Wellington Shields

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Quarterly Market Strategy Report

Liquidity-driven Market

2023 ended with a flourish after Federal Reserve Chairman Jerome Powell indicated that interest rate cuts were likely in 2024. This surprising "Fed pivot" by Powell following the last FOMC meeting of the year, unleased a buying surge that generated one-month gains of 4.8% in the Dow Jones Industrial Average, 4.4% in the S&P 500, 5.5% in the Nasdaq Composite and a stunning 12% in the smaller cap Russell 2000 index. The December 2023 rally carried the Dow Jones Industrial Average to a new record high and the S&P 500 came within 1% of its all-time high.

Chairman Powell's indication that rates would soon come down, unleashed a liquidity-driven advance fueled by the $7.5 trillion in cash seen in demand deposits, retail money market funds, and small-denomination time deposits. Yet, despite strong December performances, the Nasdaq Composite closed the year 6.5% from a record high and the Russell 2000 ended 17% below its November 8, 2021 high of 2442.74.

For the full year, the Dow Jones Industrial Average gained 13.7%, the S&P 500 gained 24.2%, the Nasdaq Composite inked a gain of 43%, and the Russell 2000 index rose 15%. Overall, it was an amazing yearend performance for a year that until then had been only modestly successful and a time most analysts expected to include a recession and a poor stock market.

Remembering 2023

The first half of 2023 was expected by many, including us, to be the final chapter of the post-pandemic hangover. There were many signs of an imminent recession, including a long and severely inverted Treasury yield curve, a slump in the real estate markets, recessionary levels in consumer and business sentiment surveys, historic weakness in the leading economic indicators, and negative year-over-year retail sales. Consumers were experiencing declining purchasing power due to rising prices, and corporations suffered profit margin squeezes from escalating costs for labor, transportation, and raw materials. Yet despite all these warnings, the economy continued to grow a bit each quarter, and in the third quarter of 2023, GDP reached 4.9% on a seasonally adjusted annualized basis.

Summary

Chairman Powell's indication that rates would soon come down, unleashed a liquidity-driven yearend advance fueled by the $7.5 trillion in cash seen in demand deposits, retail money market funds, and small-denomination time deposits.

Our assumptions for 2024 include GDP growth of 0.8% YOY, some weakness in topline growth but modest S&P earnings growth of 10%, a possible 75 basis point decrease in the fed funds rate, inflation to moderate to 2.75%, Treasury bill yields to fall to 4.25% and Treasury bond yields to be lower and stable at 3.6%.

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In the early and unsettled environment of 2023, some investors began to focus on the long-term growth prospects of artificial intelligence. This led to the popularity of a small group of stocks called the Magnificent Seven, which included Apple Inc. (AAPL - $192.53), Microsoft Corp. (MSFT - $376.04), Amazon.com (AMZN - $151.94), Nvidia Corp. (NVDA - $495.22), Alphabet Inc. (GOOG - $140.93), Tesla Inc. (TSLA - $248.48), and Meta Platforms Inc. (META - $353.96). These companies quickly became the investment darlings of 2023 driven in part by an analysis from PwC indicating that artificial intelligence was expected to improve productivity by 40% by 2035 and the global AI market was expected to grow 37% annually from 2023 to 2030. Not surprisingly, at a time when a recession appeared to be around the corner, these stocks became the most exciting investments to own. From our perspective, we felt it was also important to note that PwC's surveys also showed that 73% of US companies have already adopted artificial intelligence in some areas of their business. This poses questions about the near-term potential of AI.

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A Wall Street Journal article (*"It's the Magnificent Seven's Market. The Other Stocks Are Just Living in It."* December 17, 2023) noted that these seven stocks soared 75% in 2023, while the remaining 493 stocks in the S&P 500 rose only 12% and the S&P 500 index gained 23%. But more importantly, these stocks represented 30% of S&P's market value, which approaches the highest-ever share for seven stocks. Perhaps most surprisingly, the group represents more than the combined weighting of all stocks in Japan, France, China, and the UK, in the MSCI All Country World Index.

Magnificent Seven Stock Performance

Company	Ticker	Market cap, in trillions	2023 gain
Apple	AAPL	$2.99	48.20%
Microsoft	MSFT	$2.79	56.80%
Alphabet	GOOGL	$1.75	58.30%
Amazon	AMZN	$1.57	80.90%
Nvidia	NVDA	$1.22	238.90%
Meta Platforms	META	$0.91	194.10%
Tesla	TSLA	$0.79	101.70%
S&P 500			24.20%

Source: Investors Business Daily

This outsized performance of a small group of stocks is reminiscent of the bubbly Nifty Fifty and the Dot-Com eras. In these earlier equity manias, a small group of stocks led dramatic advances that persisted for a year or two. But eventually, an extremely overvalued market later ended in tears. In our opinion, even though the current advance may not be over, there is risk in the overall market, and more importantly in these seven stocks. The Magnificent Seven stocks have discounted a substantial amount of future growth which means they would be

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vulnerable should anything challenge the expectations of AI-driven earnings growth. At the same time, these numbers suggest there is much better value found in the broader marketplace.

OUR 2024 FORECASTS

Our assumptions for 2024 include GDP growth of 0.8% YOY for the full year, which implies slowing economic activity and the possibility of a negative quarter of growth, but the year should escape a full recession of two consecutive falling quarters of GDP. In this environment we are assuming some weakness in topline revenues, but efficiencies developed during the economic shut down and a rocky economy in 2023 will help companies generate modest earnings growth of 10%. Given the Fed's recent pivot we are expecting a possible 75 basis point decrease in the fed funds rate. To do this, we are assuming a modest decline in inflation to 2.75% which will allow the Fed to maintain a real yield of 220 basis points in the fed funds rate throughout the year. In line with this, our forecast expects Treasury bill yields to fall to 4.25% in line with an easier Fed policy, and for Treasury bond yields to be lower and stable at 3.6%.

There are many risks to these forecasts since external factors like the Houthi's attacks in the Red Sea have the potential to interrupt trade and send oil prices higher. Other risks include the possibility that efficiencies from artificial intelligence may prove to be less than expected. The wars in Ukraine and Israel could increase past current borders and trigger fear of a widening escalation. Politics should be a major topic in 2024 since there will be nine parliamentary elections in Europe in 2024, as well as elections in the UK, Mexico, Taiwan, and the US.

Although the economy may manage to muddle through a year of sluggish growth in the economy and earnings, equity valuation remains a hurdle. Our forecasts for 2024 coupled with our valuation model, yield a mid-point predicted PE of 15.8 and a top-of-the-range PE of 18.4. This, combined with our 2024 S&P 500 earnings forecast of $230 creates a midpoint S&P 500 target of 3634 and a high of 4295 for 2024. Using a higher IBES 2024 earnings estimate of $245.21, these targets rise to 3875 and 4511, however, yearend prices have already exceeded these levels. And for those who think our model's predicted PE multiples are too low, note that at the end of 2023, the S&P trailing PE was 22.3 and the 12-month forward PE was 19.6. These are at or above the top of the normal range for PE multiples. In sum, this implies that next year's earnings growth has already been factored into current prices and this will leave the equity market vulnerable during every earnings season in 2024.

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SECTOR CHANGES

A shift in relative performance at the beginning of an advance is often a sign of new sector leadership and we are using December's relative performance as a predictor of 2024 price action. As a result, we expect good performance from the consumer discretionary, financial and materials sectors. Weak relative performance in December suggests

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underperformance in energy, staples, and utilities. December's good performance in financials is a bullish factor since new bull market cycles require participation from this sector. However, the out-performance in the materials group may be a warning that inflation is not yet under control. Altogether, 2024 may be a year that requires nimbleness and attention to good fundamentals.

Closing prices are as of December 29, 2023

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