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Wealth Advisory Market Update

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Market Update

Equities

The S&P 500, a commonly used market measurement, experienced a significant 6.6% increase during the month of June. This pushed the index up over 16% for the year. It is worth noting that this upward trend has been driven primarily by a select group of stocks, with a particular emphasis on companies involved in Artificial Intelligence. It is crucial to acknowledge that these stocks, as well as the overall market, have reached overextended valuations. The S&P 500 is currently trading above historical means across multiple metrics.

Despite rising interest rates, there has been a peculiar phenomenon observed in recent months where money continues to flow into long duration assets. Under normal circumstances, growth stocks exhibit a correlation with interest rates, as evidenced by the patterns observed in the previous year. Nevertheless, over the past six months, a decoupling has occurred, particularly in AI-linked stocks, which have become detached from reality, similar to the technology sector's behavior in 2020 and 2021.

In our analysis, it appears that the market is currently experiencing another hype cycle. This phenomenon has been observed multiple times over the past decade, wherein the market becomes excessively optimistic about a "new" technology. Stocks associated with this technology, particularly growth stocks, outperform the broader market as excitement builds. However, when the market eventually recognizes that the actual productivity and adoption of the new technology fall short of expectations, a revaluation occurs. This pattern has been evident in various areas, including 3D printing, autonomous cars, blockchain, cryptocurrencies, the metaverse, and now generative AI.

During these cycles, investors tend to pour their resources into companies linked to the new technology, leading to a bubble in stock prices. However, the subsequent realization of the technology's limited impact on productivity and adoption triggers a sharp decline in the stock prices of these companies. It is important to note that we are not making definitive claims about the current state of AI. It is possible that AI could usher in a new era of technological productivity, but it is also plausible that it may not live up to the heightened expectations. As cautious observers, we maintain a skeptical stance, recognizing the potential risks associated with hyped technologies.

When examining the performance of other indices in comparison to the S&P 500, it becomes apparent how much the seven mega-cap tech stocks are exerting influence. For instance, the S&P 500 equal weight index has achieved a 6% increase thus far this year, while the S&P 500 index itself has experienced growth of 17%. In stark contrast, the tech-heavy Nasdaq 100 has surged by 38%.

Presently, the market is heavily skewed towards a few dominant stocks, and the proportion of market constituents outperforming the broader index is currently less than 25%. Five companies, namely Apple, Microsoft, Alphabet, Amazon, and Nvidia, comprise 25% of the entire S&P 500. We had initially anticipated good performance from the technology sector at the beginning of the year because of how oversold it was coming into 2022, but the extent of this movement has exceeded our expectations. Our belief is that fundamentals will regain significance in the near future, and we will remain committed to adhering to our disciplined approach.

Monetary Policy and Economic Indicators

Following ten consecutive rate hikes, the Federal Open Market Committee (FOMC) has decided to pause its rate-hiking campaign. This outcome was largely expected, as many had predicted that the Committee would maintain unchanged rates and then hike once again in July, giving rise to the term "skip." A notable deviation in the recent meeting was the revision of the Committee's predictions, known as the dot plot, which provides insights into future rate expectations among FOMC members. Currently, the members anticipate two additional 25 basis point hikes by the end of the year. This surprised the market, which subsequently focused much of the press conference on this development in the FOMC's forecast. Fed

Chairman Jerome Powell emphasized that all members foresee some form of tightening heading into the second half of the year. Questions also arose regarding the possibility of the Fed changing its target inflation rate. Powell reassured reporters, reiterating the Fed's steadfast commitment to achieving a 2% inflation rate.

The meeting once again saw discussions surrounding the potential for rate cuts. However, the Chairman firmly rejected this narrative, stating that neither he nor any panel member predicts any rate cuts for the year. In terms of economic data, Mr. Powell acknowledged that while headline inflation has subsided, there are few indications of progress in core inflation, especially in services. He also highlighted the role of unemployment in driving the economy and inflation. Recently, at a forum, Chairman Powell expressed that more restrictive policies are forthcoming due to the robust labor market. We believe the biggest risk to the FOMC is they don’t do enough and the economy overheats once again.

Currently, the Fed Funds Futures market indicates an 82% probability of a rate hike in July. Despite the Fed's repeated attempts to communicate that the fight against inflation is ongoing, the market remains skeptical and is still pricing in a rate cut by the end of 2023. Inflation continues to surpass the Fed's target, and historical evidence suggests that bringing down inflation in the final few percentage points can be challenging. For years, market participants were advised not to oppose the Fed during easing phases. However, in the midst of the most restrictive policy environment in years, investors are now defying this advice.

Although economic indicators have recently surprised on the upside, signs of a recessionary environment persist. Thus far, the labor market and consumer sentiment have demonstrated resilience to higher interest rates. However, we attribute much of this resilience to the substantial excess liquidity in the system and rates still not being high enough. If the Federal Reserve genuinely aims to combat inflation, a meaningful reduction in its balance sheet would be necessary in our opinion. The FOMC remains the biggest factor for the markets and economy going forward.

Strategy

From our perspective, equity markets bear a resemblance to the conditions observed in 2021. Consequently, we remain steadfast in adhering to our disciplined approach and seeking investment opportunities with risk/reward profiles that are appealing. Our forecasts indicate a probable pullback in the near term, although this expectation has persisted for several months now. Markets tend to remain irrational longer than anticipated. We witnessed this two years ago before the same type of growth stocks fell by over 50%. Therefore, it is crucial to invest in fundamentally sound companies trading below their intrinsic value, particularly in the current environment marked by a hawkish Federal Reserve and an economy that seems from macro data to be slowing. Historically, such companies have exhibited better performance during market downturns.

Regarding fixed income, our strategy has remained consistent since the beginning of the year. As interest rates rise, we continue to add duration to portfolios. Our movements within various sectors are determined by spreads. Over the next few years, we anticipate a decline in rates, which is why we have been reallocating funds from the front end of the curve to longer maturities. As of now, we have increased the average duration of our bond portfolios by approximately 1.5 years.

As always, we strive to navigate this challenging environment to the best of our ability. The team at AMB expresses gratitude for your support and the opportunity to collaborate with you in achieving your financial goals.

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