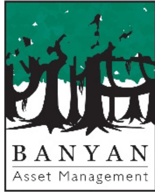


# "Slaying The Inflation Dragon"
## Market Commentary – April 2022

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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 6.9% in the fourth quarter of 2021.** This equals the advance estimate and is lower than the second estimate of 7.0%. On March 16, the Federal Reserve revised its economic projections that were last released in December. It now sees GDP growth of 2.8% in 2022, 2.2% in 2023, 2.0% in 2024, and 1.8% in the "longer run" (beyond 2024). The 2022 estimate plummeted from 4.0% in December to 2.8% in March, which is a massive change in only three months. The Fed sees inflation, as measured by PCE, at 4.3% in 2022 (up from the December forecast of 2.6%). With the Consumer Price Index (CPI), a similar measure of inflation on consumers, coming in at 7.9% in March, inflation seems a long way from cooling to "only" 4.3%.

**In March, the Fed began tightening monetary policy to attempt to slay the inflation dragon.** The Federal Open Market Committee (FOMC) announced on March 16 that the target federal funds rate was raised by 0.25% to a range of 0.25% to 0.50%. As for the Fed's bloated balance sheet (measuring a record high of $8.96 trillion in assets on March 23), it "expects to begin reducing its holdings…at a coming meeting." In its March economic projections, the Fed revealed its forecast of the federal funds rate at 1.9% in 2022, 2.8% in 2023, 2.8% in 2024, and 2.4% in the longer run. Futures markets expect a more aggressive approach with the federal funds rate at 2.3% in 2022 and 2.9% in 2023, before tapering to 2.6% in 2024. In any case, the trend of short-term interest rates in 2022 is up, which is bearish for overpriced growth stocks. The next FOMC monetary policy announcement is scheduled for May 4.

**Bond investors are starting to telegraph their concern that a recession in the U.S. may loom within the next several months to two years.** The following were U.S. Treasury yield curve rates as of March 31: 0.52% 3-month, 1.63% 1-year, 2.28% 2-year, 2.42% 5-year, 2.32% 10-year, and 2.44% 30-year. The yield curve "inverts" when short-term interest rates are higher than long-term rates. Some economists look at the 2-year vs. 10-year, or the 5-year vs. the 30-year. The Federal Reserve Bank of Dallas prefers the 1-year vs. 10-year, citing that since 1956, the yield curve inverted before each of ten recessions. The recession can occur from a few months to a couple of years after the inversion. Note that the mild yield curve inversion today is limited to the "long end" of the Treasury curve and has not yet affected shorter maturities. The yield curve story, and implications of recession, may gain more attention in the months ahead.

**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 $225.47, which implies a price-to-earnings (P/E) ratio of 20.1 with the S&P 500 at 4,530. The earnings yield (E/P) of 4.98% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.32%. The spread between the earnings yield and 10-year Treasury is 2.66%, roughly the same as one year ago. Interestingly, in April 2021, the earnings yield at the time was 4.34% (23.0 P/E). Valuations are correcting with higher Treasury yields.

**The S&P 500 was pushing on support around 4,170 by mid-March and managed to launch a surprising 10% rally from there.** Price action was bullish, as the S&P 500 motored back *above* its 50-day and 200-day moving averages. Volume on the rally was light, however, indicating less conviction in the rally. Perhaps a trading range is in store, with a lower bound of 4,170 and an upper bound of 4,800 (near the high). These levels have become the major support and resistance areas to watch.

**Value continues to outshine growth in this environment.** At Banyan Asset Management, our overall portfolio now sports a modest 12.4 P/E on 2022 EPS, 1.0 beta, and 4.4% dividend yield. Investors are emerging from their infatuation with technology to discover an exciting market full of opportunities. Still, we must be cognizant that tough months may be ahead as the Fed attempts to choke off inflation.