink at recent financial market volatility and back down on its campaign to raise interest rates. Markets are entranced by what the Fed considers “neutral” for interest rates (a level intended to neither speed nor slow economic growth, while satisfying the FOMC’s statutory mandate). On October 3, Fed Chairman Jerome Powell said “we’re a long way from neutral at this point, probably”. The S&P 500, in response, dropped 11% by the end of the month. Interestingly, on November 28, Powell described interest rates as “just below” neutral. This drastic change in tone is likely a response to stock market volatility, although the Fed would hesitate to admit it. After leaving rates alone at its meeting on November 8, the FOMC is expected to increase the federal funds rate by another 25 basis points at its next meeting on December 19. The real question, though, is what will happen in 2019. If the Fed indicates that it is close to ending its rate hike efforts, stocks could rally.

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 $169.42, which implies a price-to-earnings (P/E) ratio of 16.3 with the S&P 500 at 2,760. The earnings yield (E/P) of 6.14% represents attractive value relative to the 10-year U.S. Treasury note yield of 3.01%. The spread between the E/P and 10-Year Treasury seems be maintaining a comfortable margin above 3 percentage points. Looking forward, it will be critical that companies grow their earnings to justify current stock prices. EPS over the past 12 months was $150.53, which means a P/E of 18.3, an E/P of 5.45%, and a spread of only 2.44 percentage points above the 10-year Treasury. It is much tougher to justify current stock valuations without the anticipation of expected earnings growth. Companies must now execute.

After a steep drop in October, the S&P 500 chopped its way higher in November. Support has been established at 2,630, which is just above support around 2,580 from the February and March 2018 lows. Looking up, resistance exists at 2,810 (ceilings on October/November rallies) and 2,930 (near the all-time high). The issue of growth versus value has cooled, with both styles approximately moving in lockstep last month. Considering 2018 as a whole, though, growth has maintained its favor over value. We expect this to reverse in the months and years ahead.

Our readers may find it curious why recent market commentaries have not emphasized the November mid-term election or the trade negotiations with China. While Banyan Asset Management believes that politically conservative policies are friendly to businesses and stocks, we also do not believe that left-leaning politicians are intending to hurt the country. While frustrating for both sides, a system of checks and balances is healthy (and is how our country was wisely engineered from its inception). As for the threat of tariffs with China, we are witnessing negotiation tactics on the public stage. Neither China nor the U.S. truly wants to ruin their relationship and both are likely bluffing. These events make great headlines and cause day-to-day volatility in financial markets, but ultimately it comes down to interest rates.