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By the Way

Monthly commentary from Jack Way

""No one is running on austerity"

It can be useful to review where we've been to get a better sense of where we are and perhaps even help to see where we might be headed. We only need to look back to last October to realize how much of significance has happened to the U.S. economy and the S&P 500 Index in the space of only six months. After an almost 30% rally in only 3 months, it was logical, but not universally anticipated, that markets should take some time to consolidate, regroup and even decline to find renewed strength to move on to new higher levels. On the contrary we entered 2024 with the majority of investors, and in fact the Federal Reserve Board itself, exhibiting a certain complacency that a "soft landing" for the economy was on schedule and all was well. However, as the first quarter unfolded reports indicated slightly weaker than expected GDP growth, and more importantly that inflation was not continuing its path lower but actually indicating the potential for a renewed period of higher prices. This became, along with valuation levels being in the top decile by almost all historic measures, the catalyst for the S&P to decline. As a result, we now find ourselves in a trading range between the all-time high around 5250 and the recent low of 4970. Until the market breaks out of this range we can expect to continue to experience short-term volatility between the two levels depending on the expectations for interest rates and the daily musings of FED Governors on the outlook for rate cuts.

An argument is being made in certain circles that equity markets are broadening and that the days of domination by the Magnificent 7 ("Mag 7") and a few other large cap names are over. I am not so moved. The top ten companies by market weight in the S&P 500 make up 33% of that Index which is a new high for concentration since at least 1990; (as far back as I looked). The "Mag 7" is responsible for 76% of the rise this year, and NVIDIA accounts for 40% of that number. They are still in charge in my opinion, and they had better stay strong. I remember Nortel was over 30% of the Toronto Stock Exchange in early 2000. The stock collapsed and played a large part in the TSE losing over half its value. If we are going to see new highs the big weights will need to continue to lead or at least participate fully. I found a concise table produced by the research department at Goldman Sachs that highlights the growth of the "Mag 7" over the last decade:

Market Cap ($ Billions)

	10 Years Ago	Today
Microsoft	$334	$3,081
NVIDIA	11	2,185
Apple	447	2,616
Amazon	149	1,904
Google	380	1,920
Meta	153	1,274
Tesla	25	500

The large cap stocks also had to be a major factor in the growth of S&P 500 earnings. The current forecast for 2024 is $243 per share and for the next year $275. That's not enough to make the Index valuation cheap, but it definitely improves the outlook. In addition, 78% of the companies in the 500 are beating earnings estimates, and 59% are beating revenue estimates.

With the heightened concern about where inflation is headed, the FED is and will continue to be, much more nuanced in planning for rate cuts. The markets have already reduced the expected number of cuts from 6 at last year-end to 2 today, and the "when" is also being called into question. There is a lot for the FED to unpack in its analysis of future inflation and about the only potential positive will be its ability to manufacture a soft landing, where the economy slows enough to put a lid on prices but not fall into a recession or worse. What follows are some of the many challenges facing the Board in that quest:

1. Despite the growth in GDP there is no sign of a decline in U.S. budget deficits
2. Forecasts predict just the interest expense of the Federal Government will double in the next 10 years
3. 65% of the U.S. budget is indexed to inflation (e.g. Social Security, Medicare and Medicaid)
4. 35% of the U.S. debt has now been financed in the Treasury Bill market; that can't last
5. Neither political party has any interest in cutting spending (particularly in an election year) as someone said last week, "No one is running on austerity".

On the more hopeful side ISM surveys for April hinted at a moderate slowdown in the U.S. economy which would help in the effort to curb inflation. ISM reported services at 49.4, manufacturing at 49.2 and new orders at 49.1 – all below 50 which indicates expected contraction but not as yet severe. Last Friday brought a surprising report on Non-Farm Payrolls which came in at 175,000; well below estimates of 240,000 and 315,000 in March. Those are the kind of numbers that take the heat out of the labor market and so-called "sticky inflation". In fact, Average Hourly Earnings only increased 0.2%. Likely music to the FED's ears. Don Rissmiller of Strategas enlightened me that 0.2% is consistent with an economy that can grow without "runaway" inflation. Wages can increase at 4% consisting of 2% inflation and 2% productivity. Despite the FED funds rate sitting at 5.3% (up from 0%), the U.S. GDP continues to grow and at a higher rate than other developed countries (consensus forecasts have the U.S. at 3.1% this year and Europe at 0.7%). Although as one pundit said recently; "America is on the steroid economic model, strong on the outside but killing itself on the inside".

The Presidential election draws ever closer but without any real market impact so far. This, in my opinion, is whistling past the graveyard (old man expression, you can look it up 😊). As I've said numerous times the dispersion of outcomes depending on which person and also which party wins in November is vast. Taxes, tariffs, immigration are just some of the issues that could go in very different directions in 2025 with an associated fallout for markets. This is of particular interest for us here in Canada because a Trump administration would likely raise tariffs (maybe or maybe not on Canada), which would have an unfavorable impact on international trade volumes and likely would be a negative for Canada. Dan Clifton, also of Strategas, points out that the level of the "Misery Index" (adding together Inflation and Unemployment) has correctly predicted 15 of the last 16 Presidential winners. Currently it stands at 7.05% with 7.3% the line in the sand that has signaled a loss for the incumbent. President Biden needs inflation to remain benign. It's being said that "regular" Republicans may be prepared to hold their nose and vote for Trump as a way to keep control of Government for their party.

Geopolitics remain fraught with the unknown but meaningful risk of an accident.

The FED and the U.S. Treasury Department continue to use all the tools at their disposal at any sign of weakness in the economy or financial system. By inference, we can assume that would be supportive of equity markets as well.

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