



MARKET News Flash

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American Portfolios (AP)
Chief Investment Officer
Cliff Walsh, CFA®, brings you
this AP Market News Flash
offering breaking commentary on
recent market conditions.

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The U.S. Federal Open Market Committee (FOMC)

left the target range for the federal funds rate at 0-0.25 percent, in line with the futures' market expectations. The committee noted that the ongoing health crisis represents short- and medium-term risks to the economic outlook, although it did point out the recent improvement in economic data. The target interest rate range is expected to remain at this level until the committee is confident that the economy has weathered the storm, meaning full employment and inflation at or even above its 2 percent target and maintaining that rate for an extended time period. According to the committee's forecast, the current emergency rate level will remain in place at least through 2023, adding another year of emergency-level rates to its forecast.

The Federal Reserve (the Fed) also stated that it would continue its monthly purchases (QE) of at least \$120 billion of government and agency bonds to "support the flow of credit to households." We are not at all convinced that is what QE accomplishes, based on the near zero correlation between it and U.S. GDP. We think it is much more likely to support the equity markets, of which the Fed's balance sheet carries a greater than 70 percent correlation to the S&P 500. Regardless, the status quo and Fed support appears likely to continue.

We continue to believe that the Fed's balance sheet expansion is a major driving force behind the financial market's strong performance off the March bottom, creating a significant divergence from economic reality, even when looking out to 2022. We think valuations are elevated and we have growing concerns about the massive amount of debt monetization and deficit financing currently taking place.

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At the start of the year, the consensus estimate for 2021 S&P 500 operating EPS stood at \$193. It now stands at just under \$166/share. Consensus has declined by 14 percent year-to-date, while the S&P 500 is still up nearly 5 percent on the year and hit a new high only two weeks ago. For 2022, the consensus forecast started the year at \$209, but has declined to \$193, an 8 percent reduction. This, coupled with the market's positive return this year, has inflated the 2021 P/E from 16.7x to 20.4x, and the 2022 P/E from 15.5x to 17.5x. This is concerning to us because this expansion is seemingly less about fundamentals and more about inorganic stimulus.

Perhaps, though, the market multiple expansion is warranted, given the lower-for-longer interest rate forecast and expected continued support from the Fed. However, the market's reaction to the news was rather interesting. Not only did the market sell off on the news, but value closed well into the green (up roughly 0.5 percent), outperforming growth shares by nearly 175 basis points—hardly the response most would expect from extending the duration of a flat yield curve. Is this signaling that the great divergence between growth and value has peaked and will continue to narrow? We shall see; and, it will be interesting to find out.

We will provide a more in-depth overview of the financial markets and economy at our national conference, Connections 2020, to be held Oct. 21-23.

Sources

ⁱ <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200916a.htm>

ⁱⁱ <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200916b.htm>

ⁱⁱⁱ FactSet Research

^{iv} FactSet Research

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