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By the Way

Monthly commentary from Jack Way

"on the other hand"

It has been a remarkable first half of 2023 for markets, and very little has gone exactly as expected. The low for this cycle on the S&P 500 was made last October, but we entered the new year on the heels of a 6% decline in December and serious concerns about the economy, inflation and interest rates. However, surprisingly good economic releases; better, if not great, inflation; and even suspicion the FED was getting closer to relaxing its tightening policies all led to a renewed bullish sentiment and higher markets. Despite the disruptions caused by the failure of three U.S. banks and the debt ceiling debate, which took us back to flat for the year, the S&P 500 closed the six months (with the help of a hair-on-fire rush to buy AI companies) at a new year-to-date high, up 16%. That number pales in comparison to the NDX (the top 100 stocks in the NASDAQ Index) up 37%, and U.S. mega cap tech stocks up 52%. If you weren't playing in some part of that arena there's a good possibility a GIC or Money Market fund outperformed your portfolio. Digging deeper, here are the six-month total returns for the seven largest companies in the S&P 500: Apple +46%; Microsoft +40%; Google +25%; Amazon +52%; NVVIA +179%; Tesla +109% and META +134%. In all, the top ten weightings in the index accounted for well above 80% of the total return from all members. Where to from here?

I, for one, remain sceptical that such narrow leadership can continue to take markets higher forever. While there have been some signs of strength broadening out, (for instance 52-week highs have increased somewhat and the industrial and discretionary sectors of the market are outperforming) the weight of the evidence is not yet convincing to me. As always there is an "on the other hand" view, and in this case it would be a simple look at a chart of the S&P 500. If no one told me the how's and why's of the performance this year, I would easily say this is bullish and needs to be bought. Nevertheless, I'm not saying that.

There are numerous macro factors that could impact markets, but the clear frontrunner is the policies of the Federal Reserve. I suspect we spend too much time and effort trying to decipher what the Board's intentions are. It is worth remembering how late the FED came to the fight against inflation. It was only 15 months ago, March 2022, that the FED announced the end of Quantitative Easing (QE) which had been brought in to counter the effects of the pandemic and bolster the economy. The Board chose to discount a more important, as it turned out, fact that the CPI at that time was ticking along at an 8.5% rate and headed higher; at least they had stopped saying inflation is "transitory". That's by definition being behind the curve, and it's not difficult to argue they are behind again today by perhaps tightening for too long. We all know monetary policy acts with a lag, but we, and in fact the FED, don't know how long, which leads to an inability to correctly assess the lingering impact of taking rates from 0 to 5+% over the last year.

Nevertheless the FED still matters a lot. We now have the minutes of the FED meeting that led to the decision to not raise rates in June. There were some members still advocating for an increase due to continued strength in the economy and problematic inflation. What was much more unanimous was that the inflation battle is far from over and the key takeaway that more hikes are in the offing this year. The Board also forecast a mild recession later this year as it continues to attempt to slow the economy and bring down the rate of inflation. Unfortunately, the FED is only equipped with blunt tools (raising rates and lowering liquidity) to solve the delicate problem of easing the rate of growth but not provoking a deep recession. The risks of unpredictable outcomes and unintended consequences are vast and varied. The FED's fight is exacerbated by the continued strength in parts of the U.S. economy, namely consumer spending and employment, despite its tightening policies. As if on cue, ADP reported that in

June private sector jobs rose by 497,000 versus a consensus estimate of 220,000, and annual pay was up 6.4%. That's an undesirable combination of more growth and more inflation.

Offsetting the signs of growth are several predictive series such as Leading Economic Indicators (LEI) and Purchasing Manager Indices (PMI) which are almost universally forecasting weaker or contracting economies around the world. The manufacturing sector is of particular concern while service sectors are less of an issue. Europe is a definite drag on growth, and the rebound in China after reopening has proved anemic. Goldman Sachs lowered its second quarter GDP estimate for China to 1% from 4.9%. In the U.S. an unemployment rate of 4% has historically been defined as "full employment". With the current level of 3.7%, it is worthwhile to ask where the impetus for more growth might come from. The elephant in the room is what will U.S. fiscal policy look like if there is significant economic weakness? I believe the floodgates would open once again to paper over such weakness. Given that President Biden and his party already have new spending proposals on the docket and 2024 is an election year it won't take much of a leap. The Congressional Budget Office (CBO) is estimating an increase in fiscal expenditures of 6.5% next year, which compares to a 3.5% rate in the years leading up to the pandemic. That should be helpful to the economy, but certainly not to taming inflation. We can argue forever about the future of the U.S. economy, but at least for the moment there is no indication of a recession. Which reminds me, someone recently pointed out that with the exception of a couple of months of decline in 2020 (pandemic induced) it has been 14 years since the last U.S. recession.

Other items that are attracting my attention include:

1. The U.S. Supreme Court (aka the "Trump court") continues to eviscerate liberal initiatives. Just last week it blocked student loan repayment cancellations, made affirmative action illegal in higher education, and, most surprising to me, ruled a Christian website designer had the first amendment right to discriminate against same-sex customers.

2. Money Market flow has been 4x that of equities since last October and 8x since March. Will there be a reversal as a "fear of missing out" kicks in?

3. Republicans in the House of Representatives are thinking of raising the retirement age from 66 to 69 in an effort to save money.

4. Darden Restaurants (operates 9 brands from Olive Garden to Ruth's Chris) reported a quarterly decline in chicken and seafood prices. (Hasn't reached Loblaws yet.)

5. In 2007 Credit Suisse had a larger market capitalization than Apple.

6. Famously a contrarian indicator, the cover of Business Week recently proclaimed Commercial Real Estate (CRE) "Scary".

For those of us in more northern climes, let's enjoy the summer

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