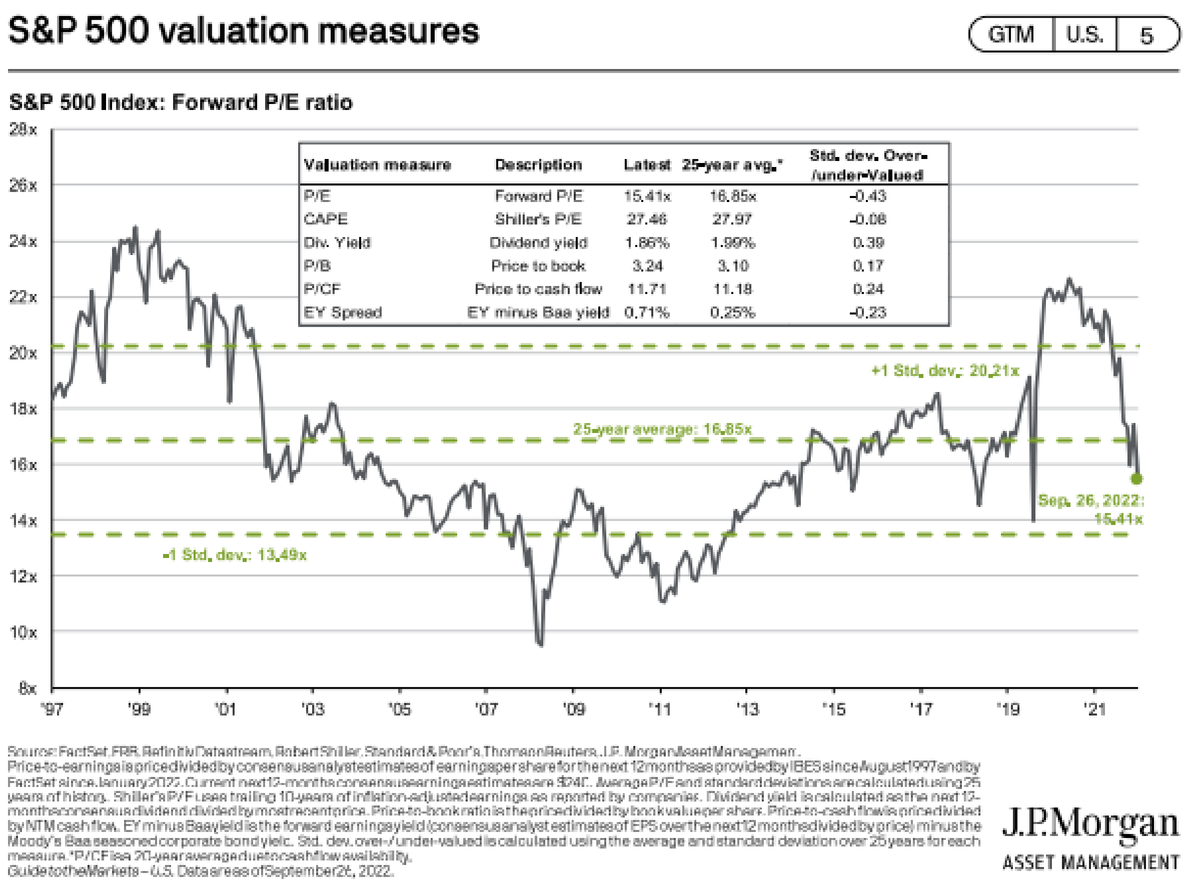
Trusting the Fed and other Bad Habits

Markets over time deviate from between optimism and despair. Prices are determined by individuals and what they think, at any particular time, what a company is worth. It doesn't have to make sense. To make a quick point, for educational purposes only, let's look at Amazon. In the past year it has been between $188 and $101. Currently, at the time of this writing, it's around $116. Is it worth $116? Well, at this date and time, the consensus opinion says yes. It will surely change its mind tomorrow… and next week… and next month. Yes, its revenue and profits are growing at a fairly rapid pace, but does that matter? Bulls would say it's too cheap and Bears would say it's too expensive… and hence we have markets to settle the battle. But the battle is never "settled." The "mood" of the market changes faster than a teenage girl. I can say that, I've raised three!

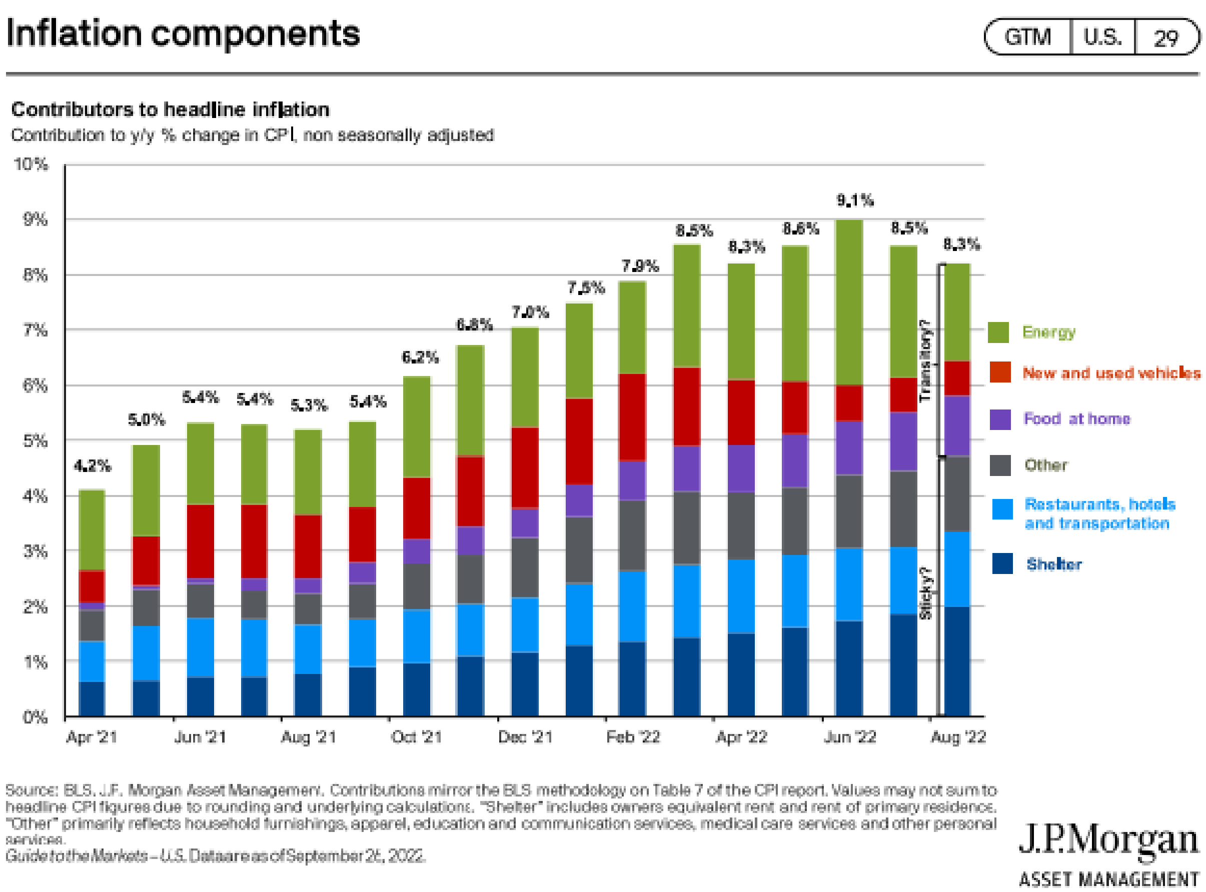
But at the end of the day the market is not always determined by dreams, wishes, and random thoughts. There is (almost) always a "reversion to the mean." Corporate earnings and their corresponding prices have a unique way of showing that. Note, I said "showing" not predicting. Take a look at the chart below:



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	15.41x	16.85x	-0.43
CAPE	Shiller's P/E	27.46	27.97	-0.08
Div. Yield	Dividend yield	1.86%	1.99%	0.39
P/B	Price to book	3.24	3.10	0.17
P/CF	Price to cash flow	11.71	11.18	0.24
EY Spread	EY minus Baa yield	0.71%	0.25%	-0.23

Here we see the ratio of prices and earnings, i.e., the P/E or price earnings ratio. You will note some periods of extreme optimism (end of 1999 and the dot.com period) and some periods of extreme pessimism (2008 and the Great Financial Crisis). If we measure these ratios over a long period of time we get a good idea of what is "expensive" and what is "cheap…" and what is fairly valued! At the end of the last year, the forward P/E ratio on the S&P 500 was 20.9, 24% above its 25 year average of 16.9 times. As of the end of last week, 9/23/2022, it was 15.4, 8% below its long-term average. If you take out the 10 largest companies (the remaining 490) the P/E is only 14.7 or around 15% below its long-term average. If you look at Mid and Small stocks (S&P 400 and S&P 600) they are selling more than 1 standard deviation below their long-term average. Extremely low levels.

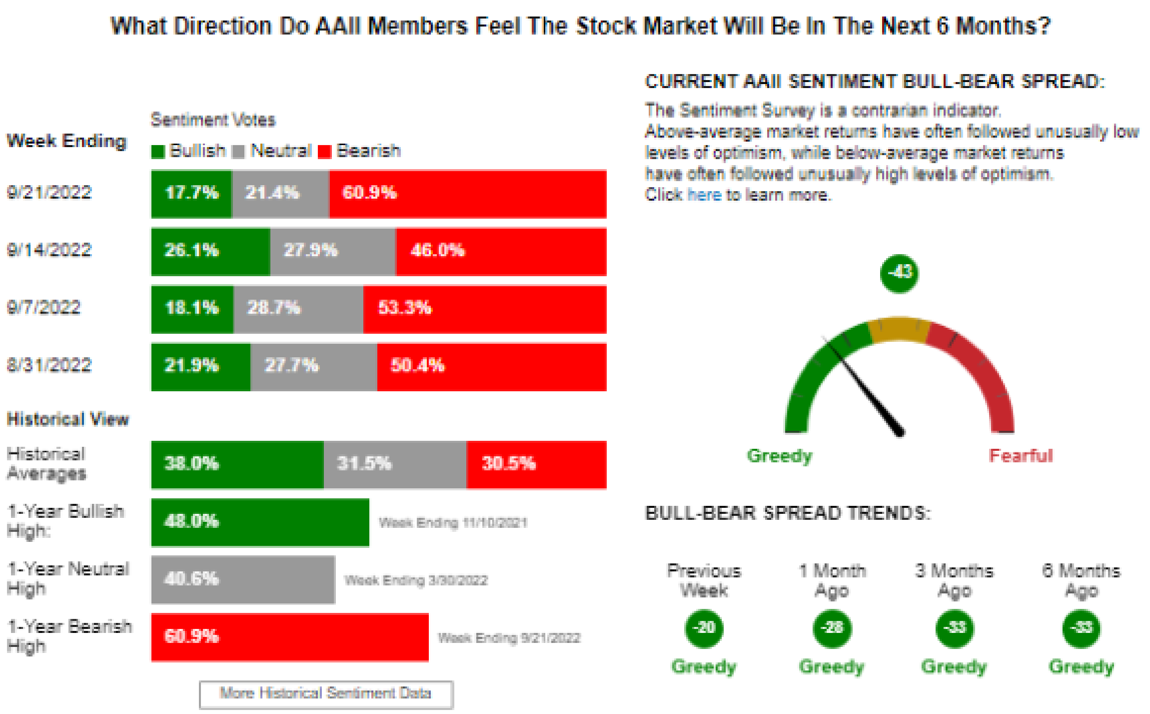
Currently, there are three main outside factors affecting the markets. The big one is the Federal Reserve and its current mandate to raise rates to quell inflation. We can discuss and debate this topic all day, but at the end of the day the Fed is going to do whatever they want. And they want to bring inflation down to 2 – 2 ½%. To give you a little historical perspective, see the chart below:



It's interesting to point out that the Fed is always driving by using the rear view mirror. They look at this and say inflation is at 8.3%. Excuse me, but inflation WAS at 8.3%. The last 3 month-over-month changes to inflation have been -0.1%, unchanged, and 0.1%. So, if we annualized the last 3 months, the current inflation is zero. But the Fed will continue to raise rates… until they don't. There are two more CPI releases (October 12th and November 11th) before the next Fed meeting. A lot can happen between now and then. It is appearing more and more evident that this current decision to continue to raise rates until next year is a policy error. The Fed has changed their outlook and direction on a fairly consistent basis. To take the Fed at their word as a long-term policy has been… well, foolish. They will change again, but probably not real soon.

I did mention 3 things affecting the market and the other two are China and Ukraine. China has their Communist Party Congress in October. Look for them to "reassess" some of their "look-down" policies and lean more pro-growth. Kind of the necessity for them. For Ukraine, it's anybody's guess. For Russia, it's been disastrous, and we should not discount the possibility of some change in Russian policy (or leadership!). All wars eventually end. This one looks tired, and in the "saving face" stage. Who knows.

Getting back to the markets, valuations and prices, we mentioned "optimism and despair." It should be noted that some folks (in particular AAII – American Association of Individual Investors) have been tracking investor sentiment quite effectively for years. They have been polling individuals to see if they are bullish or bearish. The idea is that it's a great "contrarian indicator." The theory is that when a person is bullish, they have already bought… and now they can (in theory) only hold or sell. And the opposite applies to the Bears. They've already sold. So, see the chart below.



Source: https://www.aaii.com/sentimentsurvey

Note the most current week of 9/31/2022. Only 17.7% bullish… personally, I don't over remember seeing it that low before. I do know that the 27 times before it got below 20%, the market was higher 27 times. 27 to 27! The only 100% of the time "correct" indicator. Also note the bearish indicator – 60.9%... an all-time historical record. According to this chart, we should be getting "greedy." Bull markets always start in the basement of investor despair.

Let me leave you with this thought. Are we getting close to the final stages of interest rate hikes? The next one MAY be the last one. If not, maybe one more a month later. And since the stock market historically looks 6 months in advance, do you think the Fed will still be raising rates in 6 months? Or will they be closer to lowering them? If you look at the Futures market, they are saying a potential of lowering the interest rates in the 3rd quarter. Just saying…

Link to monthly economic forecast for 10/1/2022: https://www.youtube.com/watch?v=PaaZxGZvs6c

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