"Don't Dig Too Big Of A Hole"

Market Commentary – February 2023

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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 2.9% in the fourth quarter of 2022. This is lower than the 2022 Q3 reading of 3.2%. The components of the 2022 Q4 GDP number are: consumer spending +1.42 percentage points, investment +0.27 percentage point, net exports +0.56 percentage point, and government spending +0.64 percentage point. The sum of these numbers equals +2.89%. Overall, this number is weaker than the headline appears. Consumer spending is historically 70% of GDP in the U.S., so the +1.42 percentage points contribution of consumer spending corresponds to roughly 2.0% GDP growth. Investment is a desirable way to grow GDP, but the +0.27 percentage point result masks two underlying problems. First, fixed investment penalized GDP by -1.20 percentage points, led by Residential sluggishness hurting GDP by -1.29 percentage points. Offsetting this weakness was change in inventories, adding +1.46 percentage points to GDP. Unfortunately, inventory growth is volatile and not sustainable. Finally, net exports and government spending are historically volatile and hover around 0%, and both of these values contributed materially to 2022 Q4. It pays to take a look under the hood at the details, rather than to believe the "strong GDP growth" media headline hype.

The next Federal Open Market Committee (FOMC) announcement on monetary policy is scheduled for February 1, which is likely to stir volatility in financial markets for the new month. The benchmark federal funds rate currently stands at a target range of 4.25% to 4.5%. Futures markets predict that the Fed will stop hiking rates around 4.9% (only 0.5% higher). If this proves accurate, the Fed is nearing the end of its aggressive rate tightening campaign. Meanwhile, the Fed's balance sheet had $8.471 trillion in assets as of January 25, 2023. Recall that the Fed projected in May 2022 the reduction of assets by $47.5 billion per month starting June 1 and $95 billion per month starting September 1. With assets of $8.914 trillion on May 25, 2022, there should be $8.296 trillion on the balance sheet as of February 1, 2023 ($617.5 billion fewer assets). The Fed has contracted the balance sheet by $175 billion less than they originally telegraphed – a material difference! We maintain that this is a clue the Fed is secretly worried about unintended consequences of their tightened monetary policy.

As many investors learned in 2022, it is important to not dig too big of a hole with negative investment returns. This is best highlighted with some examples. Assume you have a $1 million portfolio. If the portfolio drops -10% during the year, you now have $900,000. To turn that $900,000 back into $1 million, you need to earn $100,000 on $900,000, or +11% (lose -10%, need +11% to breakeven). If your $1 million falls by -25%, you need to earn $250,000 on $750,000 to breakeven (lose -25%, need +33%). If your $1 million collapses by 50%, you need to earn 100% to breakeven (likewise, lose -80%, need +400%). The point is that in the realm of losses, the bigger hole you dig, you need to earn exponentially higher returns to breakeven. This is a large part of the logic of taking a balanced approach to portfolio management.

Technical factors of the market are bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $223.63, which implies a price-to-earnings (P/E) ratio of 18.2 with the S&P 500 at 4,077. The earnings yield (E/P) of 5.49% represents fair value relative to the 10-year U.S. Treasury note yield of 3.52%. As the 10-year yield has dropped, the S&P 500 P/E has floated higher. In turn, mega-cap technology stocks have enjoyed a relief rally.

The S&P 500 is on the cusp of a "golden cross", where the 50-day moving average (3,946) surpasses the 200-day moving average (3,954). Because technicians follow this pattern, it is a recipe, although far from a guarantee, of an explosive rally higher. Interestingly, the timing could correspond to financial markets interpreting that the Fed is nearing the end of its war on inflation. While being mindful of these market patterns, we focus on undervalued stocks with strong balance sheets, low betas, and high dividends.