"Nearing The End"

Market Commentary – April 2023

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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 2.6% in the fourth quarter of 2022. This is lower than the advance estimate of 2.9% and the second estimate of 2.7%. On March 22, the Federal Reserve revised its economic projections that were last released in December. It now sees GDP growth of 0.4% in 2023, 1.2% in 2024, 1.9% in 2025, and 1.8% in the "longer run" (beyond 2025). If the Fed is correct with its assessment, we are going to see some depressing GDP results from the current level of 2.6% (which itself is not stellar). The Fed sees inflation at 3.3% in 2023 (up from 3.1% projected in December) and unemployment at 4.5% (down from 4.6% in December). Overall, the U.S. is suffering from an economic hangover after binging on loose monetary and fiscal policies during COVID.

On March 22, the Federal Open Market Committee (FOMC) raised its benchmark federal funds rate by 0.25% to a target range of 4.75% to 5.0%. The Fed is quickly nearing the end of this rate hike campaign. Financial markets were struck by a black swan in March with the sudden failure of two U.S. banks, and a handful of others seemingly in dire straits. The Fed now has the unenviable task of balancing its war on inflation with handling the risk of potential financial contagion. The FOMC sees its federal funds rate at 5.1% in 2023 (implying one more 0.25% rate hike), 4.3% in 2024, 3.1% in 2025, and 2.5% in the "longer run" (beyond 2025). Fed funds futures predict only a 26% probability of another 0.25% increase by May 2023 (i.e., market participants believe the Fed is already done raising rates). Moreover, futures markets see the FOMC *cutting* the federal funds rate by 0.25% in November 2023. Interestingly, the Fed's balance sheet skyrocketed from $8.340 trillion on March 1 to $8.706 trillion on March 29 to help handle the bank situation. Recall that the federal funds rate was at a target range of 0% to 0.25% until March 16, 2022. Aggressive monetary tightening over the past year is causing visible cracks in the financial system.

A quick refresher on the inverse relationship between bond prices and bond yields is in order. Higher bond yields drive lower bond prices (and vice versa). In a rising interest rate environment, bond investors may face "unrealized losses" on their bond portfolio. As long as the investor holds a bond to maturity and the bond's coupon (i.e., interest rate) continues to be paid, the loss will never be realized. The bond will ultimately rise in price and mature at par value, returning all original capital to the investor. The loss on the bond's *temporary* decline in price only becomes realized should the investor *sell* the bond at the low price. Such sales could be forced due to exogenous events, such as a liquidity crunch. Banks, which hold debt securities, can face a liquidity crunch when large numbers of depositors want their money back at the same time (i.e., a "run on the bank"). This could force a bank to sell debt securities at depressed prices, thus realizing losses.

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 $225.12, which implies a price-to-earnings (P/E) ratio of 18.3 with the S&P 500 at 4,109. The earnings yield (E/P) of 5.48% represents attractive value relative to the 10-year U.S. Treasury note yield of 3.48%. The yield spread snapped from 1.61% last month to 2.00% today, thanks to the increased EPS estimate and falling Treasury yield.

Despite the troubling bank news headlines in recent weeks, the S&P 500 ironically closed at its highest level in March on the last trading day of the month. The next test on the upside will be taking out resistance at 4,180 (February 2023 high). There is plenty of support below, especially around 4,020 (50-day moving average), 3,935 (200-day moving average), and 3,800 (December 2022 and March 2023 lows). When analyzing stocks by market cap (small, mid, and large) and valuation (value and growth), there was a change of character during March. Money poured out of small and mid-cap stocks into large-cap stocks, while growth was favored over value. This is how opportunities in stocks we like are generated.