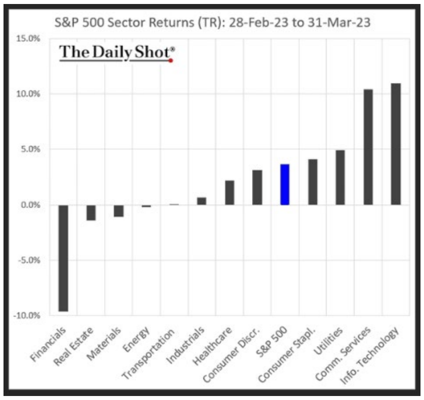
EQUITY MARKET UPDATE

As of 03/31/23 | Volume 12, Issue 3 | FFTAM.com

Markets were volatile in March as the abrupt failure of two regional banks shocked investors. Conditions worsened when the Swiss government forced Credit Suisse to merge with its rival UBS due to its precarious financial condition. Inflation softened in the US but remains well above the Fed's target. Meanwhile, Europe posted record core inflation that strips out food and energy prices. China continued to expand at a brisk pace as their economy reopens from the recent change in COVID policy. Central bankers raised interest rates once again, while investors flocked to the largest tech companies. This caused indexes to finish mixed for the month.

Big Tech Gains While Regional Banks Sink Mid and Small Cap



The S&P 500 rose 3.67% in March. Buying was concentrated primarily in the technology (+10.93%) and communications (+10.39%) sectors, while financials (-9.55%) suffered the steepest losses. Over 50% of the monthly increase in the S&P 500 was attributable to gains in Apple and Microsoft, and the top six tech companies—Apple, Microsoft, Amazon, Alphabet, Meta Platforms, and NVIDIA—represented 92% of the monthly gain! For the quarter, the index increased 7.48% with huge advances in technology (+21.82%), communications (+20.50%), and consumer discretionary (+16.05%). Once again, big tech companies accounted for 88.34% of the gains. If you back out those stocks, the S&P 500 gained only 1.41% for the quarter. The divergence in performance can also been seen when comparing the equal weighted S&P 500 (+2.90%) vs the market cap weighted results (+7.48%). The 458 basis point spread is abnormally wide and is usually seen in the late stages of an economic cycle.

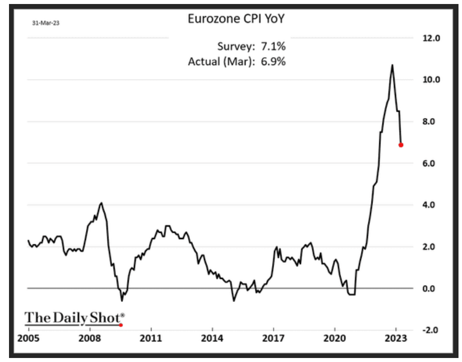
The Dow Jones Industrial Average rose 2.08% for the month. A higher allocation to value sectors like staples, healthcare, energy, and financials hurt results versus the S&P 500. The Dow also has a lower allocation to technology which was the best performer in March. Year-to-date, the Dow is only up 0.93%.

The NASDAQ led the pack again by jumping 6.78% for the month. 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 17.05%, its best quarterly performance since the depths of COVID—second quarter of 2020. Valuation in tech remains steep relative to other parts of the market, so we are cautious because investors have shrugged off weak earnings reports and macroeconomic headwinds.

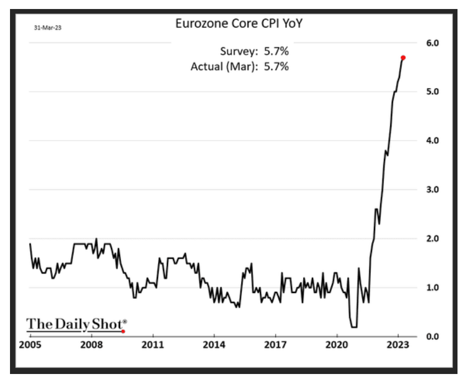
Middle-to-small-sized companies vastly underperformed the large cap indexes in March. The S&P 400 Mid Cap Index fell 3.21%, while the S&P 600 Small Cap Index decreased 5.16%. Exposure to regional banks and a lower allocation to tech explains the shortfall. So far in 2023, the S&P 400 Mid Cap Index is up 3.79%, while the S&P 600 Small Cap Index has advanced 2.54%.

<u>International Stocks Underperform on Hotter European Core Inflation</u>

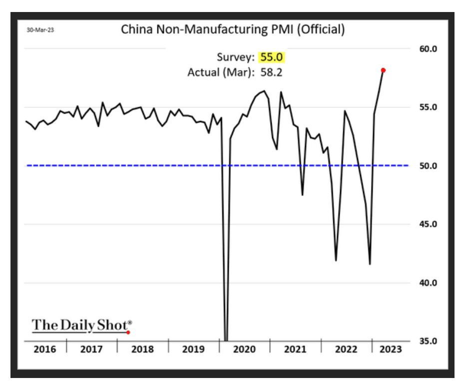
Eurozone inflation fell to 6.9%. This was below the forecast estimate of 7.1%. Lower energy prices aided results as winter continues to be milder than normal throughout Europe. This was welcomed news, but the report showed signs once again that inflation is becoming more entrenched throughout the economy as core inflation (which strips out food and energy) climbed to a new high of 5.7%. Wages rose by 5.1% from one year ago, the fastest pace on record. Eurozone Manufacturing PMI was 47.3, the ninth straight month of contraction. Services PMI improved once again to 55.6, its strongest reading since May. Economic data continues to surprise to the upside, and signs point to Europe possibly evading a recession, although overall growth is weak outside of services.



Persistently high inflation pressured the ECB to raise interest rates once again by 0.50% to 3.50%. The central bank stated further rate hikes are needed. ECB President Christine Lagarde said concerns about sticky inflation in services and models indicating stronger than normal wage growth over the next several quarters highlight the need to remain vigilant in combating higher prices despite possible issues in the banking system caused by Credit Suisse.

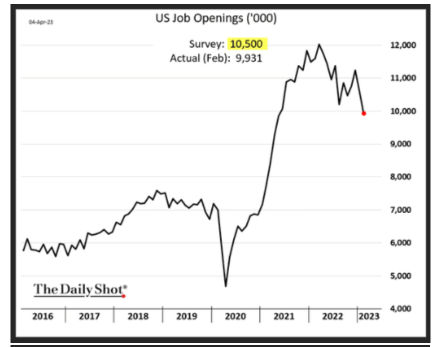


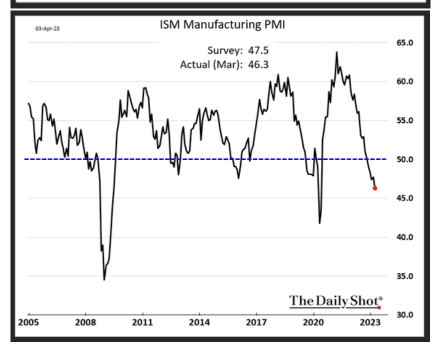
The Chinese economy is accelerating after reopening. China's Manufacturing PMI slowed to 51.9 but ahead of consensus forecasts. New export orders at factories weakened to 50.4 as economic conditions in the US and Europe tighten. Service activity skyrocketed to 58.2, the best reading since 2011. Job growth and mobility indicators also improved as consumers craved social outings after three years of constant lockdowns to prevent the spread of COVID-19. Home sales gained for a second straight month as the battered housing markets tries to recover.

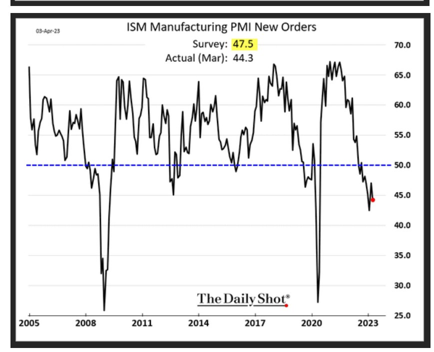


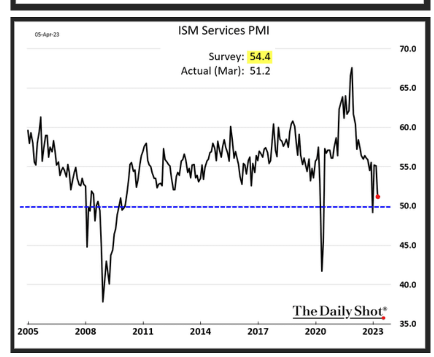
Economic achievements in China are being overshadowed by geopolitical conflicts. President Biden expanded the list of Chinese entities that American technology companies cannot sell products to for national security concerns. Japan joined the US by establishing their own list of domestic technology companies that are barred from doing business in China. A Chinese diplomat had contentious meetings in Europe after President Xi's visit with Russian President Vladimir Putin resulted in a communique that strengthened ties between the two nations. Finally, government officials in Washington grilled the CEO of Tik Tok, the popular social media app, after he was unable to debunk intelligence that the Chinese owned service is being used as an intelligence gathering tool.

The MSCI EAFE Index gained 2.61%, while the MSCI Emerging Markets Index rose 3.04%. Year-to-date, the two indexes are up 8.65% and 3.97%, respectively.









<u>US Economy Slows, Banking Crisis Adds Wrinkle of Uncertainty</u>

The labor market remains solid but is showing some signs of slowing. Last month, the economy added 236,000 jobs. The unemployment rate fell to 3.5%, even as labor force participation improved. Average hourly wages were up 4.2% from one year ago, an amount that far exceeds both Fed expectations and the pay raises seen pre-COVID. The JOLTS report showed there are 9.93 million jobs available but unfilled. This was a significant decline from the previous month, and it marked the first time job vacancies were below 10 million since May 2021. The figure equates to 1.7 job openings for every unemployed person, well 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 6.0% 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, softened with total prices climbing 5.0%, while prices ex-food and energy increased 4.6%. 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 stalling at levels 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. We are seeing further evidence that widespread inflation is a strain for consumers despite the strong labor market and higher wages. The savings rate has plunged to 4.6%. Credit card balances are at record levels and growing briskly. Debt delinquency is increasing, especially in credit cards and subprime credit score auto loans. Despite these challenges, consumer spending increased 0.2% last month, while retail sales fell 0.4%. Expenditures on services remain robust, especially for air travel, movie theaters, restaurants, and amusement parks.

Business investment soured. The ISM Manufacturing PMI was in contractionary territory for a fifth straight month with a reading of 46.3. New orders (44.3) contracted for the ninth time in ten months, while prices paid fell to 49.2. This signals that inventories are plentiful and supply chain conditions have healed for most goods. The ISM Service PMI (51.2) remains in expansionary territory, but it is decelerating. Prices paid (59.5) for services remain very strong, but new orders (52.2) declined significantly. Finally, home sales remain weak as 30-year mortgage rates hover around 6.5%.

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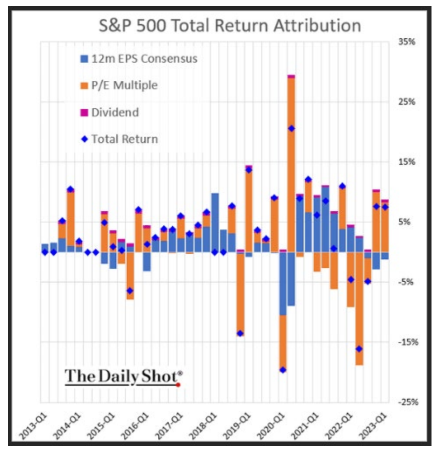
The Fed responded to the data by raising interest rates another 0.25%. During the press conference, Chairman Jerome Powell signaled that the Fed could be nearing the end of their rate hiking campaign, especially if the recent banking system stress triggers a pullback in lending. He left the door open for the Fed to hike one more time in May before pausing. He reiterated the Fed is purposefully moving interest rates into restrictive territory and will leave them there for considerable time to ensure inflation is defeated. Mr. Powell believes the Fed has significantly addressed the inflationary environment, but it remains "premature" to declare victory given the tight labor market and above average level of service inflation. He also acknowledged this strategy will weigh on economic growth. The Fed maintained its 2023 GDP growth forecast of 0.5%. The market is currently pricing-in a terminal interest rate near 5.0%. The Fed is currently at 5.0%, so the market believes the central bank is done raising interest rates. The market is also forecasting interest rate cuts beginning in July which is vastly different than the Fed's forecast. It is important to remember that any interest rate increases are coming on top of the Fed's quantitative tightening program that involves shrinking the balance sheet by $95 billion each month.

Market Valuation Appears High Given Uncertain Economy

The PE ratio on the S&P 500 is 18.20x 12-month estimated earnings. This is slightly below the 5-year average of 18.54x and above the 10-year average multiple of 17.23x. 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.

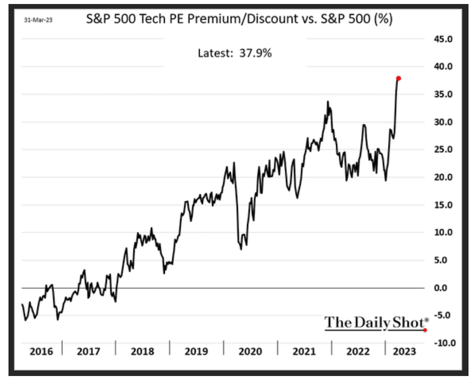


We are on the brink of another earnings season, and forecasts are weak. Analysts expect first quarter earnings to be down 6.6% from one year ago. If this comes to fruition, it will be largest profit decline since the second quarter of 2020, and it will mark the second straight quarter of negative year-over-year earnings growth. As we have previously discussed, earnings have been struggling for nine months. In the last three earnings seasons, results were sigificantly aided by energy. If you backed out the energy sector, earnings growth was already negative for the remainder of the economy.

Looking ahead, analysts now see 2023 profit growth of 1.5% according to FactSet. Wall Street has thrown in the towel on the first half of the year with expectations for negative year-over-year earnings growth in both the first and second quarters. If this materializes, profits will have shrunk for three straight quarters (five quarters if you include the ex-energy figures from the second and third quarters of 2022). This checks all the boxes for the textbook definition of an earnings recession, although the jury is still out on whether this would also mean an economic recession. In the back half of the year, analysts are now modeling 2.3% profit growth for the third quarter, and they have a very healthy 9.3% growth rate assigned to the fourth quarter. Given the market's forward looking nature, bullish investors are hanging their hat on accelerating profit growth starting in the third quarter and continuing into 2024. That is a wildcard based on the belief the Fed will cut interest rates later this year. That is difficult to model with a high degree of certainty given the erratic nature of inflation and economic performance. We believe investors need to beware of companies that cannot clear the lowered profit hurdle, especially among names that carry high valuations and little-to-no dividend yield.

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 a new 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 29.67x the next twelve-month earnings estimates. This is steep relative to the rest of the market (14.49x), 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. However, each company is experiencing decelerating earnings growth, and many of them now possess profit growth profiles that are lower than other parts of the market that trade at lower valuations. A few of the names, like Meta Platforms and Alphabet, have seen their valuations plunge after earnings misses; however, the others still trade at outlier levels. Given these companies' weight in the S&P 500, they are skewing valuations to the upside.

This unveils two main themes. First, despite the facts stated above, 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 communications. 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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