Wellington Shields

April 2024

Quarterly Market Strategy Report

A Bitcoin Quarter

Comments by Federal Reserve Chair Jerome Powell following the December 13, 2023 Fed meeting triggered a strong yearend rally that led to all four of the major US equity indices closing the year with impressive double-digit gains. The gist of Powell's December comments was that while there would be no immediate change in Fed monetary policy, rate cuts could be coming in 2024.

Two subsequent FOMC meetings that ended on January 31, 2024 and March 20, 2024 followed a strikingly similar pattern, that is, no change in policy, a hint of rate cuts this year, followed by a strong stock market rally. Note that this sequence of events suggests that the equity market has been discounting the possibility of 2024 interest rate cuts multiple times. And since forecasts for 2024 corporate earnings have declined slightly in the interim, this means the price-earnings ratio for equities has been climbing. It is this rise in the price-earnings ratio that has led many to feel the market is or is becoming overvalued and it is also the reason the fear of an equity bubble is rising. To date, the 2024 equity market has been a momentum-driven market and not a value-driven market.

However, if the stock market is forming a bubble, and we think it is, it is in the early stages. PE multiples are exceedingly high at 24.2 times trailing 12-months and 21 times forward 12-months. Yet during the 1997-2000 bubble, the financial crisis of 2008, and even the post-COVID-19 peak, the trailing 12-month PE reached 26 to 30 times earnings.

The financial media has heralded the S&P 500's 10.2% gain in the first three months of the year as the best first-quarter performance in five years, but this is a bit disingenuous since this only applied to the S&P 500 index and not to other indices. The Nasdaq Composite index had a solid gain of 9.1% in the first quarter, but this was less than the 16.8% gain seen in 2023. The Dow Jones Industrial Average rose 5.6% in the quarter which was the best first quarter since the 2021 gain of 7.8%. The Russell 2000 index rose 4.8%, the best first quarter since the 12.4% also seen in 2021. In short, it was a good first quarter performance for most stocks and most portfolios, but not the best first quarter in five years.

Summary

If the stock market is forming a bubble, and we think it is, it is in the early stages. PE multiples are exceedingly high at 24.2 times trailing 12-months and 21 times forward 12-months. Yet during the 1997-2000 bubble, the financial crisis of 2008, and even the post-COVID-19 peak, the trailing 12-month PE reached 26 to 30 times earnings.

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CRYPTOCURRENCY

Still, the first quarter of 2024 may go down in history, not as the best equity performance in five years, but as the first time ETFs were introduced on spot bitcoin. After more than a decade of rejecting spot bitcoin ETFs in hopes of protecting investors from market manipulation, the Securities and Exchange Commission (SEC) was forced to approve them in January after an appeals court ruled that the SEC had not sufficiently detailed its reasoning for rejecting the products. The SEC approved 11 spot bitcoin ETFs in late January. And according to LSEG data, net flows into the ten largest spot bitcoin funds reached a stunning $2.2 billion in the week ended March 1. The cryptocurrency has soared nearly 162% since October, jumped 44% in February alone, reached a high of $73,157.00 on March 13, 2024, and generated a year-to-date gain of nearly 67%.

This surge in demand for Bitcoin (BTC= - $70,841.00) may be representative of today's financial markets for several reasons. Bitcoin has the backing of a new generation of investors, ETFs are a form of leverage that attracts a larger audience of buyers, and there are no underlying fundamentals. Bitcoin has no assets, earnings, or revenues to analyze, yet it is surging based upon the belief that it will go higher. Likewise, momentum, liquidity, and leverage drive the typical equity bubble, not fundamentals. Bitcoin and the equity market are also similar in that they are both driven by an underlying expectation of lower inflation and lower interest rates. In sum, inflation and interest rates are the Achilles heel to both markets.

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LEADERSHIP CHANGES

Much like the popularity of spot bitcoin ETFs, many investors are using ETFs to participate in the equity market rather than buying individual stocks. And the performance of various ETFs reveals an interesting change in leadership in 2024.

In 2023 the best performing ETFs were linked to S&P sectors and industries related to **technology**, **homebuilders**, **communication services**, **consumer discretionary**, and **semiconductors**.

This year's best performers have been found in **oil**, **homebuilders**, **energy**, **communication services**, **financials,** and **industrials**.

What we find most interesting about the shift in the first quarter of the year is the outperformance of oil and energy, which suggests there could be a risk of higher energy pricing and higher inflation. The good news about this shift is the outperformance of the financial sector implies a better economic environment in 2024.

Liquidity has been offsetting both the Fed's interest rate hikes and the inversion of the yield curve.

In our view, if the Fed should cut interest rates, we hope it is accompanied by substantial quantitative tightening. If not, it could open the door for another round of higher inflation.

PIVOT OR NO PIVOT

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While the stock market is rallying in anticipation of a Fed pivot and lower interest rates, we believe a pivot is unnecessary. What many overlook is the fact that monetary policy is already very accommodative despite the rise in interest rates. Government yield curves may be inverted -- and this has been the longest inversion without a recession in history – but as the Federal Reserve made a succession of interest rate hikes, underlying fiscal and monetary policies have remained surprisingly stimulative.

For example, the Federal Reserve has been shrinking its balance sheet down to $7.7 trillion as of March 20, 2024 from a peak of $9.0 trillion in April 2022. Yet this $7.7 trillion remains well above the $4 trillion seen in normal times before the pandemic. In short, the Fed's balance sheet continues to provide considerable liquidity to the economy. Not surprisingly, this means there is plenty of liquidity in the banking system including a near-record level of total bank assets of $23.2 trillion and commercial bank deposits of $17.5 trillion (as of mid-March). These are down only modestly from the record $18.2 trillion seen in April 2022. In other words, government spending and a large Fed balance sheet have been providing liquidity and offsetting both the Fed's interest rate hikes and the inversion of the yield curve. In our view, if the Fed should cut interest rates, we hope it is accompanied by substantial quantitative tightening. If not, it could open the door for another round of higher inflation.

Bitcoin and the equity market are also similar in that they are both driven by an underlying expectation of lower inflation and lower interest rates. In sum, inflation and interest rates are the Achilles heel to both markets.

*Stock prices are as of March 28, 2024 close

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