Wealth Advisory Market Update

August 7, 2023

Equities

In July, equities, measured by the S&P 500 index, extended their gains for the year. After a 3.21% increase, the index is up 20.65% in 2023. The latest move came during the middle of earnings season which in our opinion has been less than stellar. So far, approximately 80% of companies have reported better than expected earnings. It is important to note that earnings expectations have been dramatically lowered by analysts over the last 6 months. On the surface, the numbers have looked good relative to expectations; however, year-over-year (YoY) earnings are actually down 6-12%. This tells us that the current market rally has been driven entirely by multiple expansion.

The S&P 500 index has been led by the "Magnificent Seven" for most of this year: Microsoft, Amazon, Alphabet, Apple, Nvidia, Meta, & Tesla. Nearly 70% of the return of the S&P 500 has been driven by these seven stocks with an average return of over 65%. This has driven valuation in the information technology sector well above historical averages.
When looking at the tech sector as a whole, one ratio we like to focus on is the PEG ratio (Price/Earnings-to-Growth). This measure builds off the P/E ratio by incorporating the expected growth rate of earnings. Just because a company has a high or low P/E ratio does not mean it is necessarily cheap or expensive. For example, a company trading at 30x earnings would look expensive relative to the market. However, if their earnings growth rate is 30% a year, then on a relative basis, the company is actually cheaper than the overall market.

Currently, the technology sector is trading with a PEG ratio of 1.95, well above the twenty-year historical average of 1.32. However, just because the tech sector is expensive relative to history does not mean a correction is imminent. What it is telling us is that tech is expensive, and we need to be selective with our stock selection and sector weighting.
For over a decade, the best argument for overweighting equities has been TINA (“there is no alternative”). It was hard to make a case for the bond market as yields were held artificially low by the Federal Reserve. A good measure for over/undervaluation of the market is when the S&P 500 earnings yield is above/below the 10-year treasury yield.
Since the financial crisis, the FOMC (Federal Open Market Committee) had held the Fed Funds Rate near 0% while also conducting quantitative easing (buying bonds) which kept rates low across the curve. During this time, the earnings yield on the equity market has historically been well above what you could earn in the bond market.

In theory, this was a good time to own equities. Over the last year, the FOMC has engaged in the fastest rate hike cycle in history, while inflation has remained stickier than anticipated. This has driven rates across the curve higher. For the first time in a long time, rates on the 10-year Treasury are higher than the earnings yield of the equity market. This tells us that the risk/reward profile is skewed in favor of bonds.

Japan has become a major focus of ours with volatility spiking in yields and their currency. This is a concern due to the massive carry trade that is currently in place. A carry trade is when you borrow in a low-yielding currency and invest in a higher-yielding one. With the low-interest-rate environment existing in Japan while other developed nations are currently raising rates, many investors have been borrowing from Japan to make investments in the USD, which is paying a higher yield. This works fine as long as the BOJ (Bank of Japan) keeps rates low and the currency can remain stable. It seems the BOJ may be losing control of the yield curve. If rates shoot higher, a massive amount of carry trades will have to unwind, which could lead to a global margin call. We are not saying this is imminent, but it is a major concern that we will be monitoring throughout the year.

Going forward, it is our view that a recession for the US will take place in the near term. We want to maintain our fundamental discipline and not chase returns. We believe now is the time to be prudent, continuing to focus on free cash flow and concentrating on sectors that are less cyclical in nature. The major exception is energy, where we feel the supply/demand dynamics remain in place for higher oil prices.

Monetary Policy and Economic Indicators

After what many had labeled a "hawkish pause" in June, the FOMC raised rates another 25 basis points. The press conference, as always, was the center point of the meeting as economists try to garner as much information as they can about future policy decisions from FOMC Chair Jerome Powell. Most of the questions centered around a soft CPI print in June and if that would affect FOMC rate decisions in the near future.

Chairman Powell made a point to state that CPI was just one report and will not be enough to signal victory over inflation. The Chairman continues to maneuver in the gray and not reveal the Fed's next decision. He continues to play both hawk and dove. This was evident when he said that it is certainly possible to hold rates at the next meeting but also possible to raise rates. As we have noted previously, he continues to reiterate that the Fed is strongly focused on getting to their 2% inflation target, and that there is still a long way to go to get to that number.

With regards to economic data, the Chairman said that consumer spending has slowed, but the housing sector has picked up, although not to the elevated levels seen previously. In recent meetings Powell continues to mention the tightness of the labor market. There has been an average of two hundred and forty-four thousand jobs added over the past three months, and the unemployment rate has remained at the same level since the rate hike cycle began.

Powell said that while they are not aiming to raise unemployment, history says that when the job market loosens, inflation will begin to come down. He added that the cost of not getting inflation down to 2% is their biggest concern. This is a signal that the Committee does not want to risk inflation resurging and would aim to over-tighten rather than under-tighten. The Chairman then issued a warning that reducing inflation will require low trend growth and the softening of the labor market (i.e., recession).

Economic indicators have shown a deflationary trend as of late, but there are still signs of inflation rising once again. Most notably, the price of oil has been increasing as Saudi Arabia extended their production cut of a million barrels per day through September and has left the door open to extend further. Russian output has also declined dramatically.
In the US, oil production so far has remained steady but we have witnessed a steady decrease to the oil rig count. Oil, as a result, has gained for the sixth straight week. Usually, oil prices falling has been the biggest factor in reducing inflation. We would expect inflation to pick up going forward.

In summary, the US economy has remained resilient in the face of rate hikes and inflationary pressures. However, we still believe a recession is on the horizon. Rate hikes have a lag effect, meaning they take time to work their way through the economy. We are seeing liquidity being drained from the system, and lending standards tightening quickly. We will continue to position our portfolios accordingly.

Strategy

We continue to believe the equity markets are overvalued. The entire move from the October lows has been absent fundamentals and driven by multiple expansion. We believe a downturn in the markets is on the horizon and we continue to hold cash ready to deploy at more attractive levels. We will stick to our discipline and continue to hold sound companies that offer an appealing risk/reward profile. With economic conditions deteriorating, these companies have historically performed well during market downturns.

Fixed-income markets remain attractive. We have not seen rates this high in well over a decade. We are using this opportunity to extend our duration and lock in these rates. At the current time, it is our belief that the bond markets offer a better risk/return profile than equity markets. We will continue to buy high-quality credit.
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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