



Stormy Waters

Q4 2023 Market Update



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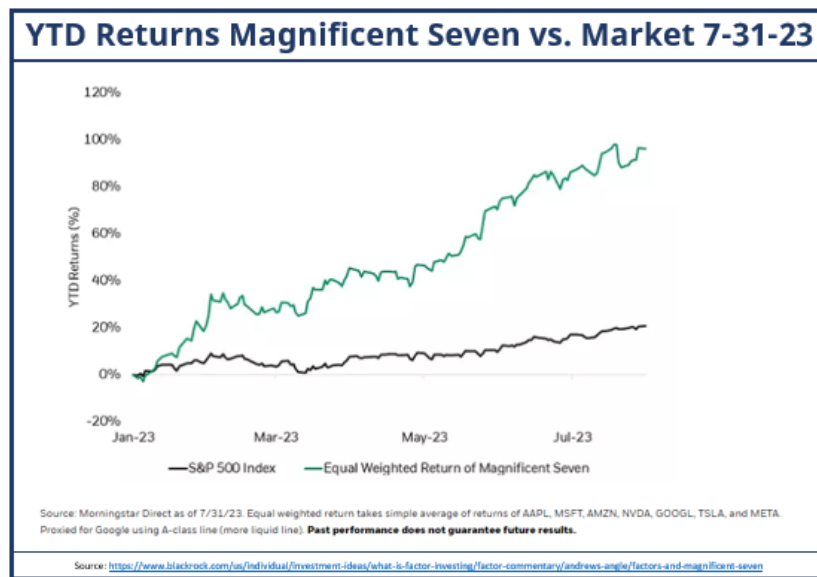
“To reach a port we must set sail- sail, not tie at anchor- sail, not drift.”– *Franklin D. Roosevelt*

Before the invention of GPS and Google maps, explorers often navigated by the stars. But how did sailors cross oceans when it was cloudy or severe weather? The Vikings are credited with developing and using sunstones to determine the direction of the sun on cloudy days, and then the rudimentary compass was invented allowing navigation by Earth’s magnetic fields. Either way, navigating choppy waters during uncertain weather presented a difficult task that took technology and fortitude to continue the journey. Markets are currently faced with a cloudy horizon and an uncertain future due to the conflicting signals we are seeing: macro-economic outlook vs. equities earnings reports vs. Treasury yield curve inversion vs. technical signals. Conflicting data points makes it more difficult to point to a high conviction path forward.

As we finish up the last week of the 3rd quarter, the markets feel volatile, drifting without much direction, and questions are arising about the ability of equities to rally out the year. Short-term market projections are extremely difficult, but we will outline what we are expecting through the end of the year along with major events, signals or changes that could affect our outlook. We feel the markets will be sideways and volatile, although they should pick up at the end of the year with the typical Santa Claus rally. For now, technicals have held and the uptrend is still intact from the Oct 2022 lows. Company profits have been strong, and earnings are beginning to be revised upwards. All these factors are bullish factors that could see markets grind higher. However, the bulk of this year’s rally has been driven by the MegaCap stocks (AAPL, AMZN, TSLA, NVDA, MSFT, META, GOOGL and NFLX) along with AI (Artificial Intelligence) mania. The narrow rally leaves it susceptible to coming unglued if the MegaCaps cannot continue to power higher. With macro headwinds, a Hawkish Fed, and, in our opinion, a teetering consumer, markets face significant hurdles to continue a strong rally like we saw in the first half of this year.

Market Outlook

A recent Bloomberg survey of 22 Wall Street Analysts published 9/18/23 has the average year-end price target on the S&P 500 at 4,366 and \$215 EPS, with 4,900 the highest target from John Stoltzfus at Oppenheimer and 3,700 the lowest by Michael Kantrowitz at Piper Sandler. The S&P 500 closed at 4,402.20 on 9/20/23, meaning markets are expected to be flat through year end. Most analysts also see earnings continuing to grow nicely in 2024 with the current average 2024-year-end EPS target at \$230. The consensus aggregate sell-side analyst implied 12-month return is all the way up to 5,130- though that is extremely optimistic vs. what the macro models are forecasting and takes the market multiple up to 22x. That does not mean we will not have draw downs and melt ups in-between now and December 31st, but it does support our theory that the easy money has been made this year and we have muted expectations through year end. Concentration continues to be an issue in the S&P 500 as the top seven companies are now weighted 28% of the index, per a recent Blackrock report, which is significantly higher than other bubble mania periods like the late 1990's tech boom. These 7 stocks have contributed about 65% of the TOTAL return of the S&P 500, meaning 493 stocks made up the remaining 35% of the overall return of the index. Through 7/31/23 the S&P 500 was up 19.52% while the S&P equal weight index (same holdings, all at an equal percentage weighting) was only up 10.73%.



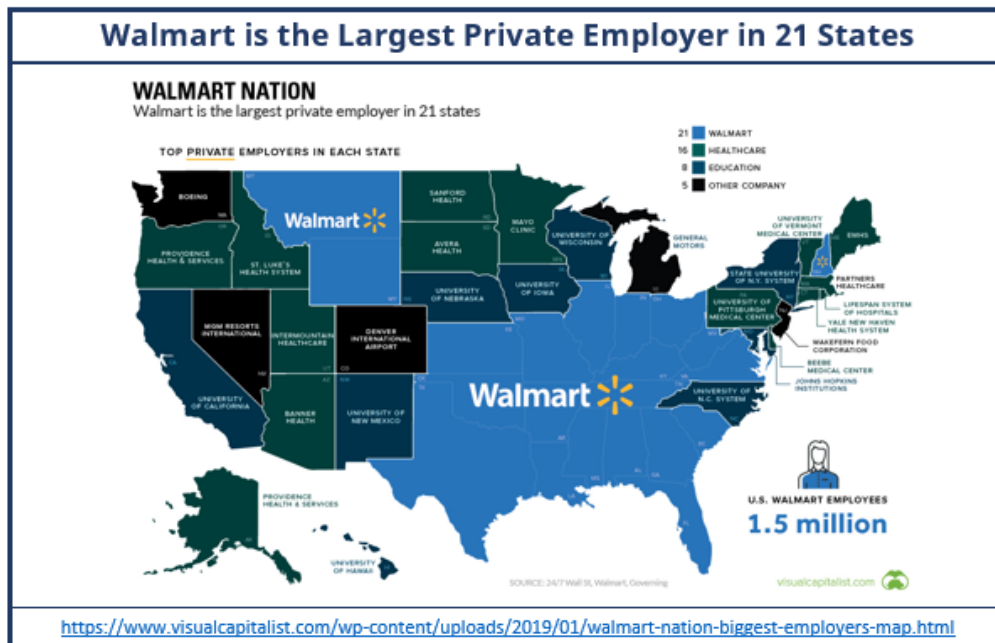
This narrow focus on a small number of stocks to drive the rally is a risk we need to be aware of. Similar to the Nifty Fifty or the tech rally of the last 1990's, mania and concentration tend to come undone. The question, in my opinion, is not *if* this rally runs into a wall, it's *when*. Many strategists have recently revised down expectations for a recession and almost everyone is now in the "soft landing" boat. I believe that a hard landing is still coming, and that lag effect is just taking its time working through the system. The amount of excess spending and liquidity has made the consumer more resilient than in prior eras, but that excess has rapidly been drawn down. While company profits and earnings were stronger than anticipated in Q2, inflation may be difficult to bring down, especially with oil and energy prices rising rapidly the last 90 days. The Fed has a difficult job of balancing the desire to get back to 2% inflation, and the potential they slow the economy too far and tip us into recession. There are 3 major trends we are watching in Q4: Fed policy trajectory, consumer health, and corporate profits.

The Fed

Outside of a major trade embargo or declaration of war, one could argue that the Fed is one of the most important departments in the US Government. Love them or hate them, the setting of interest rates is a major long-term driver of economic trajectory. At the recent September 20th meeting the Fed chose to not hike rates this month, to the surprise of nobody. Fed Chair Jerome Powell strongly warned higher for longer in his press conference and the updated Dot Plot showed one more hike expected this year and then higher expected rates in 2023 with the median expectation at 5.10%. 12 of 19 Fed voting members are predicting one more hike this year to take rates to a range of 5.50-5.75%. As Powell stated, “I’ll know it when I see it” regarding sufficiently restrictive policy. We believe there will be one more hike as well.

The Dot Plot and trajectory of what happens now is key for the economic health of our country. A pause is not a pivot to immediate rate cuts and the Fed has been vocal about how they want consistent policy and to avoid the start-stop hike/cut scenarios of the 1970’s and 1980’s. For now, it’s higher for longer and on average during the last 5 prior hiking cycles, the Fed paused 10 months between its last hike and its first cut. The most recent 2 cycles were ended with a nasty market event, although you could excuse the COVID crash and cuts as a very one-off anomaly. The 2006 hiking cycle lasted a total of 17 hikes before pausing Aug. 2006, and beginning cuts Sept. 2007- holding rates steady for 12 months. A Hawkish Fed brings to mind the mantra *Don’t Fight the Fed*. Restrictive monetary policy is a major headwind for growth.

The Fed is also reducing liquidity in the markets by running off its ginormous balance sheet, targeting sales of \$95B in securities every month. Less liquidity in the system, paired with lower lending by banks, means less money in the economy to borrow and spend on growing your company. At the same time, we are seeing increased issuance of Treasury bonds to finance the deficit the Federal Government is running, the largest deficit outside of WWII. Even with increased supply, the US Treasury bond is still considered one of the safest and risk-free investments in the world, even if we are AA rated vs. some of our European peers still at AAA. The dysfunction and inability to govern effectively, which drives the government to silly cliffs and shutdowns, is starting to wear on investors. More Debt + Higher Interest Rates = Higher Spending on Debt Interest and less money for the US government to spend on programs or employment. The US Government is also the largest employer in the United States with almost 6% of the total workforce or about 2.87mm civilian employees. Another 19mm+ work for state and local governments and if we see belt tightening and reductions in government spending, we could see unemployment creep up. To put that in perspective, Walmart employes about 1.6mm US citizens and is considered the largest private employer.



Consumer Health

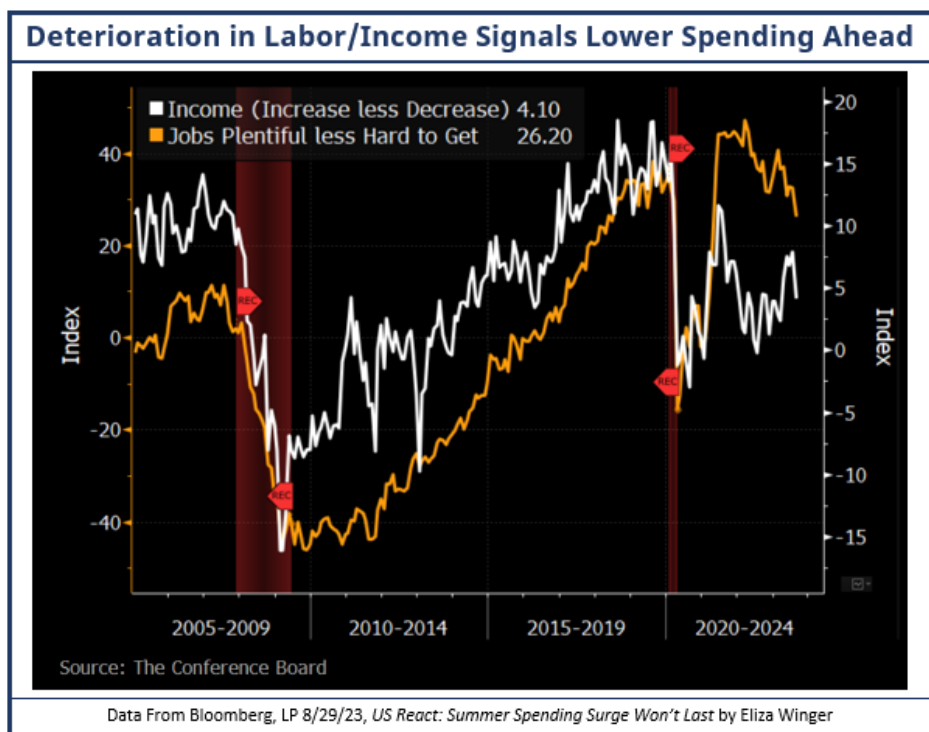
The US consumer and labor markets have been two areas of surprising strength and resiliency so far in 2023. Initially, and historically, consumers would start to struggle, and the unemployment rate would start to rise after an aggressive Fed rate hiking campaign. Both US consumers and labor markets are in healthier shape than what historical models would have predicted. The question is how long both of these trends can avoid historical precedence, and how long the consumer can continue to spend at this increased rate driving higher prices and profits in the services sector. 2 areas in the consumer sector we will be watching carefully are labor market health and consumer spending/balance sheets.

- **Labor:**

- Unemployment still sits near a record low at 3.7%, however that rate has started creeping up, even with participation increasing. Approaching 4% would put pressure on the Fed to change policies and potentially look to move more accommodative.
- JOLTs (job openings) has been falling steadily since peaking at 12mm open jobs and is now about 8.8mm open jobs. The declining excess labor demand is seen as a good trend as it means the labor market is more in balance and the ratio of job vacancies-to-unemployed is down to 1.5. But the less plentiful the jobs, the harder it is to get a job so bringing JOLTs down can be a drag on consumers.

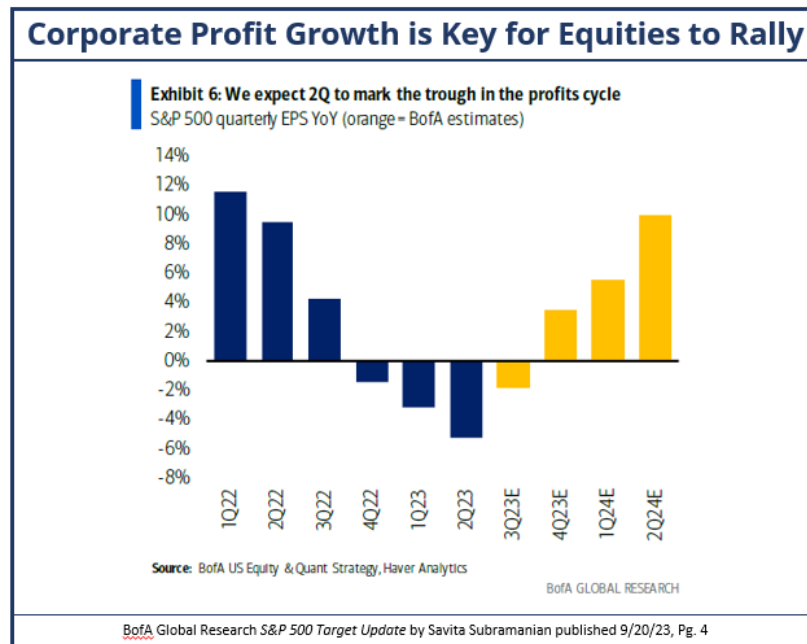
- **Spending/Balance Sheets:**

- Student loan repayments begin in October after being paused for over three years and 9 extensions. 44 million borrowers will now have to start paying them, and interest started accruing monthly in September. The average student loan balance is \$28,950.
- Recent upticks in spending have been driven by increases in costs of some necessities like gasoline and insurance costs rather than discretionary spending.
- US total Consumer Credit Outstanding is now at \$17 trillion, with over \$1T on credit cards at an average rate of 20.68%, and we have simultaneously seen a decline in Disposable Personal Income and Consumer Household savings.



Corporate Profits

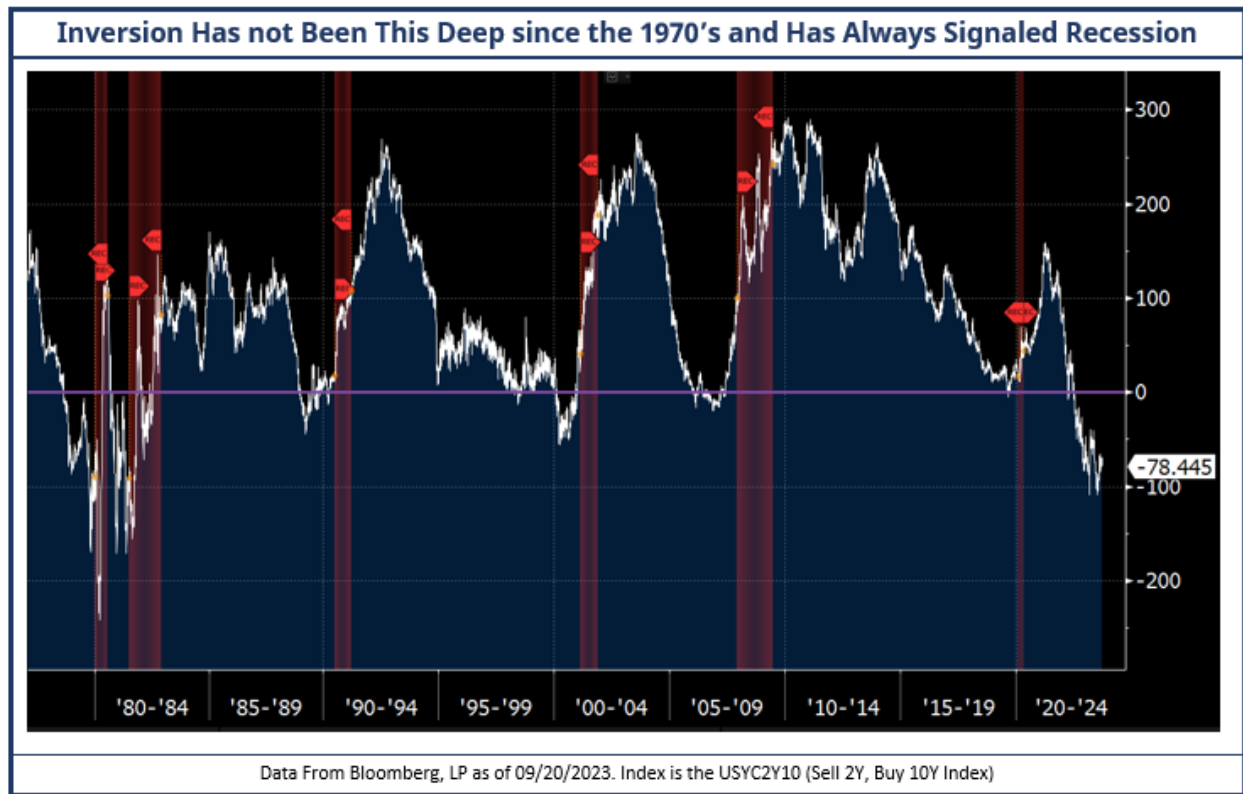
Earnings were better than expected in Q2, and expectations have been steadily rising for Q4 and 2024. But concerns about inflation and margins remain, and in our opinion the outlook is not quite as rosy as some strategists are projecting. On the positive side, supply chains are healed and an analysis of earnings calls and transcripts showed nary a mention of supply chain constraints. On the other hand, labor and cyber security disruptions are still a potential issue. Post-COVID we have seen a shift into a more labor friendly environment where the employee has more power than they wielded in the last 20 years. Employees are much more likely to switch jobs, ask for raises and generally be more mobile than in prior eras. Along with a labor scarcity (1.5 openings per available worker) we have seen unions rise up in relevance again with large strikes or threat of strikes effecting multiple industries and companies including UPS, automotive companies and media companies. The UAW strike is something to keep an eye on because if it escalates, it likely further slows down manufacturing. The writers' strike will also begin to be a large drag on media companies as they struggle to fill content and airtime without original programing. There is *only* so much reality TV and sports one can air before the audience gets tired. We have also seen some extremely large and widespread cybersecurity incidents in August including MGM, Caesars, and Clorox all disclosing material cyber breaches. It is estimated that MGM is losing between \$4mm-\$8mm/day in revenues due to the cyber intrusion interrupting operations across the globe, which is a trend to keep an eye on.



Profit margins are key as it represents how much of gross revenues are actually profit vs. eaten up by higher costs and expenses internally. Many companies have been working diligently to protect their profit margins. Pre-COVID, the S&P 500 profit margin ranged about 9%, and we saw a post-COVID bump up to 13% but are now returning back more towards trend. While net dollar amounts of profits may grow, as a percentage of revenues, the profit margin is key to health and has been falling 2022-2023. Labor costs make it difficult to increase margins, though companies are compensating by laying off workers and looking to do more with less and harness technology & AI to replace expensive human labor. The trajectory of profits, if it follows the above graph, could drive higher stocks; however margins and profit growth may be hurt more than what is factored in due to labor costs and disruptions.

Conclusion:

The mixed signals are what make this market so difficult. If October 2022 was truly the low, it came without the normal massive capitulation, market wash out, spike in unemployment and other events that historically come with market lows. There is no questioning the strength of some of the technical signals, however one cannot ignore the macro headwinds that run counter to what some of the charts are showing. We are now in the 13th month of the Treasury yield curve inversion (10-year yields lower than 2-year yields) and as you can see by the chart below, we haven't been this inverted since the late 1970's early 1980's- both of which brought recessions. Even the inversions of the late 1980's, early 2000's and 2006, much more minor than it is now, signaled recession. Historically, the lag between initial inversion and recession is an average of 15 months with a range of 6-24 months depending on the era.



Choppy waters can bring opportunities, but investors may also panic as the direction is less clear. We feel staying balanced (I know it's boring), taking some profits from growth, and looking at value and less expensive parts of the market may be the keys to driving returns going forward. Each investor needs to study their personal compass and realize it is often best to stay the course unless you have a strong signal that change is necessary. I recently ran across a silly, but poignant, Southern proverb: "The road of life is paved with flat squirrels who couldn't make a decision." Depending on your time horizon, equities may offer some opportunity through the end of the year, though muted, and we have concerns about what 2024 will bring. Data will bring more clarity as the Fed and Economic health both play a key role in the direction stocks and bonds will head. Be the smart squirrel and choose a path, don't become roadkill.



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