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By the Way

Monthly commentary from Jack Way

"Goldilocks market"

Recent data is forcing me to question my previously stated expectation that we will see a recession in the U.S. before year-end. Should I stick to my guns or am I being stubborn and hardheaded? To mix a couple of metaphors; is my outlook staled dated or at least past its best-before date? Certainly, my level of confidence is waning. Even the most cynical has to admit U.S. growth is impressive and inflation is declining. To all appearances the soft-landing scenario is on track. However, over much of my career, I have often been early with my calls. I particularly remember suffering through the last year of the 1990's tech bubble before it blew up. If or when you are finally proven correct, it's very rewarding. To reference "The Big Short" once again, after standing alone for a long time the protagonists got rich and had a book and a movie to tell their story. So I will hang in hoping for the big payoff.

The S&P 500 is reflecting all of the positive news currently out there, but maybe to excess. Too much optimism can be concerning, and currently almost all sentiment indicators and surveys are at or near overbought territory. The Index has risen 19% in the last 3 months, which puts it in the top 1% of all-time moves, and hardly likely to be repeated. This is the antithesis of how we entered 2023 when sentiment was very negative and short positions were very large, leaving lots of room for demand to push prices higher. Microsoft, for instance, now one of the "Magnificent 7" (big cap tech stocks), was trading at 21x earnings down from 33x. Today is much more like a "Goldilocks" market where everything appears to be headed higher, but I question how much of that optimism is already priced in. The "Magnificent 7" continues to be the driving force (ex. Tesla) behind higher markets and is delivering earnings to justify it. Near term, approved corporate buybacks will reinforce market demand, but that is money not being invested in research and development which would be more productive for the economy longer term. Bottom line: there are few reasons to be bearish about the stock market other than there are few reasons to be bearish about the stock market.

Last fall, Chairman Powell of the FED was quoted saying that rate cuts would be appropriate well before the inflation target of 2% was reached in order to avoid overtightening the economy and causing a recession. Despite the FED's favorite measure of inflation (the PCE) averaging 1.85% over the last six months he now wants to see more data before rates will come down. I believe what has changed is that he isn't worried about the current rate of inflation but concerned that the U.S. economy is running too hot and prices could rebound if growth is not controlled. For example, non-farm payroll employment in January was up 353,000, well above the estimate of 185,000. In addition, surveys such as the Purchasing Managers Index and others from the Institute for Supply Management (particularly in the area of new orders) were strong. Wages, the stickiest part of inflation, were up 4.5% year-over-year. That's good for consumer spending and the economy but not necessarily for Mr. Powell's inflation fight. Another headache for the FED is the persistent increases in fiscal spending by Congress, in efforts to buy their way into office. Providing an offset to the strength in the U.S., most global economies, in particular Europe and China, are not experiencing the same level of growth and that keeps something of a lid on a potential reacceleration in inflation.

It is not a great revelation that a lot of things in life are dependent on confidence and psychology, including stock markets, economic growth and inflation. Going back to todays opening paragraph, there aren't many obvious reasons to be bearish, but with so much optimism in the market I think it wouldn't take much to reverse that positive psychology. Hence my reluctance to go all in as a buyer, and actually remain a skeptic about the rest of 2024 for markets.

I am always surprised about how little change in confidence it can take to make a big change in outlook. The most recent example was Silicon Valley Bank last spring. All it took was a leading venture capitalist, Peter Thiel, telling people to withdraw funds from the bank to set in motion a run on the bank. It was demonstrative of the risks involved in the "Fractional Reserve Banking" system which is the basis of most of the world's financial systems. In short, when a deposit is made to a bank the implicit assumption is that the bank can lend out that money many times over. That works as long as not too many depositors want their money back at the same time. In the case of Silicon Valley Bank (SVB) that assumption proved incorrect. It's a surprise to me that the FED reduced the required reserves at banks to zero in March 2020, relying on interest paid to banks to maintain an appropriate level or reserves.

The SVB bank run was based on fears (mostly unfounded) about companies in the high-tech industry paying back loans. The center of attention today is the weakness in the commercial real estate (CRE) industry and in particular, New York Community Bancorp (NYCB). While NYCB stock is the market focus currently, it has been pointed out that CRE loans make up almost 30% of total assets at all small U.S. banks. No predictions from me, but this is the kind of thing that can suddenly erode confidence in the market as a whole. Janet Yellen, Secretary of the Treasury, is reassuring us that the regulators are "on the case". Nevertheless it's worth remembering that former FED Chairman Ben Bernanke told us in 2008 that problems in the subprime mortgage market would have limited impact on the rest of the economy or financial system.

As usual there are a number of things that caught my eye in the past month: Despite everything going on-line today, JP Morgan Chase, the largest U.S. bank, intends to open 500 new bricks and mortar branches in the next three years making old fogies like me happy.

While many smaller retailers are being forced to move or close due to increased rents, luxury companies like Prada and Gucci are actually buying their 5th Avenue stores.

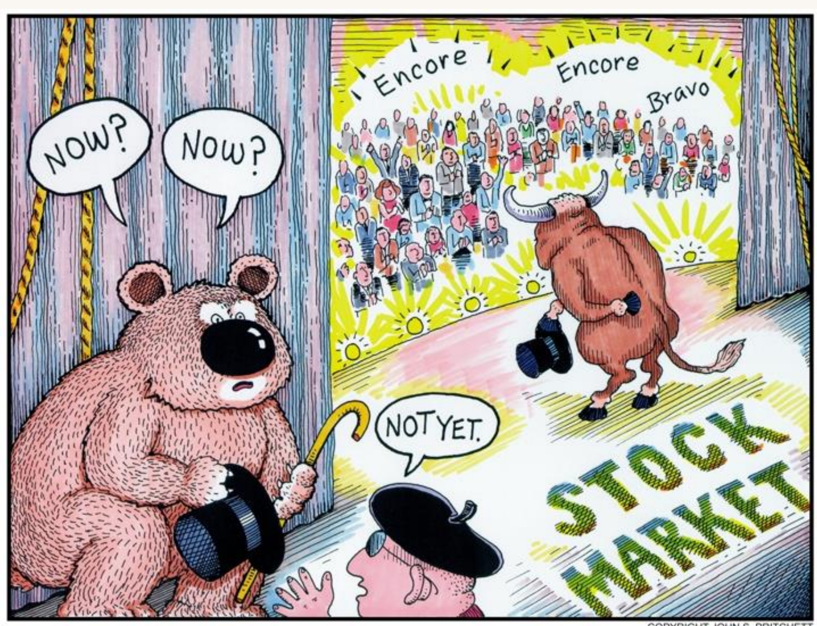
Are so-called "speed limiters" the coming thing? A California bill would require them on cars in the next 5 years. They can slow a car to the speed limit anywhere by GPS.

The volatility in bond markets seemingly has surpassed that of equity markets. It's very different.

Speaking of different; I grew up when Republicans went to college, wore three-piece suits, became lawyers and bankers and Democrats belonged to unions and built cars. Today it's the opposite.

And finally, since 1980 the third quarter of a Presidential election year has had an average pullback of 11½%; if you remove the disaster that was 2008 it is still 8¼%.

All the best.



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