Wealth Advisory Market Update

June 6, 2023

Market Update

Equities

The equity markets, measured by the S&P 500, gained .25% for the month of May. The trading range continues to be narrow which has been quite surprising given the number of uncertainties the market is facing. Currently, seven stocks are pushing the market higher. Breadth has become a real issue and without some broadening out we feel the market will remain vulnerable.

Data from Piper Sandler shows that 20% of S&P 500 stocks are beating the market. This is the narrowest leadership since March of 2000. The largest driver of returns this year all have one thing in common: Artificial Intelligence. The top seven technology stocks have gained over $3 trillion in market cap so far this year. To put that into perspective, that is larger than the entire Russell 2000. As we have indicated before, we believe the market is overvalued and not discounting the probability of US recession. This has the same feeling as 2021 when tech sold off in the second half of the year. We are not going to chase returns. Our focus will continue to be on companies we deem to trade below their intrinsic values and whose fundamentals remain sound.

The banking sector has been tumultuous in 2023 to say the least. First Republic went under at the beginning of the month which marked the third bank failure of the year. We have now had more banks go under by asset size than during the Great Financial Crisis. However, things seem to have become more stable, at least for now. We do believe commercial real estate (CRE) could become an issue soon with nearly $1.5 trillion in debt coming due over the next 5 years. The large commercial space has not fully recovered since Covid and we do not believe it will.
We are also looking for more regulation to come from congress in the form of capital requirements (Basel III). In our view, if this happens it would not take effect until at least 2025. Even considering these issues in the financial sector, we are looking for opportunities. The best time to buy is when nobody else wants to own. The key is investing in companies with the right asset/liability mix.

Despite a number of unknowns, one has been taken off the table. Congress passed, and the President signed, the Fiscal Responsibility Act of 2023 raising the debt ceiling through 2025. Both sides were able to reach an agreement and pass the bill four days before the June 5th deadline. We said all year that we thought a deal would be reached with no major fiscal changes and that is exactly what happened.

This removes one hurdle, but headwinds from geopolitical tensions and market valuations continue. For instance, just three days ago a Chinese warship came within 150 yards of hitting American destroyer USS Chung-Hoon while sailing through the Taiwan Strait, yet another aggressive military move from Beijing in the South China Sea. The Russia/Ukraine war is still ongoing and will continue to be an overhang throughout 2023. Geopolitics aside, market valuations remain extended with rates looking like they may be higher for longer, putting pressure on higher multiples on longer duration equities.

Monetary Policy and Economic Indicators

The Federal Open Market Committee raised the Fed Funds rate by another 25bps in May. Coming into the meeting, consensus expectation was for this to be their last hike. These probabilities have jumped around quite a bit since that meeting due to economic data and Federal Reserve President speaking engagements.

On the economic side, the PCE (Personal Consumption & Expenditures) is the most-watched inflation report by the FOMC. After their May meeting, the PCE report came in higher than expected. The report shows services inflation continues to move higher in the economy. It is stickier and more embedded in the economy than goods inflation which has started to decline. Fed Chair Powell has said that the Fed remains concerned about services inflation, and they remain committed to getting inflation to 2%.

In April, the Fed Funds Futures market was pricing in zero probability of a rate hike in July. The market now sees a 50% chance of a 25-basis point hike after pausing in June. With the Fed's creditability on the line, a measure which Powell says the Committee considers during meetings, they are more likely to overtighten in our opinion than to stop their campaign early. The market is still baking in rate cuts towards the back half of the year, something that the Fed speakers have said is not in their forecast. In order for rate cuts to occur this year, there would likely have to be a severe recession. Historically, when the rate hike cycle ends and rate cuts begin it usually marks the top in the market, because it means we have entered an economic slowdown.

Strategy

Equity markets have continued a melt-up to start the year. Positioning is once again at extreme levels, like we witnessed in 2021, which leads us to believe a sell-off is on the horizon. In markets like this, we like to remain patient and stick to our discipline. We are not going to chase companies that have become fundamentally overvalued. When the equity markets offer a better risk profile, we will put more monies to work.

Fixed income, measured by the Bloomberg Intermediate US Gov/Credit index, is off to a good start in 2023. Excluding the front end, rates have come down across the curve as economic worries have overshadowed inflation data. Because we kept our duration short over the last two years, we have been able to put money to work and take advantage of higher rates over the last 10 months. In our view, putting money to work here offers a good risk/return profile. We are currently taking on duration risk while avoiding credit risk. We would rather be long duration going into a recession with high credit than the other way around.

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