Market News

September 12, 2023

By Scott Loyek, CFA,® Managing Director, Chief Investment Officer

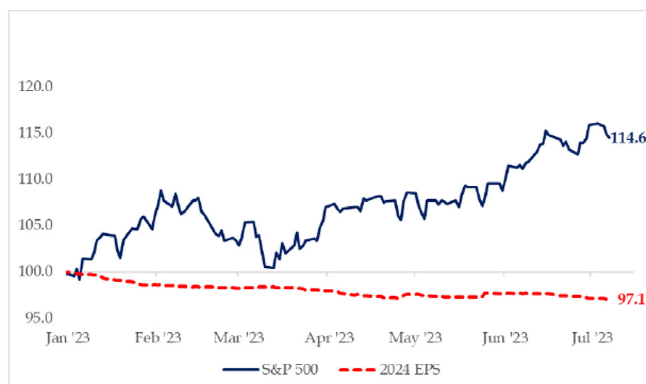
On October 12, 2022, the S&P 500 hit its cycle low at 3,577. Ten months later the S&P sits 25% higher and around 10% below its all-time high. The backdrop for this period of above-average returns includes an increase in interest rates, stress in the banking system, a downgrade of the United States credit rating, little earnings growth, and a likely government shutdown in the near future. I am fond of the saying that the market often provides its best returns when things go from "absolutely terrible" to "not so bad."

This is the best explanation I can offer for the performance of the stock market this year. Though extreme in both its pace and magnitude, the Federal Reserve's (the Fed) interest rate-raising cycle appears to be nearing its end. More importantly, the Fed appears to be making progress in its battle against inflation. The financial system has seemed to survive the stress caused by the Fed's tightening cycle with limited damage so far. Last, and perhaps most importantly, the economy and particularly employment remain strong, making the oft-predicted recession appear further away than some thought.

When we began the year, we were cautiously optimistic, primarily because valuations were on our side as the market was trading below average multiples offering us a reasonable margin of safety. While we recognized some clear headwinds, we felt that they had been largely well priced into the market. Apparently, we were not alone in this view as the market rallied strongly to begin the year. However, throughout the year we have gradually grown more cautious as markets continue to surge. Increased stock prices, flat earnings, and rising interest rates present us with a much less attractive risk-return environment.

Scott consults with TWM clients and relationship managers to implement their financial plans through building diverse portfolios of high quality, low-cost investments relative to individual goals. Scott helps clients to gain better understanding and peace of mind in a complex and often confusing world. He strives to bring patience and objectivity to the investment process on a daily basis in order to avoid the destructive impact emotional reactions can have on financial decisions. Scott joined TWM in 2006.

Chart 1: S&P 500 Index & 2024 S&P EPS (Indexed to 100, 1/1/2023)



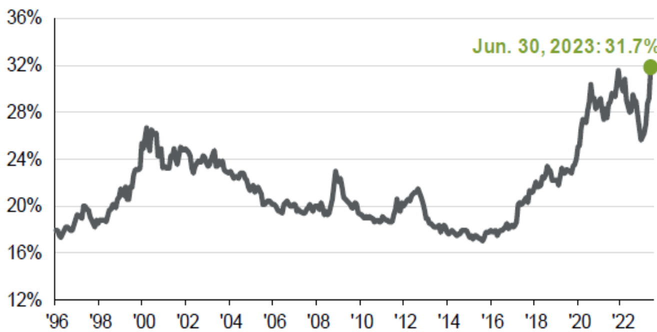
The divergence between stock prices and earnings is concerning.

Table 1

Value measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-value
P/E	Forward P/E	19.13x	16.79x	0.71
CAPE	Shiller's P/E	30.79x	27.81x	0.47
Div. Yield	Dividend yield	1.59%	1.98%	1.15
P/B	Price to book	3.84x	3.10x	0.91
P/CF	Price to cash flow	14.74x	11.24x	1.59
EY Spread	EY minus Baa yield	-0.54%	0.31%	0.45

Looking beyond the surface, we see a somewhat different picture of both valuation and returns. Due to the high level of concentration in market cap-weighted indexes, like the S&P 500, we have seen a disproportionate amount of index gains driven by a few large stocks. The returns of the 7 largest companies in the S&P 500 have accounted for more than 100% of the index's return during the first half of the year. Meaning that the remaining 493 companies in the S&P 500 were essentially flat.

Chart 2: Weight of the Top 10 Stocks in the S&P 500
% of market capitalization of the S&P 500



This dichotomy is perhaps more evident when you look at the market cap weighted S&P 500 versus the equally weighted S&P 500. These are the exact same group of companies, one weighted by company size and the other equally weighted. As of June 30, 2023, the equally weighted index, which we consider a proxy for the average stock, was up approximately half as much as the market cap weighted S&P 500. However, the average stock was trading at a price to earnings ratio of 14.95x, a roughly 25% discount to the market cap weighted index. The point here is that there is a considerable disconnect between the average stock and the largest stocks in the market. This allows us to be somewhat more optimistic about our client's portfolios than we might be about the market indexes.

Table 2

Measure	S&P 500	Average Stock	% Difference
Price/Earnings	19.91	14.95	25%
Price/Book	3.71	2.33	37%
Price/Sales	2.25	1.23	45%
Price/Cash Flow	12.78	8.44	34%
Dividend Yield	1.72	2.59	-51%

Fixed Income Outlook

At different points in the year, we have found ourselves "pounding the table" in favor of both T-Bills and CD's. The dynamics of the stock market combined with Fed policy have left us in a situation where, depending on one's time horizon, these seemingly boring investments have offered very attractive risk-return profiles. This is particularly true for those clients who have had large bank balances. Interest rates on Treasury bonds and CD's have risen much faster than the yields on savings accounts. We have helped several clients earn risk-free returns north of 5% on their reserve funds.

While it could be argued that a risk-free return of above 5% is very attractive in the short term, there are longer-term risks to concentrating too much capital in one area. At some point, the Fed will lower interest rates again and these rates will decline. As a result, we think it is prudent to begin buying longer-term bonds to essentially "lock-in" these relatively higher rates for a longer period of time. Though it is impossible to predict the path of interest rates, we are currently being offered yields 2 to 3 times greater on bonds than we were just 18 months ago. By adding to our intermediate-term bond exposure, we expect to "lock-in" an attractive level of income to help shelter client portfolios through the next rate cut cycle.

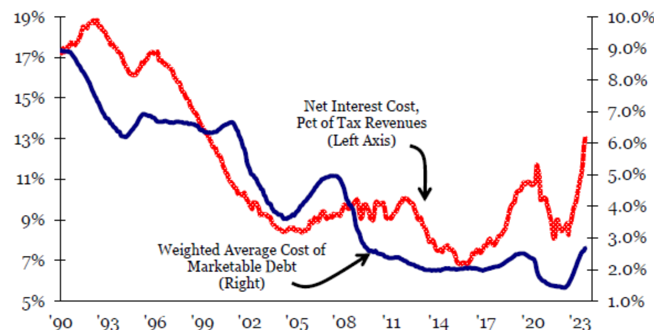
We are generally encouraged by the opportunity set in fixed income. Though this may be colored by a long period of historically low interest rates, we see the current bond market as reasonably attractive. The combination of relatively higher yields and likely being near the end of the Fed raising interest rates means that the probability of positive returns in bonds is higher than it has been in some time. Combining this with what is still a relatively strong economy and a likely benign default environment, we think, for the first time in some time, that returning our fixed income exposure to normal levels makes sense.

Economic Overview

Shifting gears to the broader economy, we continue to be encouraged by the strength and resilience we are seeing. Employment remains strong, earnings and GDP, while perhaps not surging, are also hanging in there. However, the economy does continue to face headwinds. Combining higher-interest rates and inflation with fiscal challenges and pressures on the consumer will create at least some negative impact on the economy. While the chance of a severe recession does appear remote there does seem to be a near-term limit on potential economic growth.

In early August, Fitch, one of the largest credit rating agencies downgraded the United States' debt rating. While the timing of this downgrade was somewhat arbitrary, the context in which it was made is very relevant. The combination of a growing deficit and a lack of the political collaboration that is needed to address the structural fiscal challenges facing the country will have real economic costs. Perhaps the most concerning of these is the concept of "crowding out." This refers to the idea that as government debt continues to increase it "crowds out" capital that could be used for more productive purposes. This potentially results in what could be described as a tax on the U.S. economy and a form of monetary tightening.

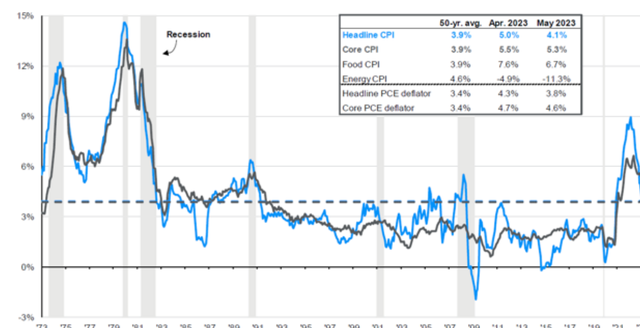
Chart 3: Net Interest Cost & Weights Average Cost of Marketable Debt



Inflation

For some time, the elephant in the room has been inflation. The Fed's aggressive rate hikes have certainly had some positive impact in terms of bringing inflation down. What remains to be seen is how far inflation will need to come down for the Fed to be satisfied. The Fed has stated publicly that its goal is 2% inflation. The consensus is that the Fed will be able to get inflation down but getting to the 2% target will require inflicting significant damage to the economy. What we don't know is if the Fed will accept a slightly higher inflation rate as a victory, sparing the economy a likely recession. We expect the Fed to pause rate hikes soon, but not begin cutting rates for some time.

Chart 4: CPI and Core CPI % change vs. prior year, seasonally adjusted



Outlook

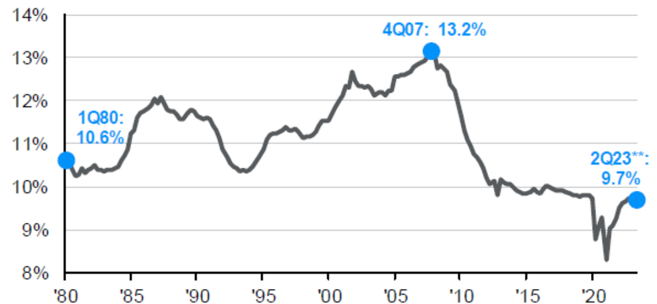
As we attempt to weigh the pros and cons of market conditions and investment opportunities, we always try to keep things as simple as possible. To that end, we often ask ourselves the simple question "Are things getting better or worse?" To a modest degree, we find the balance of the data pointing to things getting worse for equity markets. The combination of a restrictive monetary policy, a weakening fiscal environment, and a relatively expensive market valuation argues for a cautious approach in the near term.

On the fixed income side, we have a more favorable landscape, but not without concern. The improvement in interest rates and where we likely are in the rate hike cycle appear to bode well for fixed income. However, there is some risk that factors like inflation or "crowding out" could lead to interest rates remaining higher for longer than expected.

Finally, we are watching the economy and particularly the consumer. We expect employment will remain strong as the labor market remains tight. However, household debt is rising, although only to historically average levels. The reinstatement of student loan payments combined with rising consumer debt levels run the risk of weakening the consumer.

Chart 5: Household Debt Service Ratio

Debt payments as % of disposable personal income, SA



While we do find ourselves in a relatively unique situation in terms of recent history, this is a historically more normal environment in many senses than we have seen. For the first time in more than a decade, we see the cost of capital as a factor in allocating resources. Similarly, fixed income appears to be a realistic alternative to equity. These are, in fact, healthy dynamics of markets and an environment that I feel we are well-equipped and prepared to navigate. •

Sources

Chart 1: Strategas, p. 1; Investment Strategy Report, 7/10/23

Table 1: JP Morgan Guide to the Markets, p. 5; U.S. Data are as of June 30, 2023

Chart 2: JP Morgan Guide to the Markets, p. 11; The top 10 S&P 500 companies are based on the 10 largest constituents at the beginning of each month. As of 5/31/2023, the top 10 companies in the index were AAPL (7.5%), MSFT (7.0%), AMZN (3.1%), NVDA (2.7%), GOOGL (2.1%), META (1.7%), BRK.B (1.7%), (TSLA (1.6%), UNH (1.3%), and XOM (1.2%). U.S. Data are as of June 30, 2023

Table 2: Charles Schwab, Data as of June 30, 2023, S&P 500 data represented by the SPY ETF and Average Stock Data for the RSP ETF

Chart 3: Strategas, p. 57; 2Q'2023 Review in Charts

Chart 4: JP Morgan Guide to the Markets, p. 31; U.S. Data are as of June 30, 2023

Chart 5: JP Morgan Guide to the Markets, p. 24; U.S. Data are as of June 30, 2023

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