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July 2023 Market Commentary

After declining -18.1% in 2022, the S&P500 Index recovered in the first half of this year, returning +16.9%. The recovery was concentrated in the large cap growth and technology stocks; when adjusted for market weight, the Index was only up +6.9%. This underperformance of the equal weighted S&P500 Index is the most in over 30 years. Market technicians noted that the Index actually bottomed on October 12, 2022 at 3577, and when it closed at 4294 on June 8, up 20%, it marked the beginning of a new bull phase. Other observers demurred, pointing out that the Federal Reserve was still fighting its war on inflation, whose full economic impact was yet to be felt. The Fed’s preferred measure of inflation is currently 4.6%, well above its longstanding 2% target. The Fed is adamant that 2% inflation is optimal for all its constituents.

The Fed’s current tightening cycle has been the most aggressive in modern monetary history, moving its Fed funds policy rate from zero to 5% in just 14 months. The rapid pace of interest rate increases has precipitated the failure of three sizable banks; this in turn has reduced the willingness of banks in general to provide credit to borrowers. The Fed is keenly aware that its policies can take more than a year to slow the economy. In its previous tightening cycle, the Fed started in June 2004 at 1.25% and paused in June 2006 at 5.25%; in the next 15 months the stock market increased more than 20% and the economy grew every quarter until the Great Recession started in 2008. This is why the Fed paused last month and has slowed the pace of rate increases this year.

Goods inflation has already declined substantially, as supply chains have improved, but service sector inflation is resistant, as wage increases are strong at 4.3% annually. There are 1.8 jobs for every unemployed worker. The Fed believes restrictive policy can reduce the excess demand for labor and lower wage inflation without causing a recession. The stock market seems to agree; in June the advance broadened to include more of the S&P500 and even small stocks, burnishing the case for the new bull market. Although Wall Street earnings estimates for the S&P500 are flattish this year at $220 per share, they rise next year to over $245, valuing the market at 18 times 2024 earnings, a rather lofty level in a rising interest rate environment (the historical average is 16 times). Part of this excitement stems from a new bull market, but perhaps there is something else happening here as well.

A closer look at Wall Street projections in 2024 reveals a recovery in corporate profitability to record levels achieved in 2021. Part of the reason for this may be the adoption by business of new productivity enhancing tools, including artificial intelligence (AI). In a 2021 survey, the business consultant McKinsey found that 56% of respondents adopted AI in at least one function, and 27% attributed at least 5% of their earnings to AI. What exactly is AI? Simply put, AI simulates human intelligence in a computer powered by rules called algorithms. AI allows software to rewrite itself as it adapts to its environment. The impetus behind AI comes from the availability of inexpensive cloud computing power; the accessibility, storage, and labeling of data sets to build algorithms; and the competitive advantage of lowering costs, reducing risks, and developing products faster.

Broader application of AI is driving investment flows into mega-cap technology stocks; the top seven stocks now comprise 28% of the S&P500. Some observers are calling this a bubble in technology, recalling the late 1990s, but the valuation of the S&P500 (forward earnings) at that time was 25-30 times, not 18. One of our exceptional growth investments, Amphenol Corp., whose sensor technology is used in AI, trades at 27 times forward earnings—a great company trading at a full valuation.

So where does the market go from here? This year's advance has been driven in large part by large technology in general, and AI in particular. Recently market breadth has improved, but this may not continue as the full effect of the Fed's tightening over the last 15 months permeates the economy. Furthermore, the Fed's determination to lower inflation may cause interest rates to rise even more. We do not try to predict short-term fluctuations in the stock market. Instead, we search for consistent, high-quality growth companies with reasonable valuations to buy and hold for long-term appreciation. When the Fed is trying to slow the economy to fight inflation, it becomes more challenging to find these unique companies. We rely on our collective experience and team collaboration to meet this analytical challenge.

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