Wellington Shields

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Quarterly Market Strategy Report

FOMO: Fear of Missing Out

The increases seen in equity indices in the first six months of 2023 exceeded most forecasters' projections and the first half ended with a gain of nearly 16% in the S&P 500 index. This was the best six-month performance in this index since 1983; however, the action of the S&P 500 index was not the experience of all equity investors. The tech-centric Nasdaq Composite index rose nearly 32%, or over twice the performance of the S&P 500. Conversely, the Dow Jones Industrial Average advanced a mere 3.8%, or less than one-fourth the performance of the S&P 500. The broader-based small capitalization index, the Russell 2000, rose 7.2%, and the Invesco S&P 500 equal weight ETF (RSP - $149.64) gained less than 6% year-to-date.

The disparity among the performances of the indices is best explained by the fact that the returns in the Nasdaq Composite and S&P 500 indices were due to gains in a relatively small group of large capitalization technology stocks, primarily those companies with exposure to generative artificial intelligence. It was a classic display of "FOMO: fear of missing out" that drove the momentum of AI-related stocks. As an example, Nvidia Corp. (NVDA - $423.02), which designs the chips and software used to power generative AI systems, soared nearly 190% in the first half of the year and Microsoft (MSFT - $340.54), which recently partnered with OpenAI, a company that debuted its ChatGPT generative AI-powered chatbot in November 2022, gained 42% year-to-date.

According to S&P Global Intelligence, in the first six months of the year, the top 10 performing companies in the index accounted for 37.4% of the total gains in the S&P 500 and several of these stocks hit major milestones at the end of the second quarter. Apple (AAPL - $193.97) breached the $3 trillion market capitalization mark and Microsoft was next in line with a market capitalization exceeding $2.5 trillion at the end of June.

What was most surprising was the market's positive performance in spite of significant hurdles, in particular, the aggressive interest rate increases done by the Federal Reserve Bank and a series of US regional bank failures. Typically, either of these two scenarios would have triggered a decline in equity prices. However, in the month of June there were a number of developments that

Summary

Most of the recent gains in the equity market have been concentrated in generative artificial intelligence stocks which dominate the performance of the Nasdaq Composite index. This is where most of the near-term risk is concentrated.

The excitement in AI stocks is reminiscent of the Nifty Fifty era which led to the 1970 peak or the technology bubble of 2000.

We prefer investing for the longer term and focusing on companies with the most predictable earnings streams for 2023 and 2024 and where PE ratios are below the S&P 500 level of 21.6 times.

boosted investor optimism. The Federal Reserve Bank decided to pause its series of interest rate increases on June 14. CPI and PPI data for May showed inflation pressures were decelerating in most sectors of the economy. May housing statistics hinted at a possible turnaround in the residential housing recession. And finally, the last revision of first-quarter GDP growth showed economic activity increased at a 2% annualized rate, up from an earlier estimate of 1.3%. This latter point may be the good news/bad news story for the second half of the year since a strong 2% number gives the Federal Reserve more leeway to increase the fed funds rate in the months ahead without fear of pushing the economy into a recession.

RECESSION OR NO RECESSION?

Those looking for a recession in 2023 have been stymied to date, but according to historical precedents, there have been a number of reasons to expect a recession is on the horizon. First and foremost, the inversion of the government yield curve has been near historic levels and exceeded only by the inversions seen in January 1981 and September 1973. In both 1981 and 1973, a deeply inverted yield curve predicted severe recessions ahead. Economists have focused on the yield curve as a warning shot because in the last 70 years an inverted yield curve preceded each of the 9 recessions defined by the NBER.

Another economic caution signal is the Conference Board Leading Economic Index (LEI). This index is a composite of 10 variables that typically foresees turning points in the business cycle by about seven months. Over the last 60 years, a sustained decline in the LEI has preceded all but two US recessions. False signals in the LEI are rare, although a decline for several months in October 2019 did not result in a recession. Nevertheless, the LEI has been declining for 14 consecutive months and this is the first decline of this length without an economic slowdown.

Monthly retail sales are an important indicator of economic activity since roughly 70% of US GDP is driven by personal consumption expenditures. When monthly retail sales are adjusted for inflation, it is easy to see if real sales are increasing or decreasing. Typically, if real retail sales are declining for more than three months it is either a symptom of a recession already in place or of one about to appear. As of May, real retail sales have been negative for six of the last seven months, yet GDP for the second quarter was revised upward to 2%. In short, a series of economic indicators have been waving warning flags of a recession and supporting a cautious view. Nonetheless, the economy has been resilient.

However, our favorite indicator for predicting a recession may hold the key to economic strength or weakness. Year-over-year changes in total employment have accurately predicted recessions in each of the last seven economic cycles. When the total number of people employed in the US turns negative on a year-over-year basis, it is a precursor of a recession. When this deceleration or decline in job growth reverses, it signals the end of a recession and the start of an economic recovery. By this simple measure, the US economy appears to be in fine shape because as of the end of May job growth was 2.7% YOY and well above the long-term average of 1.7%. The strength in the job market supports

According to S&P Global Intelligence, in the first six months of the year the top 10 performing companies in the index accounted for 37.4% of the total gains in the S&P 500. Several of these technology stocks hit major market capitalization milestones at the end of the second quarter.

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those economists who believe the Federal Reserve may be able to get inflation down to 2% without a major recession. Overall, this mix of indicators is likely suggesting that the second half of 2023 will be a mix of hot and cold sectors and of generally sluggish growth.

STUDENT LOAN FORGIVENESS

Several post-pandemic stimuli will end in the second half of the year, and this could negatively impact the consumer. The biggest of these is the end of student loan forgiveness. At the end of June 2023, the Supreme Court blocked President Biden's bid to provide $430 billion of student loan forgiveness to borrowers. It was not a surprising development since according to the Constitution, the "power of the purse" resides in Congress, not the Executive branch of government. And though the White House responded with a string of new proposals to circumvent the Supreme Court ruling, it is very likely that a three-year moratorium of debt payment for student borrowers is coming to an end in October.

44 million Americans will soon have to start paying back student loans and have payments ranging from $210 to $320 per month. We expect this will become a burden for many households and result in a loss of roughly $70 billion in personal spending.

As a reminder, in March 2020, the CARES Act suspended payments for federally sponsored student loans, or roughly debt totaling $1.4 trillion. The Act also mandated a zero percent interest rate on outstanding balances and suspended collection activities on defaulted student loans. A Federal Reserve Board Study, *"Implications of Student Loan COVID-19 Pandemic Relief Measures for Families with Children (May 2023),* quoted an analysis which estimated that most student loan borrowers were able to improve their credit profiles during the pandemic and as of the Spring of 2022, grew their savings balances by $80 billion. This was a plus for economic activity. An analysis by Goss, Mangrum, and Scally (2022) estimated that approximately $200 billion in aggregate payments were waived for all borrowers that were eligible.

In other words, $100 billion per year in debt payments were frozen whether or not borrowers were current or in default on their loans, and this provided a substantial boost to consumer spending. However, in October, 44 million Americans will have to start paying back student loans with payments ranging from $210 to $320 per month and this will become a burden for many households. Moreover, many debtors will have had a change in their servicing companies in the last three years and this will add to the confusion in October and what is expected to be an increase in defaults and reductions in credit ratings for many borrowers.

A mix of economic indicators is suggesting the second half of 2023 will be a mix of hot and cold sectors and of generally sluggish growth.

All in all, economists expect that the resumption of student loan payments will generate a loss of roughly $70 billion in personal spending. While $70 billion may be a small number relative to nominal GDP of $26.5 trillion, it will be a major headwind for retail sales and some consumer-driven companies.

OFFENSE OR DEFENSE?

In our view, the reason investors focused on stocks linked to generative artificial intelligence is that earnings growth for the overall market has been negative for three consecutive quarters and the outlook for 2023 corporate earnings remains uncertain. Although it has not received much attention, S&P Global data shows that in 2022 earnings for the S&P 500 declined by 5.4% and expectations for

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2023 include an increase of 10% year-over-year. Overall, this does not support a robust bull market.

The June runup in equity prices was driven more by sentiment, and excitement in AI, than by earnings growth and as a result PE multiples have expanded. The S&P 500 index is now trading at 21.6 times earnings, which is 36% above the historical average of 15.9 times. This makes the equity market vulnerable to any unexpected surprises, particularly if the Federal Reserve continues to raise interest rates in the second half of the year.

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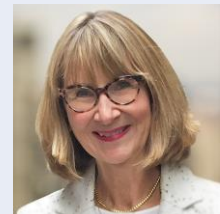
However, since most of the recent gains have been concentrated in the AI favorite stocks which dominate the Nasdaq Composite index, this is where most of the risk is concentrated. The excitement in AI stocks is reminiscent of the Nifty Fifty era which led to the 1970 peak or the technology bubble of 2000. And the $1.44 trillion sitting in retail money market funds means there is plenty of dry tinder that could move these stock prices even higher. But we would not chase large capitalization stocks at this point. Instead, we would invest for the longer term and focus on companies with the most predictable earnings streams for 2023 and 2024 and where PE ratios are below the S&P 500 level of 21.6 times.

*Stock prices are as of June 30, 2023



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