MARKET PERSPECTIVE

FEBRUARY, 2024

IN FOCUS:

The Big Surprise in 2023:

Contrary to most economic forecasts, neither a hard or soft-landing of the U.S. economy ever materialized. This was despite an inverted yield curve and the Index of Leading Economic Indicators foretelling an imminent recession. High inflation rarely has been tamed without precipitating a recession. Few economic prognosticators thought it could be done. Yet the Fed has engineered inflation down toward its 2.0% target while allowing the U.S. economy to continue growing, avoiding a hard landing.

Most economists apparently focused on a narrow domestic perspective and misjudged the full impact of the global pandemic on the U.S. economy. They concluded that the high inflation problem was persistent rather than transitory and that the Fed would have no choice but to engineer a recession to bring down inflation. A few of the doomsdayers anticipated that this would unleash a debt crisis that would cause a severe financial calamity and a very deep economic recession.

Econometric models leaning heavily on the traditional leading economic indicators misled pundits this time around, because they lacked a sensitivity to a worldwide perspective. With the benefit of hindsight, the high inflation of recent years, especially for goods around the world, turned out to be a transitory phenomenon related to the temporary disruption of global supply chains.

This global perspective also failed to account for how the economic misfortunes of China and Europe in 2023 benefited the U.S. economy. China experienced a property-led economic bust - and the Eurozone encountered a shallow recession attributable to the tightening of monetary policy by the European Central Bank attempting to curtail inflation on the continent. However, the U.S. economy remained resilient despite the Fed pursuing a policy of monetary tightening. One would conclude that because China remains a major player in global trade, it has exported their deflation to the rest of the world and certainly helped to curb potential inflation in the U.S. without requiring a traditional recession to do the Fed's work. In essence, China was absorbing the burden of a serious contracting economy for the U.S. It wasn't very long ago that most Fed watchers and market strategists held the view that only an outright recession triggered by higher fed fund rates could disrupt an inflationary spiral.

One of the misleading indicators was the yield-curve spread between the 10-year U.S. Treasury bond yield and the federal fund rate. This spread inverted during December 2022 as it had done before the start of the previous eight recessions. The 2–10-year Treasury spread also inverted earlier during the summer of 2022, similarly signally a recession was coming.

JP Morgan had been warning of forthcoming bad times, and had managed its balance sheet accordingly. They believed that the response to the pandemic with ultra easy monetary stimulus would reverse too rapidly, resulting in premature and excessive tight policy. This would happen through higher interest rates and quantitative tightening programs which would further depress stock prices and push the Fed funds rate to exceed 7%.

There were also concerns that geopolitical conflict in the Ukraine, the Mid-East, and rising tensions between the U.S. and China over Taiwan, could have severe long-term implications on energy, food and global affairs overall. A sharp reversal in quantitative easing could send both asset pricing and economic activity into a tail spin.

Many economists and credible Wall Street successful leaders predicted that the U.S. was on the brink of a serious debt crisis that would trigger a 1929-like depression. The result was in October 2022, 63% of economists were predicting a recession with negative GDP prints beginning in the first quarter of 2023. It did not materialize, despite the Fed raising the Fed funds rate 525 basis points through July of last year and inverting the yield curve. The U.S. economy proved to be very resilient - with monetary policy having far less impact on the overall economy than fiscal policy. Private nonresidential and public spending, coupled with tax incentives, offset any tightening in monetary policy pushing both public and private construction to record highs. In addition, defense spending has also been robust feeding into Israel, Ukraine, and Taiwan. Furthermore, accelerating interest paid on the Federal debt boosted interest on personal incomes.

Real wages have offset the fear that consumer purchase power would wane as excessive savings during the pandemic would erode. You can see that Real wages have been rising with unemployment exceptionally low for far longer than most economists had expected. One explanation for this tight labor market is that the baby boomers are retiring and spending more of their savings.

The good news is that inflation has been moderating without a Fed-engineered recession this time around, while the rest of the world's economies have been quite weak. The bursting of China's property bubble depressed the Chinese economy and deflated the country's prices. China exported this deflation in the goods market in the U.S. and other countries. In addition, Europe's economy has been frail. As a result, commodity prices remained surprisingly subdued and oil prices declined following the spike in early 2022.

Perhaps the most important variable that differentiated the optimists from the pessimists over the past two years has been inflation. The optimists anticipated that inflation would turn out to be mostly transitory as the inflationary shocks of the pandemic dissipated, while the pessimists believed it was persistent and could be subdued only with a recession. Most certainly the pandemic has had a huge impact on the economy and disrupted the credibility of any forecasting models of the past. Of course, keep in mind none of the above leads us to conclude that the U.S. economy is recession-proof or that inflation will remain subdued forever. We believe that the current bull market in stocks will eventually - and inevitably - be followed by a bear market.

The Good News for Now:

Now that we have survived both '22 and '23 without the widely anticipated financial and economic debacle, investor pessimism has abated. There are still a few economic prognosticators that are predicting a recession in 2024, but far fewer than over the past two years.

Given our global economic perspective, we expect an improvement this year as central banks around the world start the easing process. There are early signs that global manufacturing and service business activity are already on the upswing, paving the way for a strong U.S. economy. We are expecting accelerated global macro-economic growth as the second quarter unfolds. Global economic indicators however did confirm that the global economy did experience the soft-landing scenario last year. That reflects the combination of a hard landing in China, a soft landing in Europe, and no U.S. recession.

We can see this confirmed by global exports only down slightly, while global industrial production through November was up year-over-year by +1.4%. We are expecting global economic growth to improve this year, as central banks start easing their monetary policies against a backdrop of abating inflationary pressures. China has already begun the process with the biggest cut in bank reserve requirements in the last two years. Although commodities, which are very sensitive to global economic growth were weak in 2023, are now showing signs of bottoming.

Source: Bloomberg Finance L.P.

A Closer Look at the Markets:

<u>The MegaCap-8 Effect on Mid-Season Earnings:</u>

We are compelled to break out the MegaCap-8 from the rest of the market to gain a better perspective on our portfolio returns. Half the companies in the overall market, defined by the Standard and Poor's 500, have reported Q4 results. Early indications suggest a weaker earnings surprise percentage and y/y earnings growth than in the third quarter of 2023, but better top line revenue surprise or growth. Although revenues so far were only slightly ahead of the consensus estimates, earnings have outpaced forecasts significantly, on average as high as 6.5%. The expectation as the season unfolded was that revenues would rise only modestly and earnings would decline slightly.

What about the Standard and Poor's 500 drivers, the "MegaCap-8" (Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla)? With the exception of Nvidia (who has yet to report earnings this season), their aggregate earnings surprise was less than those for the S&P 500's stocks reporting so far. On the revenue side, the MegaCap-8 reports were in line with those for the S&P 500 in aggregate. According to Yardeni Research, on a year-over-year basis, the collective recorded earnings growth for the MegaCap-8 was 44.7% y/y, and revenues growth of 11.4% y/y. Put in context, analysts had been expecting aggregate earnings and revenues to rise 36.6% and 9.7%, respectively in the 4th quarter.

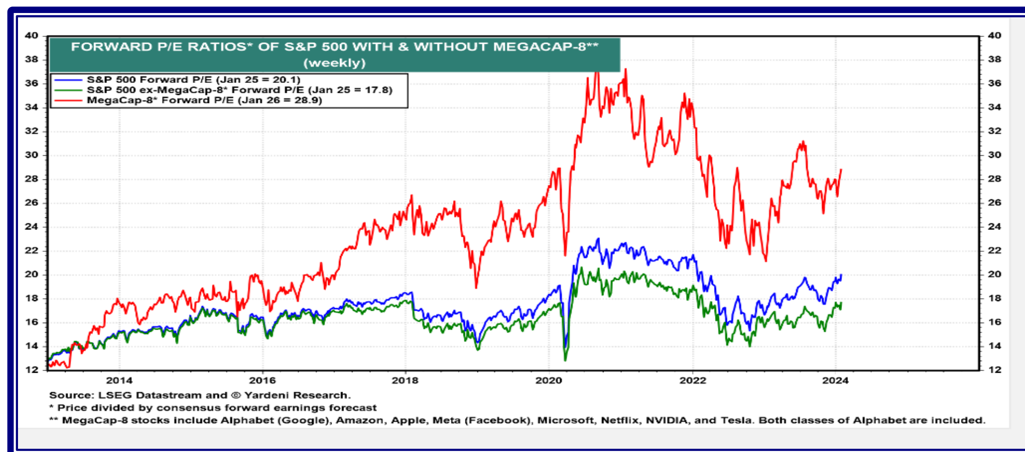
What about the rest of the market (The Standard and Poor's *492* excluding MegaCap-8)? The overall reported results without the MegaCap-8 were actually weaker than the aggregate, especially the revenue and earnings growth rates. Excluding them, the index's revenue growth so far has disappointed falling to just under 2.0% and its earnings growth fell from a mid-single digit increase year-over-year to a decline of an estimated -4.7%, only modestly beating analyst estimates.

The market response has been also skewed during the reporting season with the MegaCaps dragging the overall market up an estimated 200 basis points so far this year. Without the MegaCap-8 stocks, the S&P 500 would be up about 2.5% through the first week of February. The MegaCap-8 now accounts for a record-high 28.3% of the S&P 500's market cap. No doubt analysts' fundamental expectations for the eight companies exceed that of the S&P 500 companies on the whole, with the MegaCap-8's forward EPS, revenues, and profit margins at record highs. It's important to note that the x-MegaCap-8 universe forward profit margins have stalled at around 11.6% since mid-2023.

Anatomy of the Bull Market: Does Valuation Matter?

A brief retrospective on the tech bubble valuations of the late 1990s shows that the forward P/E of the S&P 500 peaked at 25.2 on April 12, 1999, up from 12.0 at the end of 1994. It more than doubled. In context, over the past two years the rise and fall of the markets show that the forward P/E rose to 23.6 in early September 2020, up from the pandemic lockdown low of 13.0 in late March, 2020. The S&P 500's forward P/S (i.e., the stock price index divided by forward revenues) soared to a record 2.9 in early January, 2020. That coincided with the start of the last bear market. The ratio plunged to 2.0 in October, 2020, which marked the bottom of the bear market. The S&P 500's forward P/E and forward P/S were back up to 19.9 and 2.5 respectively at the end of the first week of February.

MegaCap-8s Lofty Valuations are Skewing Overall Market Valuations to Unsustainable Levels.

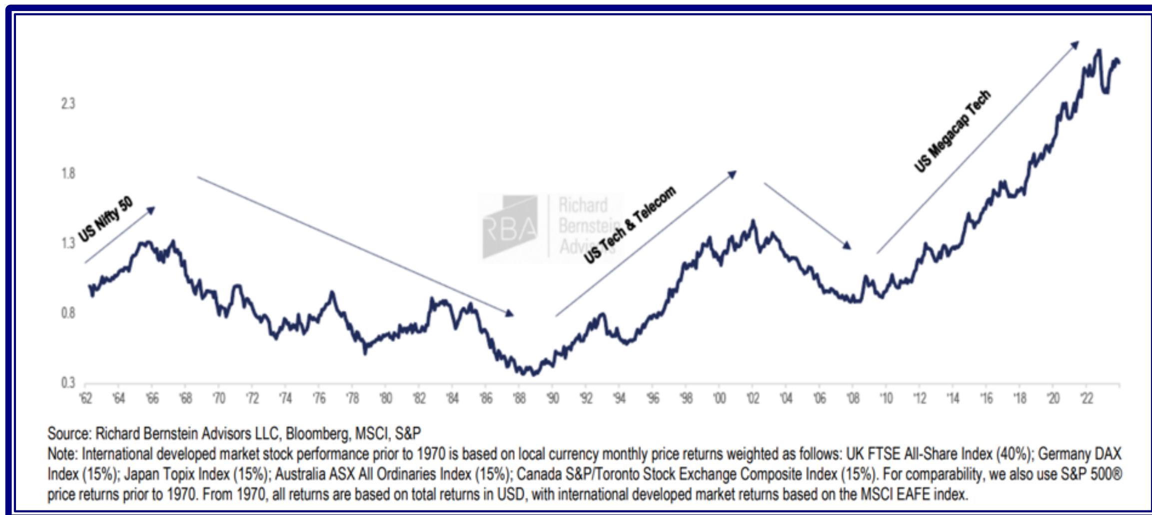


The real earnings yield of the S&P 500 (the reciprocal of the price-to-earnings ratio (P/E) to the 10-year U.S. Treasury bond yield) tends to be positive during bull markets and negative during bear markets. This time it bottomed at -4.68% during Q2-2022. That's a relatively low (and bearish) reading. However, the sharp decline in the CPI inflation rate pushed the real earnings yield back into positive territory during Q2-2023.

Valuation & the business cycle: It is widely presumed that there is an inverse relationship between the stock market's valuation multiple, on the one hand, and both inflation and the CPI inflation rates on the other hand. Although that is true, the correlation is a weak one, especially using four-quarter-trailing reported earnings of the S&P 500 to calculate the P/E since 1935, according to Yardeni Research. They found that the correlations are a bit higher using S&P 500 forward earnings since 1985.

Bottom line: The inverse correlation between the stock market's valuation multiple and inflation and interest rates seems to work through the business cycle. Rising inflation and interest rates usually cause credit crunches and recessions. It's the drop in earnings during recessions that also depresses the valuation multiple of those earnings. This time, it appears to be different so far because rising inflation and interest rates have yet to cause a recession. This could explain why the forward P/E bottomed at a relatively high reading of 15.0 when the bear market bottomed in October, 2022. Now that it is almost at 22.6, we are concerned that a bout of irrational exuberance could push multiples even higher, and potentially inflating a speculative bubble in the stock market that also occurred during the late 1990s. This perspective paints a cautious picture - and suggests that if markets continue the meteoric rise as of late that the bursting of the current bubble could cause a recession as it did back then.

Dominance of the Mega Tech Boom Looks Familiar



Source: Richard Bernstein Advisors LLC, Bloomberg, MSCI, S&P
Note: International developed market stock performance prior to 1970 is based on local currency monthly price returns weighted as follows: UK FTSE All-Share Index (40%); Germany DAX Index (15%); Japan Topix Index (15%); Australia ASX All Ordinaries Index (15%); Canada S&P/Toronto Stock Exchange Composite Index (15%). For comparability, we also use S&P 500® price returns prior to 1970. From 1970, all returns are based on total returns in USD, with international developed market returns based on the MSCI EAFE index.

Final Thoughts:

On Technology: Surely technology is the most innovative industry; however, it is also the most competitive. To justify current tech valuations using traditional valuation models requires very optimistic predictions for earnings growth which are now quite evident. Projecting that the fast earnings growth rates experienced by some technology companies will continue into the future and perhaps even spread to other secondary tech companies, that are currently losing money, in our opinion is problematic. Maybe the market has further to go on the upside, but at this point we are more comfortable staying with our time-tested principles of low price-to-earnings investing - focusing on companies that have intrinsic value and trade at substantial discounts to the overall market. This discipline should provide a margin of safety, should the markets come back down to earth in the foreseeable future.

Brief Reflections on the Bond Market:

- We believe that the capitulation process by the Fed and bond investors to a new secular inflation trend can take years - and that the current capitulation to a structurally higher inflation backdrop still has a way to go and is unlikely to be fully completed until the next economic expansion. In other words, if the next recession does not result in a credible deflationary threat, the subsequent recovery should bring inflation to a level well above the central bank's target.
- In retrospect, the 1980's bond market rates eventually exploded on the upside. This serves as a warning that bond yields could briefly drop as inflation concerns subside and prematurely justify another rally in bonds.
- This leads us to conclude that moving out to longer term maturities beyond 5-6 years is not yet an attractive buy-and-hold investment, since longer-term inflation expectations in our opinion remain too low. We expect inflation and bond yields to trend higher on average in the years ahead.
- In terms of current positioning, our view remains that risks are skewed to the upside for Treasury yields. The U.S. economy is regaining momentum, and inflation will prove stickier-than-expected, thereby limiting Fed rate cuts.

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No gross performance returns that are referenced that are calculated after brokerage commissions but before investment counsel fees are presented without the comparable net performance figures after both commissions, investment counseling fees and other custodial charges. The net counseling fees are the actual average counseling fee calculated across all the portfolios included in the composite. All performance figures are presented on a time-weighted total return basis and assume all income is reinvested. The investment advisory fees are disclosed in Part II-A of the Investment Form ADV. Some clients may benefit from available discounting in the management fee schedule associated with the overall size of the portfolio. Management fees will reduce overall returns to the client.

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