INVESTMENT COUNSEL

MARKET OUTLOOK

Third Quarter 2023

As the first half of 2023 closes, we see some progress on the Federal Reserve's goal to reduce inflation through higher interest rates, but we continue to see significant resistance on Wall Street to taking its medicine. The yield curve remains inverted, steeply so and for a long time now, but unemployment data looks strong, housing prices are still strong, and so many observers argue we are going to avoid a hard recession, a market correction, or even a soft landing. We acknowledge that there are many good things going on, but we continue to expect some difficulties in the second half of the year.

It is possible we have talked about inverted yield curves so much that we risk being like the boy who cried, "Wolf!" We talk about them because they are a reliable indicator of future economic weakness. There are enough curves – different short-terms and different long-terms – that one can sometimes find one curve is inverted when another is not. The government boosts short-term rates, which it controls, because it sees the danger of inflation and wants to stifle demand in order to bring inflation rates down. Investors with longer outlooks respond to that action differently, which explains the variation in yield curve inversions. Analysts have shown that if one just counts the number of curves that are inverted over the past 45 years, a recession is always imminent when more than 50% of the curves are inverted. Today, 10 out of 10 are inverted.

Sometimes it takes a long time for the government policy to have its effect. The Federal Reserve pushed up short-term rates aggressively last year, which caught some banks by surprise and led to their failure. The 10-year/3-month Treasury curve has been inverted for 160 days, which is the longest stretch for that curve except for April 1980 and May 2007. What can delay the effect for so long?

A big part of the answer is that the scale of spending and financial accommodation since 2020 was unprecedented. If you fill the bathtub all the way up, it just takes longer to drain it. Between COVID, Ukraine, extended unemployment payments, and many other programs, we filled the tub right to the brim. The Federal Reserve was quite aggressive when it started raising rates; the accumulated momentum just needs time to recede. That is why we can still have low unemployment and plenty of job openings even though the yield curve inversion is approaching historic levels and lengths. It is why home prices remain elevated. It is a contributor to the strong equity market index performance so far. Accommodative financial policy pushes money into the financial system and it takes time for that surplus money to find its way back home to the Fed.

As is often the case towards the end of a stock boom, we have had some curious outcomes this year. Artificial Intelligence seems to have replaced ESG and crypto as the new must-have buzzword when spreading stock stories. If one can fit the "AI" tag into a stock, it seems to boost returns automatically. AI-related stocks have driven virtually all the S&P 500 return so far in 2023. Stripping out those stocks, the index return would be barely positive. The narrow pursuit of AI/tech is such that these stocks – many of which we proudly own in client portfolios – have accelerated to breathtaking heights: Nvidia is priced at more than 40 times sales, Microsoft is more than 10X. We love these companies, but we know what realistic price/sales ratios look like, and these are not them.

Outside of that narrow market oddity, the broader market has navigated inflation well, with companies reporting solid results, and reported inflation beginning to trend down somewhat. The Federal Reserve's tightening program is showing signs of working, and corporations are demonstrating operational resilience in the face of it. Already, we are seeing commodity prices declining, which helps everyone else maintain margins.

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There are reminders that cheap financing often leads to overbuilding, and tightening often leads to some business failures. Silicon Valley Bank is not the only one to go under; Bed Bath and Beyond has gone to the Great Beyond and left strip shopping malls across the country looking for a new tenant.

Housing is showing signs of cooling, too. Redfin is a well-known real estate website, and it noted recently that new listings of homes for sale fell 26.5% year over year, which was the biggest decline since May 2020. And active listings dropped 11% from a year earlier, the biggest drop since April 2022. Active listings were essentially flat from a month earlier; typically, they post month-over-month increases at this time of year. Home sales are as tied to the mortgage rate as they are to anything; the increase in mortgage rates to over 5% has more than doubled the monthly payment even as home prices have not increased.

The consumer is feeling the stress of higher interest rates in other ways, too. Bank of America noted in a recent card activity report that spending is turning negative as the month of June closes. The spending declines are more significant when gasoline and car payments are stripped out. Despite the good GDP reports and the excellent job numbers, it is clear that consumption is stressed. Consumption accounts for 70% of GDP, so we may see that indicator slip in the future. Bloomberg tracks – probably with AI – the mentions of key words in earnings calls, and "destocking" came up 300 times in the most recent earnings season. It's even tough on Wall Street: mergers and acquisitions and initial public offerings are down 42% year over year to $1.3 trillion so far in 2023.

We remain cautious because of these indicators of slowing activity. The narrowness of the equity index that worried us in 2021 is back with a vengeance. Because of the skewness of the index composition (two companies account for 14% of the index weight), the earnings yield on the S&P 500 is now lower than the yield on a 1-year US Treasury bond. That has not happened since late 2000. Small cap stocks are trading at their biggest discount to large cap stocks in over 20 years. The only larger valuation gap over the past 50 years was during the Dot Com bust.

Nothing in the markets is certain, for the investment world is one of probabilities. We think the second half will be characterized by softening earnings and earnings guidance. The Federal Reserve is committed to combating inflation, so we expect further increases but perhaps with a pause or two along the way. Bonds are offering attractive yields, and we have been extending maturities to lock in those yields. If we do slip into recession, bonds will be even more attractive.

In equity allocations, we have been trimming some of those big tech names with big portfolio positions. We are finding smaller companies look relatively attractive, and we have been adding solid dividend-paying stocks. The hedge fund community, according to Goldman Sachs, has lately added mega-cap tech such that it has reached its largest share of hedge fund long portfolios since early 2020. We are zigging as the hedgies zag, with a slight twist: we are happy to hold in reserve some cash as short-term yields are in the 5% range. There is no need for a paired trade when cash earns what it does these days.

We do not forecast anything more than a normal market and economic pull-back after a strong run in the markets and the economy. The Federal Reserve has been public and vocal about its program, and we are positioning client accounts to do well as that program unfolds. As the excesses are cleared out, the solid investments we hold for clients will get their due.

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