Wealth Advisory Market Update

May 5, 2023

Market Update

Equities

The month of April finished strong with a late rally that pushed the S&P 500 index up 9.17% for the year. Earnings reports from both banks and tech companies helped fuel the rally. While these earnings reports beat estimates, it is important to note that these estimates have been revised significantly lower. A top and bottom-line beat sounds good until you dig further into the numbers.

Most of the big tech companies reports showed growth rates slowing across the entire spectrum on a YoY basis. This includes revenue growth, earnings growth, and margins. There is also plenty of mention of the phrase “uncertain macroeconomic conditions” among top executives in these earnings calls.

As we mentioned in the previous letter, the S&P 500 index is being fueled by a very thin number of stocks, mainly growth stocks. In fact, the top 10 contributors make up 80% of the entire return of the index. Furthermore Apple, Microsoft and Nvidia comprised 47% of the entire return.

An index led by a small group of stocks is not a sign of a healthy market. The market cap of the largest 10 stocks relative to S&P 500 is at a 96-percentile relative to history. Last quarter’s performance was led by the narrowest leadership ever in an up market. We continue to believe the market is overvalued and that the Tech space is once again in a bubble. Chasing short-term returns and deviating from our discipline would be a mistake. We believe the best strategy right now is to be patient.

The stress among the banking sector looked to have been contained, but the collapse of First Republic has sparked fears among financials again. After several attempts at financing via the private sector failed, the FDIC worked out a deal with JPMorgan to purchase most of First Republic’s assets and all of their deposits. When it was all said and done, First Republic which was the 14th largest bank by assets in the United States became the second largest bank failure in our country’s history. The bank was unable to recover after it lost $100 billion in deposits during the panic runs in March. JPMorgan CEO Jamie Dimon stated that the banking system is very sound and that this should be the end of the turmoil.

Uncertainty remains high across financial markets. Geopolitical tensions have continued to grow and we do not see that easing anytime soon. A surprising development came from French President Emmanuel Macron’s visit to China. Macron commented that the European Union should make attempts to shift away from the U.S. dollar as a reserve currency. He also mentioned that the European Union should avoid joining the U.S. if a military conflict occurs between the U.S. and China. These comments have strained relations between France and the U.S, and they continue to add to the many geopolitical uncertainties facing the US today. This comes on the heels of China, Russia, and Iran challenging US Dollar hegemony recently.

Debt ceiling news this week was met with a marked risk off sentiment. Due to a drop in tax receipts, Janet Yellen, United States Secretary of the Treasury, said that the U.S. could hit its debt ceiling as soon as June 1st. However, we believe this date is overly conservative and we still believe the date is sometime in July. This earlier-than-expected date forced the President and House Speaker Kevin McCarthy to come to the table and negotiate. They are now set to meet May 9th. We continue to believe a deal will get done in the coming months as any other outcome would be catastrophic.

Monetary Policy and Economic Indicators

The FOMC delivered a 25-basis point hike on Wednesday which was in-line with consensus. This announcement marked the 10th rate hike in a row in the current cycle. Once again, the most important part to the meeting was not the rate decision, but the press conference that followed. A bank failure again preceded the meeting, just like the March meeting. Powell, in similar fashion to his last press conference, ensured that the banking system is sound and secure. He believes that the banking system has broadly improved and that the deposit outflows have stabilized since March. Powell said that the Fed remains committed to monitoring the sector should anymore developments occur, but he believes that it was limited to those three banks (Silicon Valley Bank, First Republic, and Signature Bank). The Chairman stated that the Fed remains strongly committed to bringing inflation down to the 2% threshold. When asked if the Fed would allow inflation to be at 3% for a prolonged period and then eventually reach 2%, he said that the Fed would not look to do that. Powell said that the Fed will be data dependent on economic conditions to determine whether any additional tightening is warranted.

The market continues to be hopeful that the Fed will cut rates in the back half of the year, but Powell's commentary on that topic does not indicate that they will. The Chairman said that the committee believed that the inflation fight will take some time and that rate cuts are not appropriate.

The labor market remains tight, as job gains are averaging 345,000 per month. Supply of job openings continues to exceed demand, with 1.6 job openings for every unemployed person. Unemployment remains historically low at 3.5%, the Personal Consumption Expenditures Index (Fed's most watched index) rose to 4.6% on an annual basis.

There are some areas of the economy that have slowed, but the overall tone of the meeting was hawkish. Going forward, we believe that yesterday's rate hike will be the last hike as it stands today. We believe, however, that rates will stay higher for a longer period than what the market is currently anticipating.

Strategy

The equity markets remain volatile. The squeeze in growth companies has continued through April. Recently we have started to see money managers capitulate and chase the indices higher. Historically this is a good indication that a market correction in these companies is coming. Our strategy has not changed: we feel growth is once again in bubble territory; and quality value names offer an appealing risk/reward profile.

Many market participants are pricing in rate cuts as early as September which has supported this rally and pushed valuations back to extremes. At the current time we do not believe this will happen. For now, the Fed seems determined to hold rates higher for longer.

On the Fixed income side, we have continued to add duration to portfolios. We believe bonds are offering proper compensation for the underlying risk. We are not making a rate call but putting money to work at rates we have not seen in over a decade. We have continued to invest in high credit paper.

We do not believe now is the time to take on extra credit risk. We still believe rates will be lower in the future than they are now, so locking in money today is the prudent move in our opinion.

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.

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