"Money For Nothing"

Market Commentary – August 2021

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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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 6.5% in the second quarter of 2021. This is higher than 6.4% in 2021 Q1 and represents an historically torrid pace of growth. The components of the 2021 Q2 GDP number are: consumer spending +7.78 percentage points, investment -0.57 percentage point, net exports -0.44 percentage point, and government spending -0.27 percentage point. The sum of these numbers equals +6.50%. Consumer spending on goods (durable and nondurable) was still strong, although it eased a bit from Q1. Meanwhile, consumer spending on services more than picked up the slack. Investment was penalized by -1.13 percentage points due to more inventory depletion. Companies are struggling to find workers, which is depleting various inventories across the country. Eventually, these inventories will need to be rebuilt, fueling future growth. We are experiencing unusual shock waves from the Great Cessation of 2020, caused by the COVID-19 lockdowns.

The Federal Reserve continues to stoke economic growth with unprecedented monetary stimulus. In its monetary policy announcement on July 28, the Federal Open Market Committee (FOMC) maintained its federal funds rate at a target range of 0%-0.25% and the Fed's balance sheet increasing by $120 billion per month. As of July 28, there were $8.27 trillion of assets on the Fed's balance sheet ($0.12 trillion higher than June 23, as expected). Financial markets are addicted to the Fed's intoxicating potion of rock-bottom interest rates and purchases of Treasury and mortgage-backed securities. Recall that the FOMC "seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run." The future of Fed policy deserves a deeper dive into employment and inflation.

The Fed faces a conundrum of reducing unemployment while calming inflation. Unemployment stood at 3.5% in February 2020, immediately before the Great Cessation. It spiked to 14.8% in April 2020, bottomed at 5.8% in May 2021, and ticked up to 5.9% in June. While 5.9% is much lower than 14.8%, it is also stubbornly higher than the 3.5% reading before the COVID-19 mess. Within the past several months, inflation has become red hot. The Consumer Price Index (CPI), a measure of inflation experienced by consumers, rose 5.4% over the last 12 months as of June 2021, while the Producer Price Index (PPI), a measure of input costs, jumped 7.3% year-over-year. The Fed expected such inflation but believes it will be "transitory". Will it? Juicy COVID-19 unemployment benefits give workers an incentive to game the system and stay home. "Money For Nothing", as Dire Straits famously sang in 1985. Businesses cannot find workers to meet booming demand. Higher wages are being offered, which is inflation. Wage inflation is tricky, though, because businesses cannot easily *cut* employee pay in the future. If the Fed changes its stance and believes inflation is here to stay, the easy monetary policy party will end.

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) during 2021 is $189.83, which implies a price-to-earnings (P/E) ratio of 23.2 with the S&P 500 at 4,395. The earnings yield (E/P) of 4.32% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.24%. Note how the spread between E/P and the 10-year Treasury has increased to 3.08% (versus 2.60% in April).

The S&P 500 has lulled investors into a false belief that it only rises. The index continues to hit new all-time highs, so there is no technical resistance overhead. Support should be near 4,280 (50-day moving average), 4,165 (April/May resistance and June support), and 3,940 (200-day moving average). Interestingly, since the 10-year U.S. Treasury yield peaked around 1.75% in March, growth stocks have picked up steam relative to value stocks. We are not lured by this siren's song. The overall portfolio at Banyan Asset Management enjoys a 12.0 P/E on 2022 EPS, 1.0 beta, and 4.1% dividend yield. These parameters should help smooth the shock of the next market correction, which is only a matter of time.