



“Change Of Character”

Market Commentary – February 2025

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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 2.3% in the fourth quarter of 2024. This is lower than 3.1% in 2024 Q3. The components of the 2024 Q4 GDP number are: consumer spending +2.82 percentage points, investment -1.03 percentage points, net exports +0.04 percentage point, and government spending +0.42 percentage point. The sum of these numbers equals +2.25%. Consumer spending was strong across both goods and services, contributing +1.37 and +1.45 percentage points to GDP, respectively. As for investment, once factoring out the volatile inventory category of -0.93 percentage point, fixed investment weighed on GDP by -0.10 percentage point. If the tepid investment value was caused by political uncertainty surrounding the election, it should rebound in 2025 Q1. With respect to individual stocks, we have observed some companies thriving, while others, in a variety of sectors, are struggling. The economy has pockets of strength and weakness at the moment.

On January 29, the Federal Open Market Committee (FOMC) maintained the target range for the federal funds rate at 4.25% to 4.5%. As for the future of interest rates, the FOMC “will carefully assess incoming data, the evolving outlook, and the balance of risks”. Futures markets see the next 0.25% cut in the federal funds rate by July 2025, a second 0.25% cut by December 2025, and a third 0.25% cut by December 2026. If inflation refuses to cool in the months ahead, these cuts could be in jeopardy. The Fed’s balance sheet had \$6.818 trillion in assets on January 29, down \$68 billion from December 25 (roughly in-line with the Fed’s reduction commitment of \$60 billion per month). Before COVID-19 in February 2020, there were \$4.2 trillion of assets on the Fed’s balance sheet. Moreover, there were only \$0.9 trillion in assets on the balance sheet in September 2008, immediately prior to the bankruptcy of Lehman Brothers. The inflated balance sheet may have indirectly contributed to the bubbles in mega-cap tech stocks and Bitcoin. The next FOMC announcement on monetary policy is scheduled for March 19.

Technical factors of the market are bearish (more supply than demand), while fundamentals are unattractively priced – therefore, we are mildly bearish on the market. The Standard & Poor’s forecast for S&P 500 operating earnings per share (EPS) through December 31, 2025 is \$271.09, which implies a price-to-earnings (P/E) ratio of 22.3 with the S&P 500 at 6,041. The earnings yield (E/P) of 4.49% represents unattractive value relative to the 10-year U.S. Treasury note yield of 4.58%. At Banyan Asset Management, we started tracking the relationship of E/P to the 10-year Treasury in December 2007. January 31, 2025 is the first time in our analysis where we have observed the 10-year Treasury yielding more than stocks. This indicates that the S&P 500 is arguably too expensive, driven by the seven largest companies in the index. These seven companies make up \$17.7 trillion of the \$53.7 trillion S&P 500 index market capitalization with a weighted P/E of 36.8. If 32.9% of the index has a P/E of 36.8, then 67.1% of the index has a P/E of 15.2 for the overall P/E to be 22.3. A P/E of 15.2 is an E/P of 6.60%, which is attractively priced compared to the 10-year Treasury note yield of 4.58% (a yield spread of 2.02%).

While the S&P 500 closed at a record high of 6,118 on January 23, three of the “Magnificent 7” stocks broke to the downside. The weakness of these three market leaders was offset by strength in the other Magnificent 7, but there was also a change of character in the stock market in January. Capital flowed into the “S&P 493”, mid-caps, and small-caps, including value stocks. One catalyst for the change of character is DeepSeek, a Chinese company that has allegedly created artificial intelligence models with output rivaling those of U.S. companies while using cheaper, less powerful hardware. When companies make abnormally high profits, disruptive forces (i.e., “a better mousetrap”) can topple the previously invincible. The “E” in P/E may prove too high for the Magnificent 7. Meanwhile, higher interest rates can put a lid on P/E itself. Warren Buffett famously equated interest rates in the financial world with gravity in the physical world. Higher interest rates cause valuations to come crashing back down to earth. Capital from bubbly stocks may continue to rotate into previously unloved stocks trading at attractive valuations.