Wellington Shields

October 2023

Quarterly Market Strategy Report

October: The Turnaround Month

After a spectacular equity performance in the second quarter of 2023, the six-month surge of 16% in the S&P 500 index was the best first-half performance seen in this index in forty years. However, it did not last. The third quarter took much – or in the case of the Russell 2000 index, nearly all – of these gains away. Losses in the third quarter were 2.6% in the Dow Jones Industrial Average, 3.6% in the S&P Composite, 4.1% in the Nasdaq Composite index, and 5.5% in the Russell 2000. By the end of September, the popular indices closed with more modest year-to-date gains of just over 1% in both the Dow Jones Industrial Average and the Russell 2000 index, nearly 12% in the S&P Composite, and a still substantial 26% in the Nasdaq Composite index. In short, a narrow list of large-capitalization technology stocks that dominate the Nasdaq Composite continued to be the outperforming segment of the stock market in 2023. On the other hand, the average stock ended mostly unchanged after the first nine months of this year.

HIGHER AND LONGER

There was a multitude of reasons for the price weakness experienced in August and September, beginning with the fact that a government shutdown was at hand. Financial markets have weathered many government shutdowns in the past without much difficulty. But distinct from other recent shutdowns, such as the record 35-day government shutdown that began in December 2018, the Federal Reserve's monetary policy is currently restrictive and expected to remain so. It was different in December 2018 when the Fed was signaling it was tilting dovish and about to wrap up its hiking cycle. In short, the overriding problem at the end of the third quarter was that the 10-year Treasury yield hit a 16-year high above 4.5% and may continue to climb upward. This could become a major hurdle for equities in the months ahead.

The concept of higher interest rates was also made clear by Fed Chairman Jerome Powell and his fellow Board members. Although the Federal Reserve chose to pause rate hikes in September, comments

Summary

We continue to forecast a broad trading range market for 2023. This range is best defined by the Russell 2000 index between support at 1650 and resistance found at 2000.

Still, we would not rule out a decline in early October. This could produce an excellent longer-term buying opportunity!

Look for stocks where earnings growth is greater than the S&P Composite and the PE multiple is less than the S&P Composite. This combination should outperform in the longer run.

following the September FOMC meeting indicated that additional rate hikes were likely in the near future and interest rates were apt to remain high throughout most, if not all, of 2024. This crushed the consensus view that rate cuts would likely materialize by mid-2024. Adding to the view that interest rates would remain higher for longer were comments by Jamie Dimon, CEO of JPMorgan Chase & Co. (JPM - $145.02) who stated that many businesses and investors were not prepared for a worst-case scenario in which interest rates hit 7% and stagflation grips America. As a result, investors were forced to reassess equity risk and valuation at the end of the third quarter.

There was a multitude of reasons for the price weakness experienced in August and September, beginning with the fact that a government shutdown was at hand. But a 16-year high in the 10-year Treasury yield poses the biggest risk for the fourth quarter.

OCTOBER TURNAROUND

From a historical perspective, September tends to be a seasonally weak month for equity performance. In fact, September ranks dead last in terms of performance and is the only one of all twelve months that averages a loss. Conversely, October, which tends to have a worse reputation than September, ranks seventh of all twelve months with an average gain of 1.0% in the S&P Composite. What is unique about October is that it tends to be a turnaround month and while its performance has often been dramatic it has also been a month that includes a number of bear market lows. This year October could be a particularly interesting time since so many risks are on the horizon and apt to be discounted.

Higher interest rates have debunked the Goldilocks view that a soft landing coupled with falling inflation and lower interest rates would materialize in 2024.

THE END OF GOLDILOCKS

In addition to the risk of the government shutting down, there is a United Auto Workers strike that is ongoing and negotiations do not seem to be close to an agreement. Whatever agreement passes, it will be scrutinized by economists for signs of future wage cost pressures and linkages to inflation. In terms of household finances, the reinstatement of student loan payments on October 1st and the October 15th due date for individual tax payments for Californians are likely to take a bite out of future spending. This could slow the economy.

Oil prices surged at the end of September after the government announced that US crude stocks fell to the lowest level since July 2022.

Large-capitalization technology stocks have been at the core of positive price performance this year, but the Federal Trade Commission and 17 State Attorneys General are currently suing Amazon.com, Inc. (AMZN - $127.12) for monopolistic and unfair business practices with an aim to break up the company into smaller pieces. Simultaneously, the Department of Justice and eight states are also suing Alphabet Inc.'s Google (GOOG - $131.85), the second DOJ antitrust lawsuit against the company in just over two years. This suit focuses on Google's monopolistic activities in the online advertising business and seeks to make Google divest parts of its business. Both suits could produce landmark changes in the internet space and could unsettle the market in October.

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From a global perspective, it is important to monitor the crisis facing China's property development sector. China Evergrande Group (3333.HK – 0.32), collapsed in 2021 and set off a panic in global markets. Now Country Garden Holdings Company (2007.HK – 0.91), the country's largest real estate giant, is in default. The property sector represents roughly a quarter of China's economy, is closely tied to China's financial system, and many Chinese individuals who paid deposits on properties could lose all of their investment if the company fails. Experts feel these real estate troubles could spread into China's broader financial markets and this could do significant damage to the world's second largest economy. If so, it would be a major negative for global economic activity.

Oil prices surged at the end of September after government data showed that US crude stocks fell to the lowest level since July 2022. This announcement drove energy futures to their highest settlement in 2023 and compounded worries about tight energy supplies as we head into the winter heating season. This event coupled with the previously announced production cuts of 1.3 million barrels a day by Saudi Arabia and Russia have energy analysts forecasting crude oil prices of $100 a barrel in the near future. The technical charts for WTI energy futures also suggest higher prices. Higher energy prices will be a problem for future inflation benchmarks and will only add to the view that further Fed rate hikes may be necessary in the future. All in all, the Goldilocks view of a soft landing for the economy, lower inflation, and lower interest rates was debunked in September and this left equities vulnerable.

TRADING RANGE MARKET

However, this has not changed our view that the equity market will be stuck in a broad trading range in 2023. This range is best defined by the chart of the Russell 2000 index which has been trading between support at 1650 and resistance found at 2000. Trading range markets are not unusual from a historical perspective, and they typically result from an overhanging issue in the economy such as high inflation or broad-based debt problems. We believe they can be a substitute for a more dramatic bear market cycle, and they allow equity valuations to normalize. Keep in mind that equity prices rose substantially in the first half of the year, but earnings did not. As a result, equity valuations became stretched.

However, trading range markets do require a change in strategy since there tends to be a rotation in leadership throughout this "flat" cycle and this experience can be frustrating for long-term investors. Yet in the long run, buying stocks which represent good value, a solid predictable earnings stream, and an above-average dividend yield tends to generate the best overall performance. Look for stocks where earnings growth is greater than that of the S&P Composite, but the PE multiple is lower than the S&P. This combination should outperform in the long term.

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Meanwhile, we would not rule out a decline in early October that creates an excellent buying opportunity!

*Stock prices are as of September 29, 2023

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