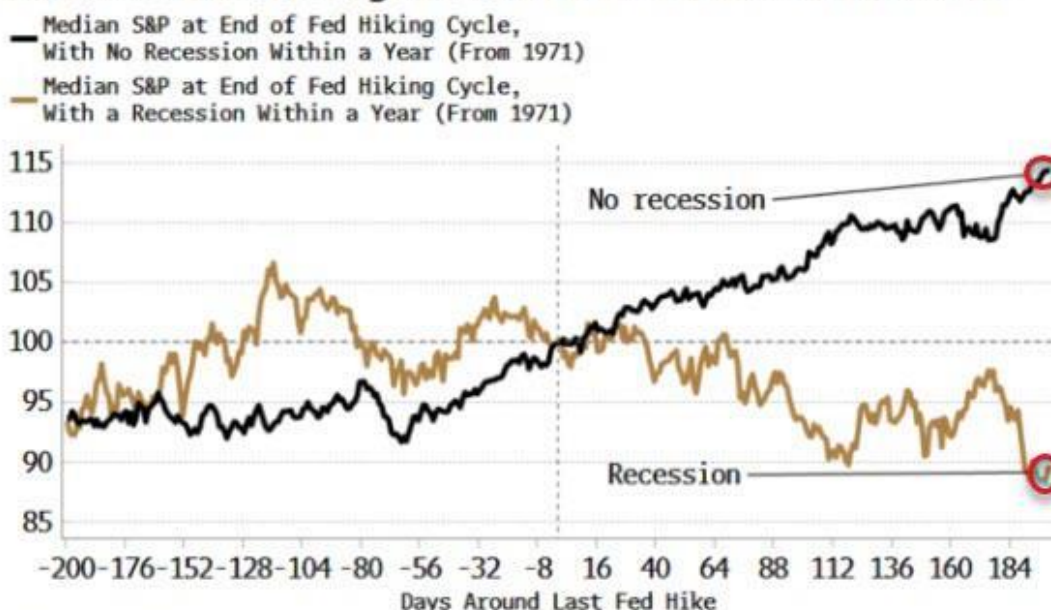
Market Update:

November 15, 2023

With yesterday's favorable CPI report and the weaker October labor report released early this month, markets are growing convinced that the Fed has completed the rate hike cycle.

Assuming the last rate hike of the current cycle occurred on July 26th, we are now 111 days past that event. The chart below produced by Bloomberg shows the median path of the S&P 500 around the last rate hike of each cycle since 1971. The data is segmented into cycles that produced recessions and those that did not. The S&P 500 is currently about 1.5% below its level on July 26th when the Fed last hiked interest rates. Before the upswing began on October 28th the S&P was down 9.8% from its level on July 26th, almost exactly in line with the median performance of the S&P 500 following the last rate hike in the cohort of cycles where recessions resulted from the rate hikes. In contrast, the median S&P 500 advance at this length of time from the last rate hike was approaching 10% in the cohort where recessions did not occur.



The performance of the S&P 500 over the past few months much more closely resembles performance trends of past recessionary cycles than that of cycles where recessions did not follow rate hikes. The heavy weighting and outperformance of the top 7 tech names in the S&P 500 this year flatters the relative performance of the index. The equally weighted S&P 500 index remains 7.1% below its level on July 26th and the Russell 2000 index of small cap stocks is down 9.2%, neither of which are consistent with past non-recession cycle performance.

We continued to believe that a recession in the coming quarters is more likely than not given the magnitude of the Fed's tightening cycle, the signal from both the magnitude and duration of the inverted yield curve, weakness in other leading indicators and underlying economic imbalances that are likely to be aggravated by tighter monetary conditions.

Nevertheless, equity markets have been up sharply since late October. The catalysts behind the sharp move in equities over the past couple of weeks have almost universally been related to the following easing interest rate pressures:

1. Fed Indications that no future rate hikes are planned.
2. Higher unemployment and weaker job gains in October.
3. Much lower-than-expected CPI report for October.
4. Related to the above factors, there is a dramatic swing in investor sentiment.

As noted, the advance in the equity markets in recent months has been extremely top heavy with 7 technology-oriented stocks accounting for essentially all of the equity markets' gains this year. The valuations for each of these stocks individually and collectively are extremely high, which is reflected in the extremely elevated value of the overall market. These stocks account for roughly 30 percent of the S&P 500's value. Today that value sits at roughly 157% of GDP, above the level reached at the height of the tech bubble, which itself was a previous historic extreme. These high valuations imply weak future returns and potentially large downside risks.

The weaker performance for the vast majority of the US equity market reflects a weak economic environment despite the narrative presented in the media and the purported strength in last quarter's GDP numbers. The unemployment rate has risen from a low of 3.4% earlier this year to 3.9% in October. Unemployment rising by 0.5% on a 3-month moving average basis has often signaled the onset of past recessions and we are closing in on that threshold (Sahm rule from economic literature). Unlike GDP and payrolls, unemployment is not subject to large revisions, imputed values for missing data, or manipulation by government statisticians.

Similarly, tax revenues collected at both the federal level and state and local levels are in decline. Tax revenues are not subject to revisions, and they provide a good economic signal absent major changes in tax laws. Declining tax revenue rarely occurs outside of recessionary environments. Along with other indicators, unemployment and tax revenues suggest the economy is struggling, not surging.

Long-term interest rates spiked to over 5 percent in October, their highest since before the financial crisis began in 2007. They have retraced a portion of that latest leg higher over the past couple of weeks, but nevertheless remain attractive from both an income generation perspective and for the potential to generate capital gains in the event the Fed begins to lower interest rates next year, inflation continues to moderate, and the economy continues to struggle as appears to be the case from the most recent data points. As such, we retain our view that the bond market is poised for solid performance after the past 3 very challenging years. While the kneejerk reaction of the equity markets the past couple of weeks has been to celebrate lower yields and the likely end to the tightening cycle, the factors that are anticipated to contribute to strong performance from bonds in the coming months are likely to weigh on equities. Particularly those with the most egregious valuations.

Charts and data are provided on the following pages.

CHART 1: Huge Sentiment Swing to Bullishness Over the Past Week.

While bullishness is not as extreme as was the case this July or December 2021, the surge brings it near the upper level of the past couple of years. This is a short-term contrarian negative market indicator.

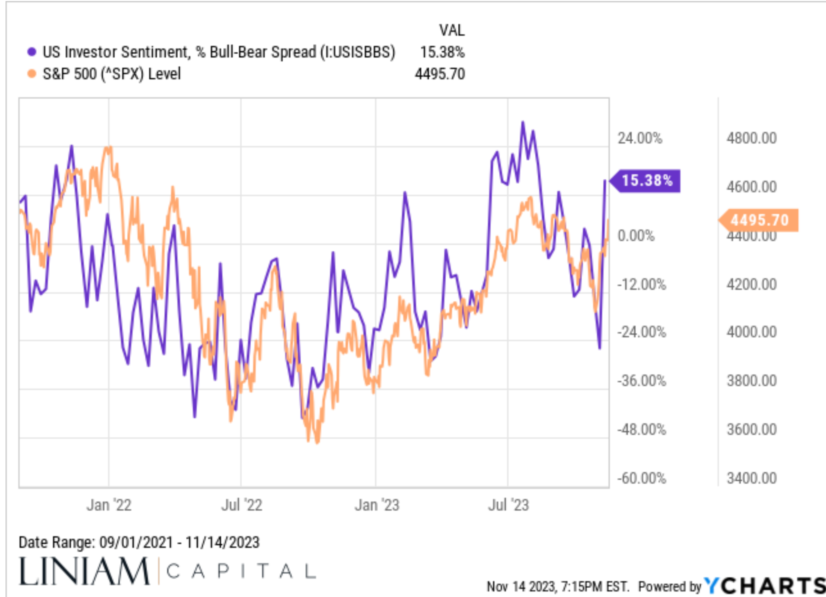


CHART 2: US Equity Performance Has Been Very Top Heavy Since March

The largest capitalization weighted stocks have dominated index performance since March. Market returns have been lackluster without the effect of the seven stocks that hold a nearly 30% index weight.

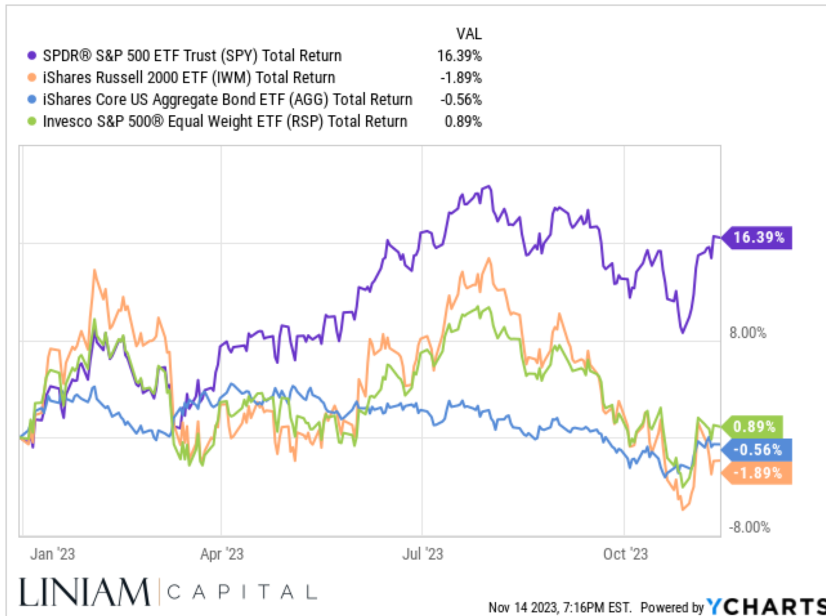


Chart 3: Seven Stocks Account for All the Gain in the Equity Market This Year

These stocks were generally laggards last year but have all experienced robust gains this year, despite valuations that are multiple times higher than the broader market.

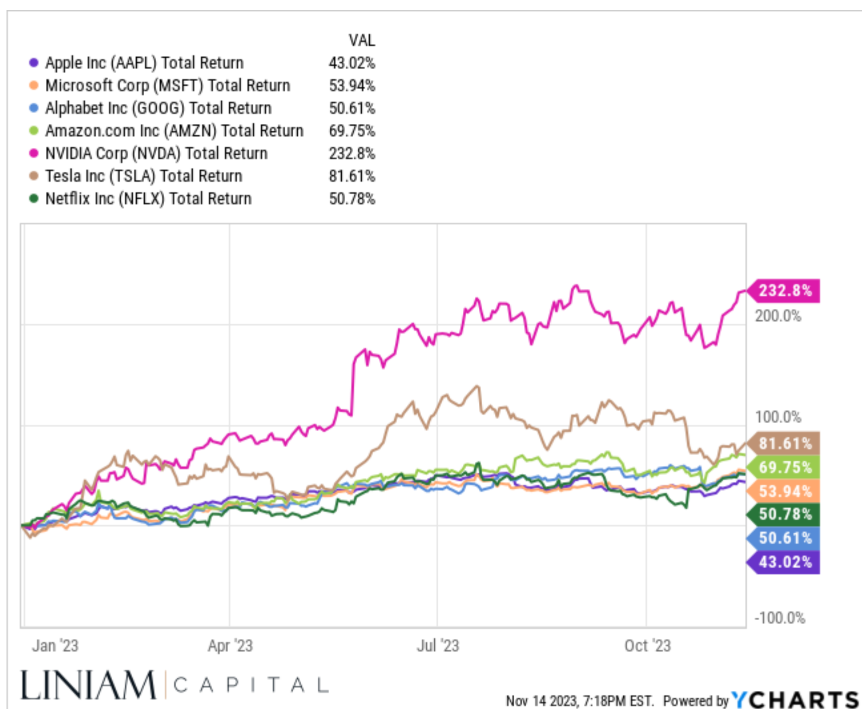


Table 1: Valuation Measures for the Top 7 Stocks

Capitalization Weighted Index Concentration	Weight	Price/Earnings	Price/Sales	Price/Book
AAPL	7.39%	30.6	7.2	43.5
MSFT	7.41%	35.8	11.2	11.8
GOOG	3.94%	26.1	5.4	5.7
AMZN	3.52%	75.7	2.2	7.4
NVDA	3.22%	119.7	26.9	32.4
META	1.97%	29.6	6.9	6.0
TSLA	1.60%	75.6	8.5	14.0
7 Tech Names	29.05%	56.2	9.7	17.3

Chart 4: Overall Market Valuation Still Extremely Elevated

One of Warren Buffet's favorite valuation measures remains below the 2021 peak but above the level reached at the weight of the tech bubble in early 2000.

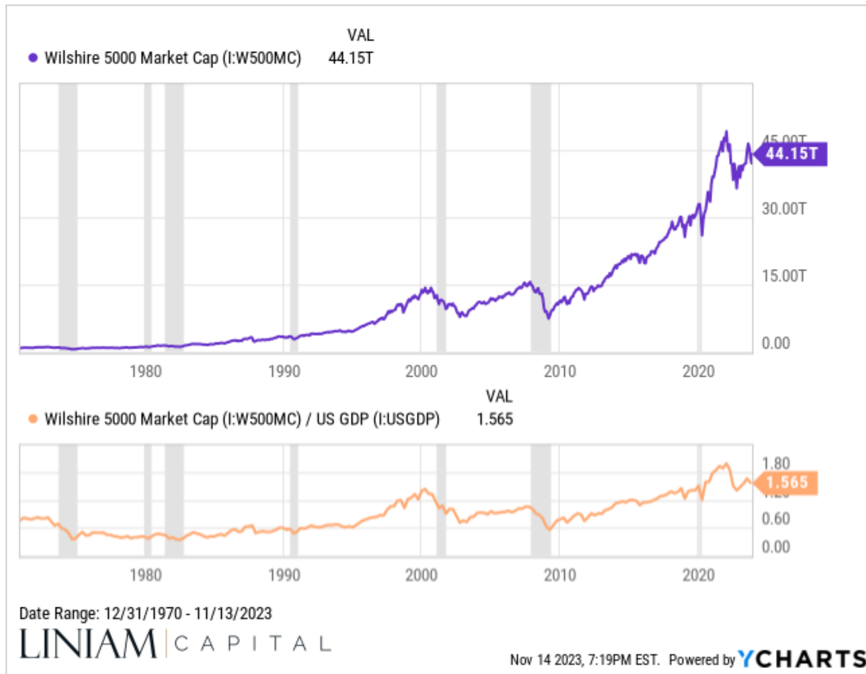


Chart 5: Unemployment Approaching a Recession Threshold

Unemployment has been creeping up since April as average job growth has slowed. Further increases in 2024 are likely. A rise of 0.5% on a 3-month average basis from its 12-month low is a recession signal.

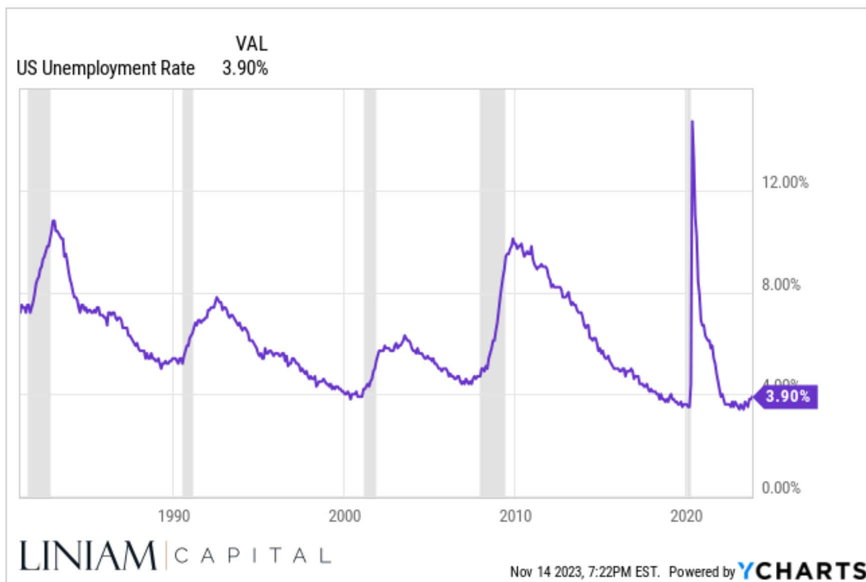


Chart 6: Federal Tax Revenues in Decline

There have not been any major reductions in effective tax rates that would account for the decline in tax revenues. This most likely reflects lower profits, capital gains and/or personal income.

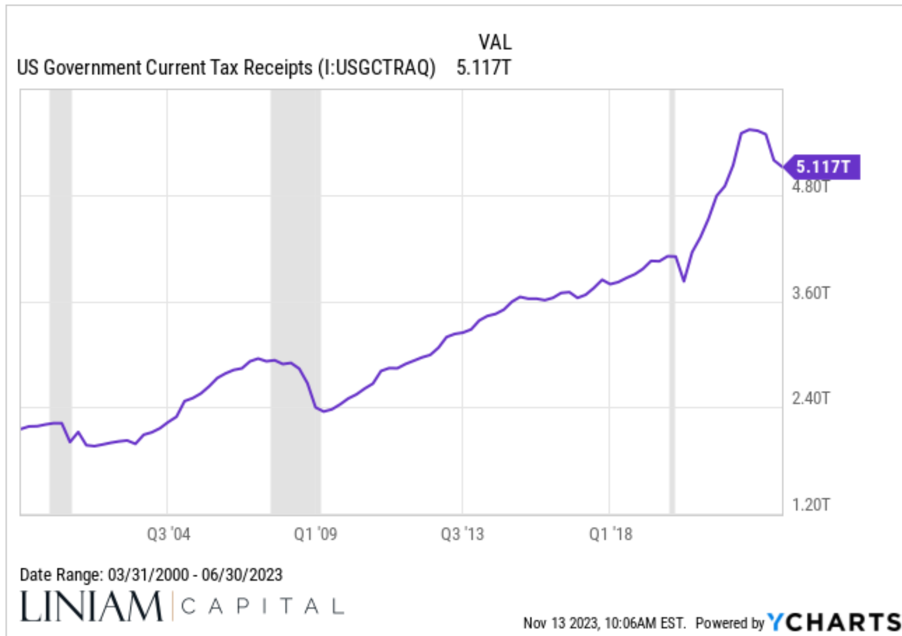


Chart 7: State and Local Tax Revenues in Decline

The performance of state and local tax collection shows a similar pattern, though the sources of tax revenue are somewhat different.

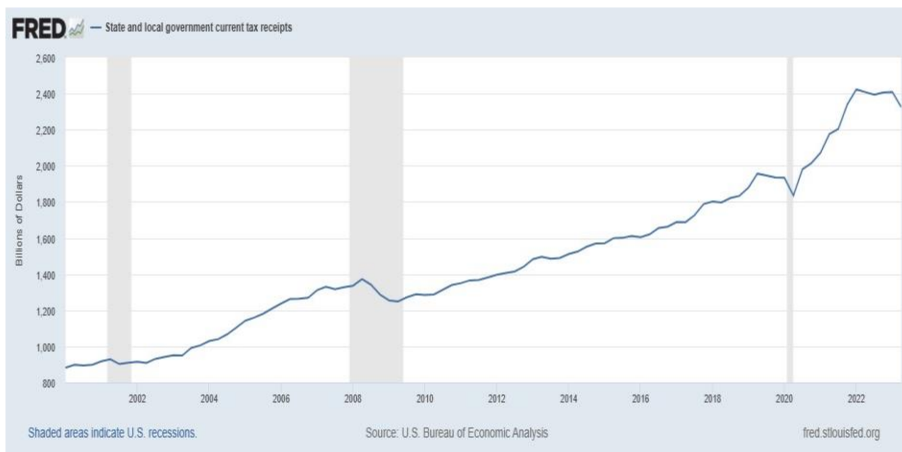


Chart 8: Interest Rates

Long-term interest rates began to rise in June of this year and surged into October, bringing them to pre-financial crisis levels.

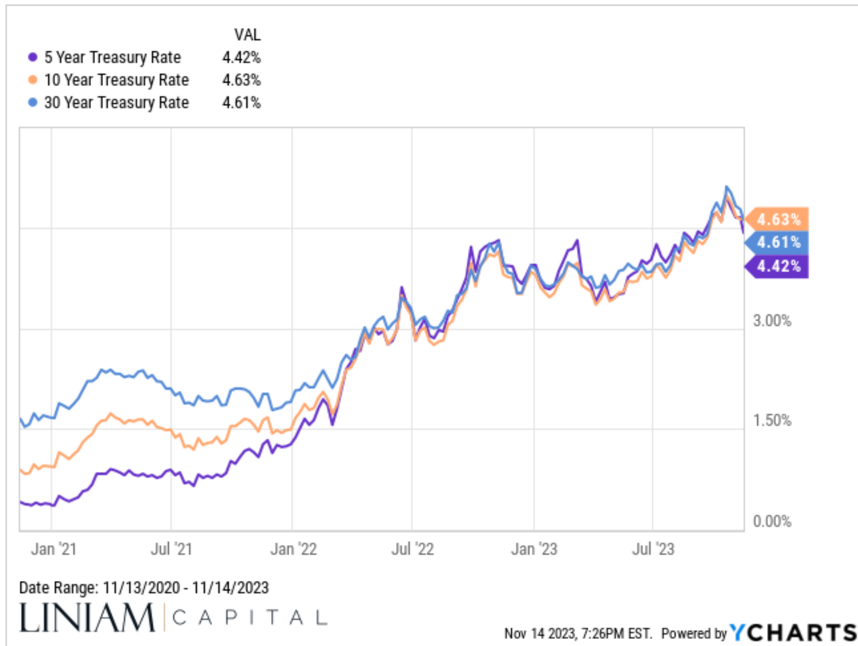
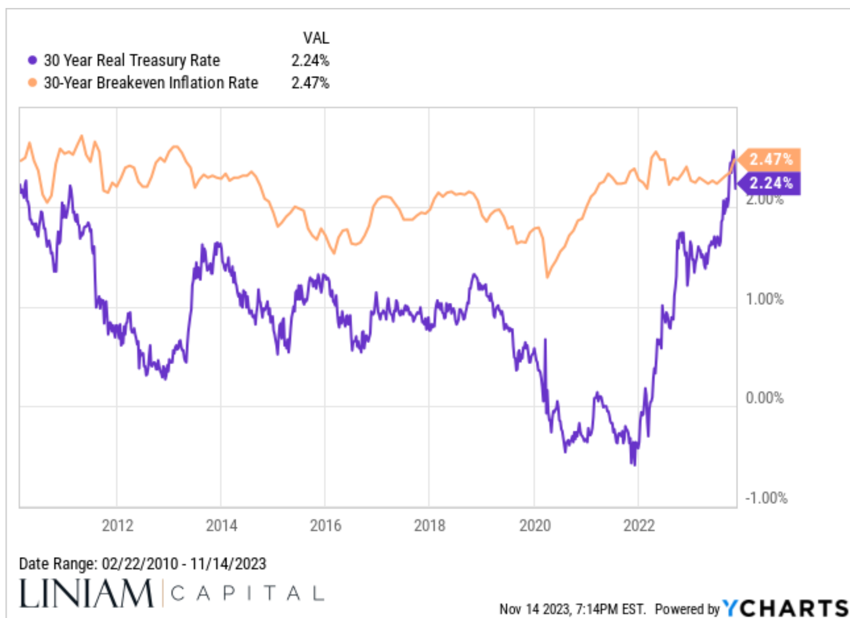


Chart 9: Real Yields

The surge in yields was a reflection of higher real yields as opposed to inflation compensation, which has held fairly steady for long-term obligations.



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