EQUITY MARKET UPDATE

As of 05/31/23 | Volume 12, Issue 5 | FFTAM.com

Stock market performance was mixed in May; however, further inspection of the returns indicates a weary market. Indexes are being propped up by a handful of mega cap US tech companies. Excluding those names from the equation shows stocks for the most part are flat-to-down for the year. Volatility is low despite continued troubles in the banking sector and weakening economic data. Inflation remains stubbornly high for central bankers. The month ended with President Biden and House Speaker McCarthy reaching an agreement to lift the debt ceiling for 2 years.

AI Related Tech Stocks Are Skewing Returns

The S&P 500 rose 0.43% in May. Buying was concentrated in only three sectors—technology (+9.46%), communications (+6.21%), and consumer discretionary (+3.21%). Excitement over artificial intelligence led to huge gains in NVIDIA (+36.34%), Microsoft (+7.11%), Amazon (+14.35%), Apple (+4.61%), Alphabet (+14.47%), Tesla (+24.11%), and Meta Platforms (+10.15%). Without these seven names, the S&P 500 would have been down 2.35% for the month. Year-to-date, the story is similar. The index is up 9.64% with technology (+33.95%), communications (+32.81%), and consumer discretionary (+18.64%) the only sectors in the green. The big tech companies listed above—Apple (+36.82%), Microsoft (+37.57%), Amazon (+43.55%), Meta Platforms (+119.98%), NVIDIA (+158.93%), Alphabet (+39.26%), and Tesla (+65.55%)—are responsible for all the money made in 2023! Without those companies, the S&P 500 is down 1.13% on a market cap weighted basis. The divergence in performance can also been seen when comparing the equal weighted S&P 500 (-0.65%) vs the market cap weighted results (+9.64%). The 1,029 basis point spread is abnormally wide and has only been seen a few times in history. The chart to the right shows this is the narrowest rally in history, and the only time so few names account for all the money made.

Annual S&P 500 Contribution of 10 Largest Weights During Positive Performance Years

Year	Top 10 as % of Total	S&P 500 % Perf.
2023 YTD	**104.1%**	**9.5%**
2007	78.7%	3.5%
2020	58.9%	16.3%
1999	54.5%	19.5%
2021	45.0%	26.9%
1998	36.8%	26.7%
1996	33.9%	20.3%
2017	33.3%	19.4%
2019	32.8%	28.9%
1991	28.6%	26.3%
2006	27.6%	13.6%
2016	26.6%	9.5%
2003	23.6%	26.4%
1995	22.3%	34.1%
2014	22.2%	11.4%
2004	21.1%	9.0%
2005	20.5%	3.0%
2010	19.6%	12.8%
2012	19.2%	13.4%
1997	19.1%	31.0%
2013	17.6%	29.6%
2009	15.5%	23.5%
1992	14.9%	4.5%
1993	12.2%	7.1%

The Dow Jones Industrial Average fell 3.17% for the month. Lack of technology and declines in Nike and Goldman Sachs hurt results versus the S&P 500. So far in 2023, the Dow is barely positive at 0.25%. The index has a lower allocation to technology and communications which have been the best performing sectors.

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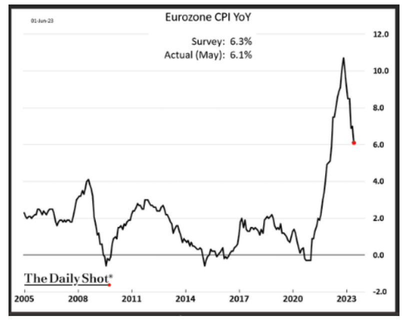
The NASDAQ jumped 5.93% in May. With concerns about the overall economy, investors are seeking shelter in the largest tech companies. Enthusiasm about potential advances in artificial intelligence and bottom fishing after several highflyers were crushed last year are also fueling gains. Year-to-date, the NASDAQ is up 24.07%, by far the highest return among major indexes.

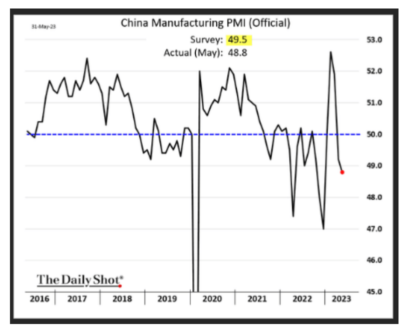
Middle-to-small-sized companies vastly underperformed once again in May. The S&P 400 Mid Cap Index fell 3.20%, while the S&P 600 Small Cap Index decreased 1.77%. Exposure to regional banks and a lower allocation to tech explains the shortfall. So far in 2023, the S&P 400 Mid Cap Index is down 0.32%, while the S&P 600 Small Cap Index has declined 2.07%.

International Stocks Fall on Weak Economic Data



Eurozone inflation was 6.1%, a sharp drop from the previous month. The report showed signs once again that inflation is becoming more entrenched throughout the economy as core inflation (which strips out food and energy) barely budged at 5.3%. Inflation inside of the service sector posted another record high. Wages are growing at their fastest pace in history and exceed the levels seen in the United States. Eurozone Manufacturing PMI was 44.8, the eleventh straight month of contraction. Services PMI remained strong at 55.9. Economists predict a stronger GDP reading in the second quarter as the low energy prices strengthen discretionary income for consumers; however, there are concerns about tighter lending standards as the ECB addresses inflation via higher interest rates.

The ECB raised interest rates once again by 0.25% to 3.75%. The hike was smaller than previous meetings, but ECB President Christine Lagarde was clear that the central bank has no intention to pause at these levels. In their post meeting statement, the ECB said, “the inflation outlook continues to be too high for too long.”

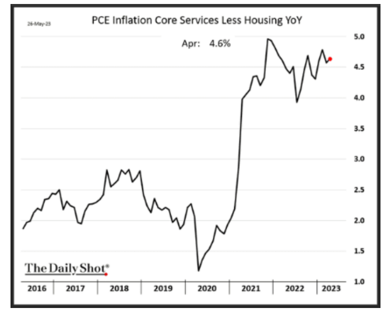


The Chinese economy reported mixed results after a brisk start to the year from COVID reopening. China’s Manufacturing PMI softened to 48.8 which was well short of forecasts. This was the second straight month of contraction. New export orders at factories weakened to 47.2 as economic conditions in the US and Europe tighten. Service activity was strong at 54.5, but it was less than last month’s reading and below market expectations. Job growth is contained primarily to the service side of the economy as consumers engage in social outings and travel after three years of constant lockdowns to prevent the spread of COVID-19; however, youth unemployment remains extremely high around 20%.

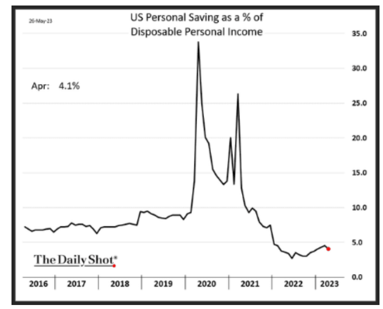
Concerns about a weaker than expected reopening in China and persistent inflation in Europe caused the MSCI EAFE Index to fall 4.12%, while the MSCI Emerging Markets Index declined 1.66%. Year-to-date, the two indexes are up 7.25% and 1.15%, respectively.

US Economy Slows but Labor Data Strengthens

The labor market remains solid. Last month, the economy added 339,000 jobs. The unemployment rate rose to 3.7%, while the labor force participation rate held steady. Average hourly wages were up 4.3% from one year ago, an amount that far exceeds both Fed expectations and the pay raises seen pre-COVID. The JOLTS report increased to 10.103 million jobs available but unfilled. The figure equates to 1.82 job openings for every unemployed person. This is still strong compared to historical levels, but it is off the highs seen earlier this year. The demand for labor continues to outstrip supply in most industries which signals tightness in the labor force, but the intensity of competition to recruit and retain employees has waned. This is something the Fed is paying very close attention to because wage inflation is the most durable and hardest to defeat type of inflation.



Consumer inflation eased as prices jumped 4.9% from one year ago. Core inflation that removes food and energy prices rose by 5.5%. PCE data, the Fed's preferred measure of inflation, strengthened with total prices climbing 4.4%, while prices ex-food and energy climbed 4.7%. The data presents a major challenge for the Fed. For the past six months, inflation has slowed significantly from the previous high-water marks; however, recent information shows the glide path downward is occurring much more slowly than forecasted. Inflation readings remain well above the Fed's 2% target, especially when you look at inflation in services. With high levels of inflation still existent in many parts of the economy, the Fed must take a harsher stance on interest rates to defeat it. The savings rate is 4.1%, below the levels seen pre-COVID. Credit card balances are at record levels and growing briskly. Debt delinquency is increasing, especially in credit cards and subprime auto loans. Consumer spending was up 0.8% last month, while retail sales rose 0.4%. Expenditures on services remain strong, especially for air travel, movie theaters, restaurants, and amusement parks.



Business investment remains weak. The ISM Manufacturing PMI was in contractionary territory for a seventh straight month with a reading of 46.9. New orders (42.6) contracted for the eleventh time in twelve months, while prices paid plunged to 44.2. This signals that inventories are plentiful and supply chain conditions have healed for most goods. The ISM Service PMI (50.3) remains in expansionary territory, but it decelerated significantly from the prior month. Prices paid (56.2) for services remain very strong, while new orders (52.9) weakened meaningfully. Finally, home sales remain weak as 30-year mortgage rates hover around 6.75%.

The Fed responded to the data by raising interest rates another 0.25% to 5.25%. They adjusted their post meeting statement by removing the language "additional policy increases might be appropriate" and replaced it with "we will monitor economic and financial market developments and the effect of earlier rate increases in determining the extent to which additional policy firming may be appropriate to return inflation to 2% over time." During the press conference, Chairman Jerome Powell refused to confirm whether the Fed was done raising interest rates. He said, "the committee did not discuss a pause at this meeting" and "any future Fed action will be data dependent." As we approach another Fed meeting in mid-June, several board members have indicated the possibility of not raising interest rates at this meeting to give the Fed time to assess whether the banking crisis and debt ceiling negotiations have had a negative effect on the overall economy. They remain vigilant in communicating that it is "premature" to declare victory over inflation given the tight labor market and the strength in the service sector. The market is now pricing-in another 0.25% hike at the July meeting with rate cuts starting at year-end.

Market Valuation Appears High Given Uncertain Economy

The PE ratio on the S&P 500 is 18.03x 12-month estimated earnings. This is slightly below the 5-year average of 18.54x and above the 10-year average multiple of 17.31x. It is also less than the pre-COVID PE ratio of 19.40x. With interest rates at their highest levels in 16 years, the PE ratio appears elevated.

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First quarter earnings season has concluded. Year-over-year profits were down 2.1% compared to analysts' forecast of down 6.7%. This marked the second straight quarter of negative earnings growth which is the textbook definition for an earnings recession.

Looking ahead, analysts now see 2023 profit growth of 1.2% according to FactSet. Wall Street is bracing for additional earnings erosion in the second quarter with profits forecasted to be down 6.4% from one year ago. In the back half of the year, analysts are now modeling 0.9% profit growth for the third quarter, and they have a very healthy 8.3% growth rate assigned to the fourth quarter. This does not jive with the fixed income markets that expect rate cuts starting in December. Someone is obviously wrong because if corporate profits are growing near double digits then why would the Fed need to soften monetary policy? We conclude that additional volatility in asset prices is to be expected as we move through the second half of the year.

Our Outlook & Strategy

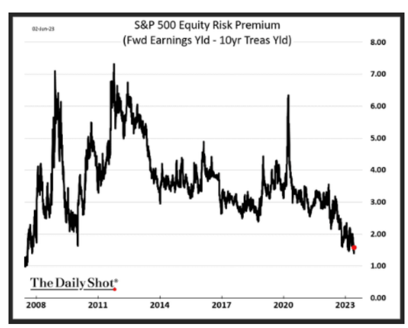
The biggest challenge for stocks in 2023 still involves central banks navigating how to remove emergency stimulus policies needed during the depths of the pandemic without tipping the global economy into recession. A watchful eye also needs to be kept on China as they reopen their economy after a long bout of "Zero Covid" policy. The perceived strength of regional banks and their ability to lend adds another wrinkle to an already complicated puzzle. Higher interest rates increase the attractiveness of bonds, which reduces the PE multiples investors are willing to assign to stocks. This places outsized stress on stocks trading at lofty valuations, especially those that cannot clear the earnings growth hurdles analysts have forecasted.

When digging into the market's fundamentals, the overall valuation on stocks is deceptive. The top seven tech names—Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla—collectively trade at a forward PE ratio of 32.17x the next twelve-month earnings estimates. This is steep relative to the rest of the market (13.29x), and it appears especially rich versus US Treasuries and high-grade corporates.

Investors are currently seeking shelter in these names as fears about economic growth rise. They also view these companies as major beneficiaries of the upcoming investment wave in artificial intelligence. Given these firms' weight in the S&P 500, they are skewing valuations to the upside.

This unveils two main themes. First, despite the elevated valuation, investors are reluctant to part ways with the names that were responsible for the bulk of the gains in the past 10 years. Second, many are justifying ownership of these companies on the belief that current interest rates cannot hold for much longer. This is a major disconnect from the Fed who believes interest rates will have to remain higher for longer to stomp out the roots of inflation (structural shortages in labor, energy, and housing along with supply chain recalibration away from China post-COVID).

The current valuation in the stock market is providing a historically thin equity risk premium that compensates stock investors for the excess risks taken compared to bonds. This tells us forward returns for equities will likely be below average mixed with higher bouts of volatility, especially for companies trading at above average valuations that cannot clear analyst growth expectations. Given that mathematical backdrop, we have chosen to take a more defensive tilt in our portfolios by boosting select positions in healthcare, utilities, and real estate. Their lower valuations and defensive business models should lead to relative outperformance in a volatile market environment facing numerous macro challenges.



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