Wealth Advisory Market Update

March 7, 2023

Market Update

Equities

The equity markets opened February on a strong note but then experienced a pullback, and February ended with the S&P 500 down 2.44%. The good news is that the S&P is still up 5.69% for the year. We also continue to see a short squeeze in growth stocks, something we mentioned in our last update and expect to see more of in the short term. For example, data between January 31st and February 15th from Goldman Sachs and JP Morgan Chase & Co., indicates that prime brokerage businesses have seen the second largest short covering of U.S. tech stocks in the past decade. Hedge funds find navigating this short squeeze environment difficult, and as a result these shorted stocks continue to outperform the overall market. This squeeze also keeps the technology sector's forward multiple high, at 22x earnings. The high beta trade continues to be detached from fundamentals, much like in the first half of 2021.

With the most recent earnings season nearly complete, the results have been less than stellar. S&P 500 companies are set to post a 4.6% drop in earnings compared to the previous year. The average earnings result beat expectations by 1.3%, yet were well below the five-year average of 8.6%. Guidance has not been optimistic; eighty-one companies have issued negative EPS guidance while only twenty-four have issued positive EPS guidance. Ten of the eleven sectors have cut their earnings estimates for the year and the only sector that has increased its mark was Consumer Staples. This decline in current year estimates is the largest decline in earnings estimates since 2016. In addition, we are seeing market liquidity dry up, causing more intra-day volatility and we do not anticipate a change anytime soon.

While the market in the short term continues to be driven by technicals, it is important to remember that in the long run fundamentals will take hold. Strong balance sheets are the key for sustainable growth. Although current economic reports continue to show troubling results, we believe it is important to not get distracted by market trends. Our focus continues to remain on market dominant players with pricing power.

Monetary Policy and Economic Indicators

All eyes are now focused on the upcoming Federal Open Market Committee (FOMC) meeting. Since the Fed slowed down their pace of rate hikes to 25 basis points in January, economic numbers have shifted. As we mentioned in the last update, Powell's speech was very dovish. He used the word "disinflationary" ad nauseam and as a result, the markets responded bullishly to his message. Unfortunately, February gave us a stretch of economic data that was anything but positive for the FOMC. It started with a hot jobs report that shocked many of the experts. Consensus expectations predicted 185,000 jobs to be added, but the actual figure was 517,000. This tight labor market is a concern for the Fed, indicating that rate hikes have not yet slowed the economy.

In addition to the job's reports, retail sales came in above expectations and continued to show a resilient consumer. This is the third straight month that retail sales have come in better than expected. Next came Core PCE. The Core Personal Consumption Expenditure (PCE) Price Index measures the change in the price of goods and services purchased by consumers for the purpose of consumption, excluding food and energy. After the index declined for four straight months, the trend reversed. Core PCE rose from 4.4% in December to 4.7% in February. This resurgence makes notions of "disinflationary" data sound awfully similar to the notions of "transitory" Inflation. These recent releases lead us to believe that the Fed will have to change course and increase the next rate hike to 50 basis points in March. The data indicates that inflation will continue to be sticky, and it will be challenging to get to the Fed's target rate of 2%.

As we inch closer to the summer, the debt limit becomes more noteworthy. As we mentioned in our last update, "*The debt limit remains the greatest political risk of 2023.*" Negotiations remain at a standstill. Both Janet Yellen and Jerome Powell have stressed the importance of getting a deal done. We still expect that both sides will come together and reach a deal before the clock runs out. Congress is still divided and we do not forecast any major fiscal changes on the horizon.

On the geopolitical front, tensions have continued to rise since our last update. The fighting in Ukraine has intensified, and attacks are now occurring on Russian soil. Many European nations, as well as the United States, have again increased the amount of aid and weapons supplies to Ukraine. Russia has spoken out against this and continues to issue threats to NATO for “escalating” the war. Relations between the U.S. and China remain strained. We do not expect either of these situations to be resolved in the near term. The market will continue to remain vulnerable to the ongoing geopolitical instability.

Strategy

Economic trends of 2022 are continuing to roll into 2023. On the equity front, we will continue to be overweight quality. We remain focused on market dominant players with strong, free cash flow that have inelastic demand for their goods and services. In our opinion, this strategy should perform well relative to the market, whether inflation remains ingrained in the economy or the FOMC pushes the economy into recession.

As we mentioned in recent newsletters, we began adding longer duration to our fixed income portfolios. We believe this is a good opportunity to start averaging new capital into the bond market. You may remember that it was not that long ago that rates were zero and fixed income investing seemed all but dead. All that has changed with a higher Fed Funds Rate, sticky inflation, and interest rates higher across the curve. Looking out five years, with the ability to get 5-6% interest, is something we have not been able to do for over a decade. In our opinion, the much talked about death of the 60/40 portfolio was short lived and it is a good time to diversify across asset classes. With the economy struggling, and the FOMC still on a rate hike cycle, we will continue to invest in high quality that offers enough return for the underlying risk.

As always, we continue to navigate this difficult environment to the very best of our ability. We at AMB thank you for your support and for allowing us to partner with you in reaching your financial goals.

Matthew J. Roach, CFA®
Chief Investment Strategist

Mike Servetas
Assistant Portfolio Manager