ambwealth

Wealth Advisory Market Update

May 7, 2024

ambwealth

Market Update

Equities:

The market, measured by the S&P 500 index, decreased by 4.08% in the month of April which leaves the index up 6.04% year to date. The move lower comes in the midst of earnings season. So far, companies that have beat earnings have not been rewarded, up less than historical averages relative to the market, and misses are being punished. Weak economic data also continued throughout the month. We have seen months of markets ignoring macro data and climbing a wall of worry but that reversed over the last month. With the latest inflationary data, it seems interest rates are poised to stay higher for longer at the same time growth is slowing. These things together are a cause for concern going forward, as stagflation is the most likely scenario for now.

We continue to pay attention to the ongoing concentration bubble. The top 10 stocks in the S&P 500 make up over 30% of the index. This is well above the 22% average that has been seen over the past 40 years. Such a thin number of stocks driving the index higher is not the sign of a healthy market. The Russell 3000, a broader based US stock market index, still has 70% of its components below their 2021 highs. This highlights the continued weak market breadth over the last year. With this in mind, we remain anchored in our discipline to not chase returns in companies with stretched valuations. We look for companies that are trading below their intrinsic value and are in a sector which is best suited for our economic outlook.

Earnings season is in full swing and is giving us a good look under the hood to see how inflation and slowing growth are affecting companies. Earnings on average have beat Wall Street expectations, however these estimates have been heavily reduced over the last quarter, as usual. Mention of ”inflation” in earnings reports is up over last quarter. Inflation is having a major impact on companies as the consumer is beginning to pull back and companies are having a harder time passing on costs. This is evident by margins that continue to shrink for the majority of companies that have reported thus far. Names such as McDonalds, 3M, and Starbucks are raising concerns about the state of the U.S. consumer and their spending ability. These companies are seeing lower volumes and a consumer who is becoming overly deal-conscious as inflation has cut into their ability to spend. We expect this to continually get worse throughout 2024 unless something changes drastically on the economic front. Continuing to position ourselves in companies with dominant market share and pricing power is going to become paramount going forward.

Economic Indicator and Monetary Policy:

Manufacturing data is displaying signs of stagflation. Over the past year, the data has shown lower production, higher unemployment, and higher prices. The latest GDP reading indicated that this may be the case for the whole economy. First quarter GDP grew at a pace of 1.6%, the lowest since 2022, and well below the 2.4% forecasted. On top of this slower growth, the Core Personal Consumption Expenditures index (PCE) rose by 3.7% for the quarter, well above the expected 3.4% rise and the 2% rise seen in the previous quarter. This report likely caused the Fed to become quite alarmed, as growth is slowing and inflation is reaccelerating. Without massive fiscal deficits, the US economy would already be in a recession. We did not forecast $1 Trillion being injected into the economy every 100 days over the last year. This is unsustainable, and when it does end, we believe an economic downturn will follow.

The Federal Open Market Committee (FOMC) met on the first day of May. The FOMC members have been communicating no rate move in May, so there was no surprise when the Fed left rates unchanged at 5.25% to 5.50%. The focus heading into this meeting was the Fed’s balance sheet. We forecasted nearly a year ago that the first move would not be a rate cut but a reduction in Quantitative Tightening. That is exactly what they announced. The FOMC decided to reduce their monthly redemption cap on treasury securities from $60 billion to $25 billion starting in June. This is a bigger reduction than the $30 billion expected. In our opinion, it seems the FOMC and the US Treasury are currently working in tandem to bring rates down, as funding costs continue to explode higher. It should be concerning that the FOMC is creating liquidity and easing financial conditions, even as inflation remains well above target and the Chairman says the US economy is strong. This tells us the exact opposite. In our opinion, this is an indication that the Fed believes the economy is weakening and that rates are too high. It seems the Fed may have given up their fight against inflation.

Fed Chairman Jerome Powell's press conference played out the same as most of his previous ones. He continues to believe that things are getting better on the inflation front, and he believes the economy is in great shape due to a strong labor market. The Chairman was not too concerned on the lower GDP figure, as he believes it is closer to 3.1% instead of 1.6% when stripping out certain items. This seems eerily similar to the "inflation is transitory" message that was relayed throughout 2021. On the most recent inflation data, however, Powell did point out that recent data did not give them greater confidence that inflation is returning to their 2% goal. With this in mind, the FOMC will keep rates higher for longer.

The market was happy to hear that the Chairman does not believe another rate hike is necessary, but that has been a forgone conclusion. It is our opinion that Powell is aware of the issues with inflation as well as an economic slowdown. That is why we expected the first move to be an adjustment to their balance sheet rather than a rate cut. The Fed appears to be trying to get out in front of a severe disruption in the economy due to the elevated rates. Inflation remains too high to cut rates but, at the same time, tight monetary policy runs the risk of breaking something in the economy. Their decision to reduce the balance sheet seems like a damage control decision. In our opinion, the Federal Reserve has gotten too far away from its original mandate and is now trying to steer all financial markets. Their track record is poor, and we do not expect this to be any different.

Strategy:

The current economic picture continues to progress towards a bigger downturn. This had led us to focus on a more defensive approach for our portfolios. Historical data indicates that businesses with considerable market capitalization, pricing strength, and consistent demand tend to navigate economic slowdowns more effectively. In the fixed income sector, we have extended our duration over the past month, as rates have risen higher off the hotter inflation data. We are still seeking high quality credits, as we remain cautious about the outlook for the economy. Mortgage-Backed Securities (MBS) continue to provide favorable spreads and a balanced risk return profile.

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

Matthew J. Roach, CFA®
Chief Investment Strategist

Mike Servetas
Assistant Portfolio Manager