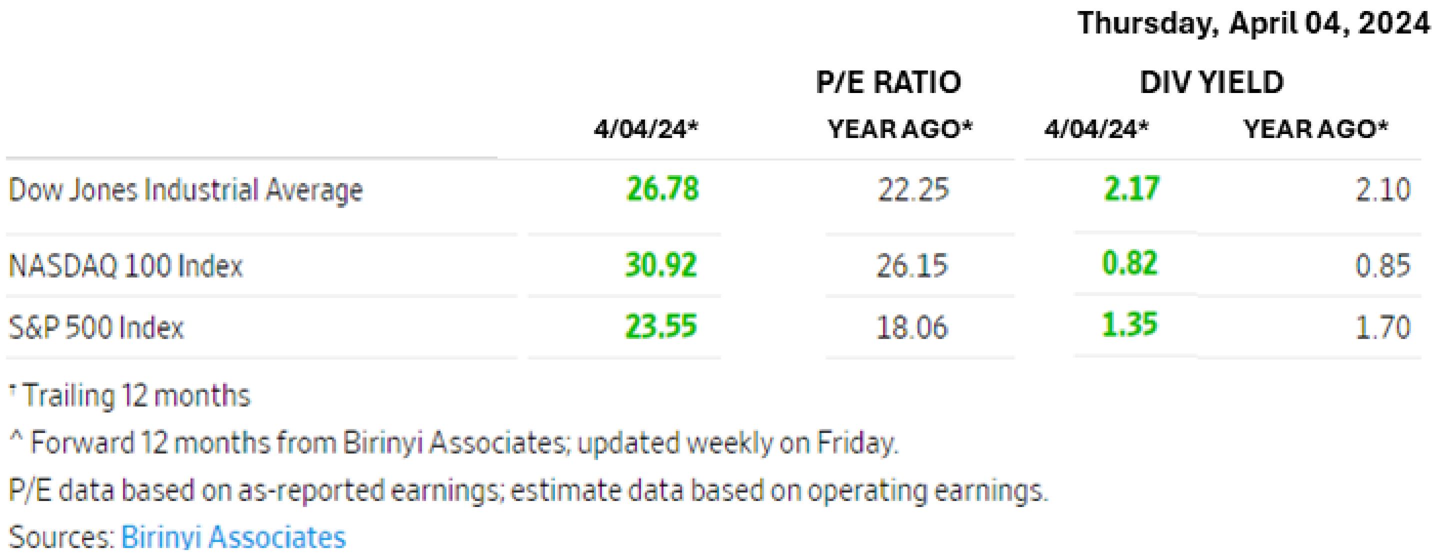
MARKETTREND℠
ADVISORS

April 2024

Dear Clients and Friends,

Has there ever been a stock market more obsessed with the Federal Reserve and interest rates? No, at least according to CNBC market pundit Jim Cramer. Investors are salivating in anticipation of multiple interest rate cuts this year. Ironically, a declining interest rate environment often means a weakening economy, which is obviously not good for stocks. Since 1955 the Fed has substantially cut rates (cumulative cuts of 1% or more) 17 times. Twelve of those were in reaction to downturns or economic crises. If the Fed cuts well before a recession, they are more likely to stave off a downturn. If a recession has already laid its foundation, rate cuts would only be catching up to an already-weak economy, which will likely have seen stocks already falling.

For now, the US economy continues to be remarkably resilient, leading US stocks to rally significantly since October of last year. A very strong first quarter of 2024 might suggest that investors have gotten over the tips of their skis a bit. Valuations are stretched. Not extremely so, but stocks are not cheap as shown by the price-earnings ratios below taken from the Wall Street Journal.



Thursday, April 04, 2024

	P/E RATIO		DIV YIELD	
	4/04/24*	YEAR AGO*	4/04/24*	YEAR AGO*
Dow Jones Industrial Average	26.78	22.25	2.17	2.10
NASDAQ 100 Index	30.92	26.15	0.82	0.85
S&P 500 Index	23.55	18.06	1.35	1.70

* Trailing 12 months

^ Forward 12 months from Birinyi Associates; updated weekly on Friday.

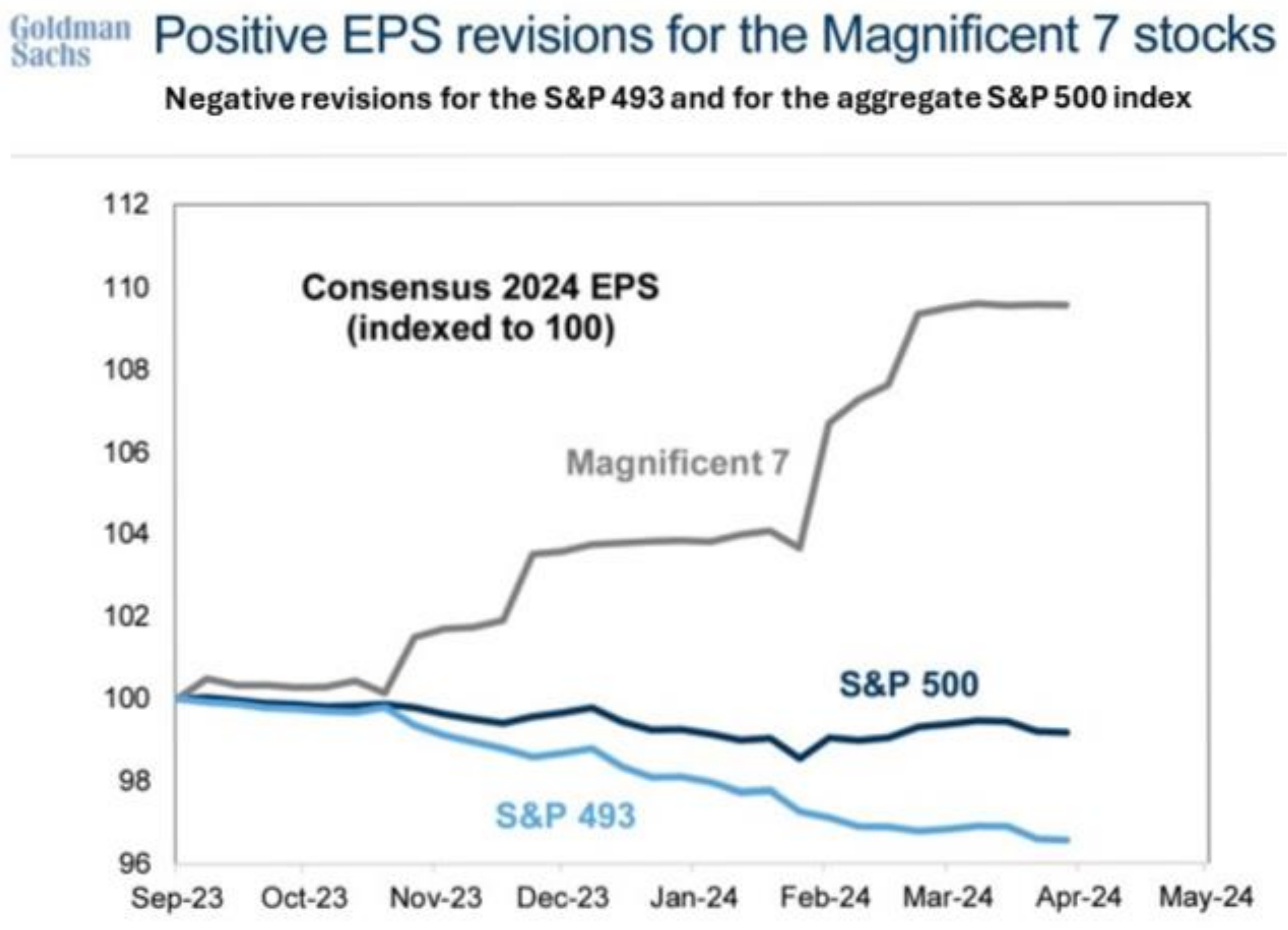
P/E data based on as-reported earnings; estimate data based on operating earnings.

Sources: Birinyi Associates

Behind the jump in price-earnings ratios are: 1) strong corporate earnings, especially among the largest companies in the market indexes (the so-called Magnificent 7) whose stock prices have been pushed even higher by AI-mania, 2) the very heavy weighting of those seven stocks in the indexes (a staggering 29% of the stock market's value), and 3) investor belief that multiple interest rate cuts are coming this year. Lower interest rates usually equal higher price-earnings ratios.

The strength of company profits has been undeniable. The key issue is always "how long can it last?" We know the Fed wants to get to 2% inflation (from 3.5% currently), which likely means a slowing down of the economy, hence slower growing corporate profits. What is interesting is that Wall Street analysts are already anticipating this slowdown and cutting their estimates for quarterly earnings at a fairly rapid clip, at least for the other 493 companies in the S&P500 index. If companies can continue to beat Wall St estimates, even in the face of slowing earnings growth that could maintain share values.

In the following chart, you can see that analysts are still raising estimates for Magnificent 7 stocks (Amazon, Alphabet, Apple, Meta, Microsoft, Nvidia, Tesla) while lowering expectations for earnings for the rest of the S&P500.


Goldman Sachs Positive EPS revisions for the Magnificent 7 stocks

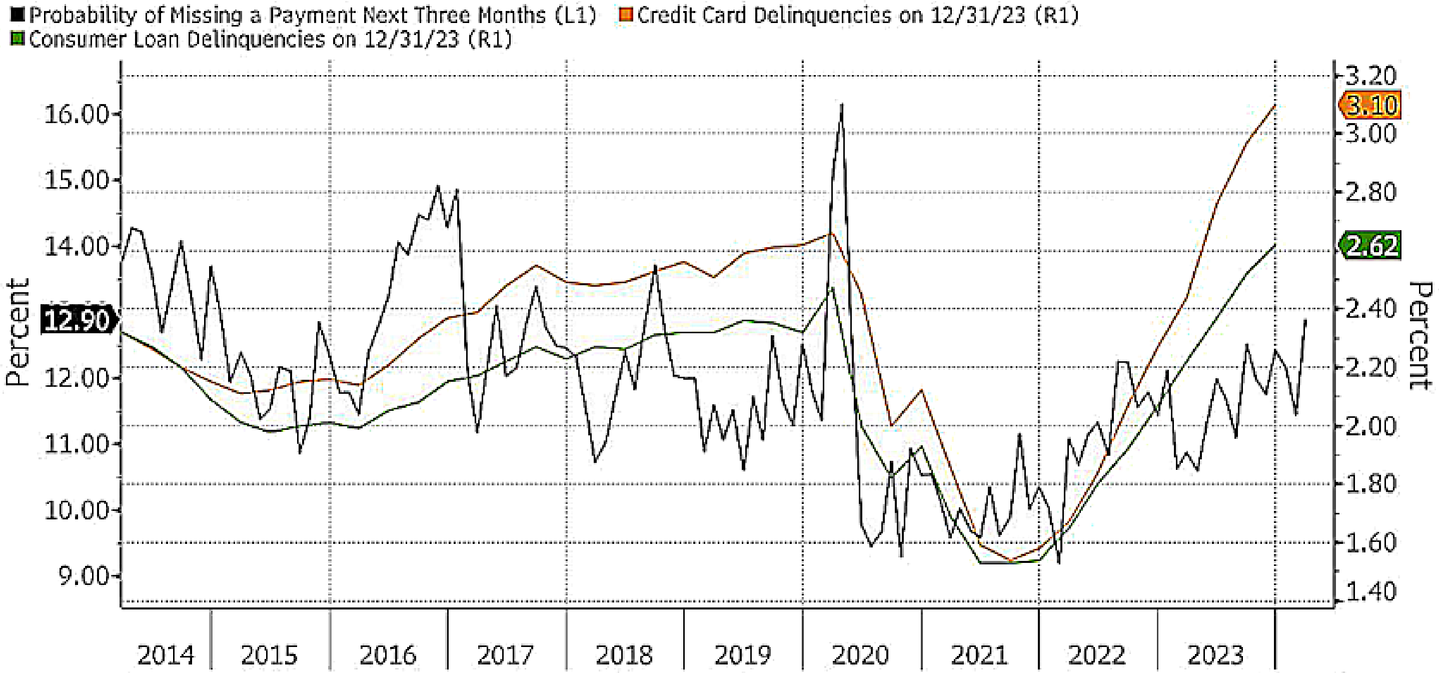
Negative revisions for the S&P 493 and for the aggregate S&P 500 index

We must keep in mind that corporate profits are not a leading indicator. And there remain some indicators that highlight possible trouble ahead. In the past, we noted companies having to refinance a wave of debt, especially in the commercial property space, at much higher interest rates. This impacts smaller companies much more than larger ones.

We also see consumer credit starting to strain in the face of higher interest rates with the exhaustion of pandemic-era stimulus and excess savings. The next chart shows the recent increase in consumer loan and consumer credit card delinquencies. While the overall delinquency rate merely returns to historical averages, the trajectory is concerning. A continued rise could slow down one of the primary drivers of recent economic growth – surprisingly robust consumer spending.

Consumers Worry About Their Ability to Pay

As delinquencies rise



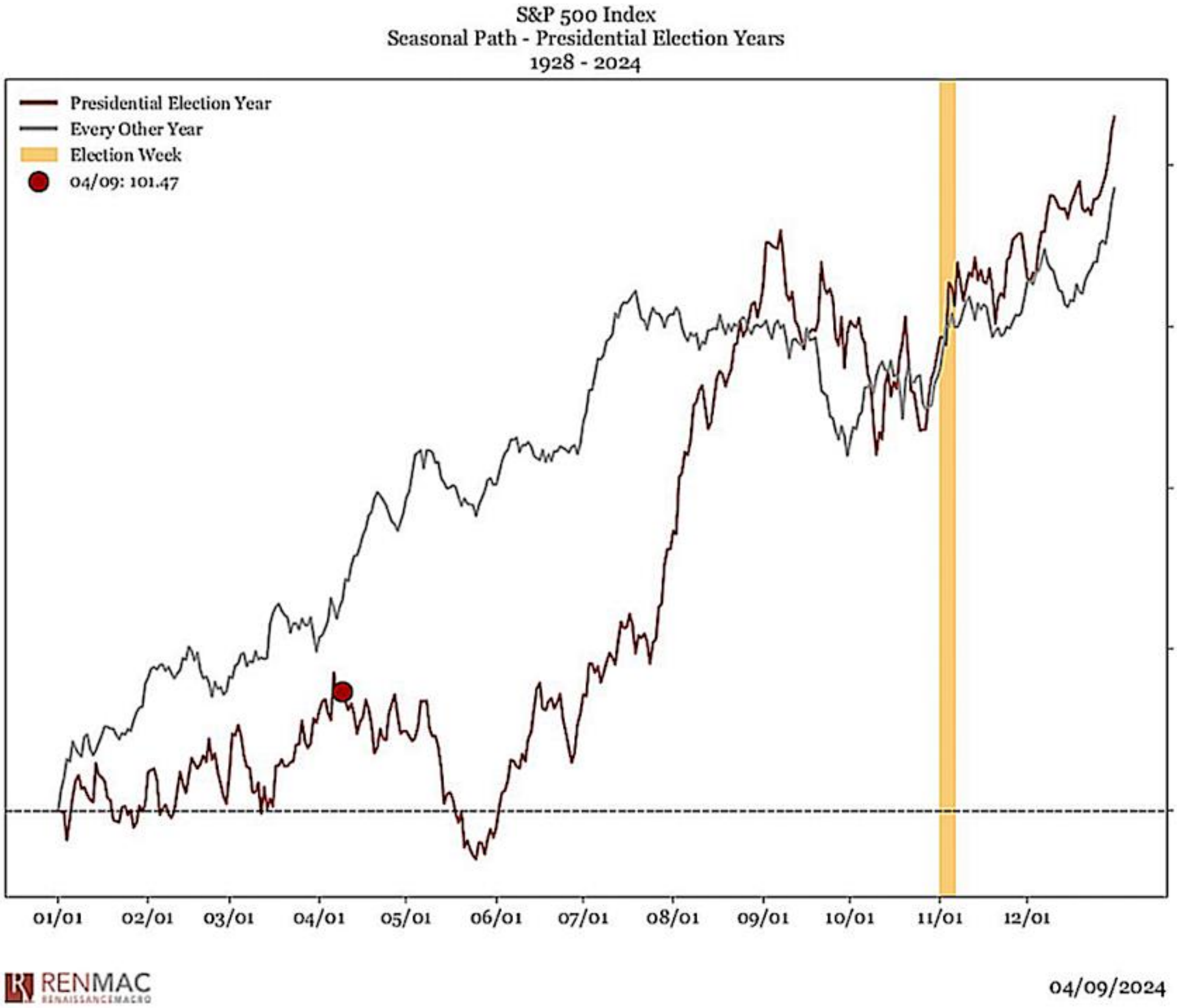
Source: NY Federal Reserve, Board of Governors of the Federal Reserve

Bloomberg

A slowing economy and stubborn interest rates will inevitably lead to stocks trading closer to their average historical valuations. For the S&P500 that's a price-to-earnings ratio of about 16-18. From our first table on page one, you can see that the S&P500 PE was 18 a year ago. To get back to that average, with earnings at current levels, implies a decline in the S&P500 from around 5200 now to 4500, undoing almost all of the market's rally from October. That would be a significant drop and would require the earnings growth of the Mag 7 to substantially under-perform expectations. Is it likely? Probably not.

However, stocks are due to take a breather from their most recent rapid advancement and some retrenchment should probably be expected. Already, over the past six weeks, we have seen markets become choppy and range-bound, a good digestion of the rally. It would not be surprising to see stocks drop back somewhat here as stubborn inflation keeps interest rates steady and investors continue pushing out their expectations for rate cuts. Indeed, in election years such as this one, stocks often slump in the middle of the year before regaining their strength as the election uncertainty passes.

Here is a chart of election-year market movements for almost the past 100 years:



S&P 500 Index
Seasonal Path - Presidential Election Years
1928 - 2024

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In summary, stock markets have been ebullient believing that a combination of solid economic growth with moderating inflation would lead to the nirvana of a "soft landing" by the Fed. It is easy to see how this nirvana scenario could be upended from any number of directions. Thus, we remain focused on possible risks, ready to employ an array of strategies to protect against any significant downside. It's part of the foundation of what we do and in our company's DNA.

To future profits,

Don Lansing
Chief Investment Officer
512-289-0620

Garrett

Garrett Beauvais
Portfolio Manager
512-796-0233