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Wealth Advisory Market Update

March 5, 2024

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Market Update

Equities:

The market, as measured by the S&P 500 index, rose by 5.2% for the month of February. This marked the best performance in February since 2015. This move comes on the heels of disappointing macro and inflation data. Current inflationary data is pointing to a reacceleration of prices in the coming months. This dashed the market's hope of a March rate cut and reduced the total number of cuts for the year. Coming into 2024, the futures markets were pricing in six rate cuts during the year. The consensus now stands at four rate cuts, with the first not occurring until this summer. Market internal indicators continue to worsen, with breadth remaining weak and concentration being at levels last seen in 1929.

Equities remain decoupled from bond yields, which have continued to rise since the beginning of the year. Historically, higher rates lead to longer duration equities underperforming shorter duration companies. So far, this has not been the case as utilities are trading at March 2000 lows relative to the S&P 500, while technology-related companies continue to outperform. The last time the market traded at these extremes, it marked the blow-off top for stocks during that cycle.

The emergence of AI remains a key catalyst driving indices higher while leaving the broader market behind. In our opinion, the few stocks that are driving the indices higher are detached from fundamentals and have entered the manic phase. Concentration risk has increased considerably. The weight of the top 5 stocks in the S&P 500 is at roughly 25%, and the top 10 is at 40%. The deterioration of internal indicators while the market marches higher is indicative of a market peak. We are not calling this the top; we are saying it looks like one.

We continue to remain steadfast in our discipline, as valuations remain extreme in pockets of the market. It is important to note that there are 41 companies in the S&P 500 trading above 10x price-to-sales and 131 trading above 5x. This valuation metric implies how much an investor pays for each dollar of the company's sales. At 5x sales, the firm must grow sales by about 50% annually to maintain that valuation. Currently, economic data is indicating a slowdown, market internals are flashing red, valuations are stretched, yields are rising, inflation remains sticky, and geopolitical risks are rising. This gives us pause and dictates a more defensive positioning in equity portfolios. We are sticking to our discipline, which right now pushes us to shorter duration equities, with strong balance sheets, inelastic demand for goods, and a dominant position in their respective industries.

Economic Indicators and Monetary Policy:

The US consumer is under pressure. Inflation, higher interest rates, and debt load are weighing heavily. Consumer spending accounts for 70% of economic growth in the US, and current data shows they are pulling back. The retail sales report showed consumer spending slowing in the month of February. It was expected to decrease by .3% but dropped by .8%.

We have mentioned previously that revolving credit is at the highest levels in history. Consumers are carrying more on their credit cards than ever before. The spending we were seeing in the back half of 2023 was not sustainable because of this, and it will not be sustainable going forward. Currently, the number of adults in distress with credit card debt has reached Great Recession levels. We do not see the situation for the consumer improving in 2024 without a major reprieve from inflationary pressures or interest rates.

The Federal Open Market Committee (FOMC) did not meet for the month of February. However, all of their key metrics were released which gives an idea of policy movement in the short term. The Consumer Price Index and the Purchasers Price Index both came in hotter than expected on month-to-month and year-over-year readings. These results saw the market's expectations for a first rate cut moving to June. Before the year started, the market was forecasting a rate cut in March. Powell delivers his semi-annual monetary policy testimony this Wednesday, which should give us more insight on future policy moves.

The Fed's favorite inflation indicator, the Personal Consumption Index, met expectations. Core PCE rose for consecutive months and rose at the fastest rate since January of last year. We are watching service data closely. Inflation in services is sticky and gets embedded in the economy, which is why we believe getting to the FOMC's target of 2% inflation is going to be tough. We believe the FOMC will make a move with its balance sheet before it does on rates. We have mentioned for a couple months that our belief in an adjustment to asset roll-offs will come this year. It will not be called QE, but will be similar to Operation Twist during the Yellen Fed. But instead of adding longer duration debt, it will do the opposite and move more monies to T-bills.

Current economic data is at odds with a soft landing. A mild/deep recession seems more likely when looking at the current state of the consumer and the inflationary data. Jamie Dimon, CEO of JPMorgan, thinks the market odds of 70-80% for a soft landing are too high. He believes the odds are half that, with a recession more likely than not. We agree with these sentiments and are positioning portfolios accordingly.

Strategy:

Recent economic data suggests the Federal Reserve will struggle to produce a soft landing for the economy, with a recession more likely. Therefore, we place a higher value on defensive strategies. Historical evidence indicates that companies boasting considerable market capitalization, pricing authority, and demand stability tend to fare better amid economic downturns. Regarding the fixed-income space, our emphasis lies on high quality credits that offer suitable risk compensation. With the recent rise in yields, we have extended duration utilizing quality corporates and Mortgage-Backed Securities (MBS) due to the attractive spreads and favorable risk return profiles.

As we navigate this challenging environment, we appreciate your support and the opportunity to collaborate in achieving your financial goals.

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