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INVESTMENT MANAGERS

ECONOMIC UPDATE MAY 2023

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Market indices were mixed in April. Large cap stocks in the S&P 500 index gained 1.6% for the month resulting in a year-to-date gain of 9.1%. On the other hand, small cap stocks in the Russell 2000 were down -1.8% bringing their year-to-date gain to only 0.9%. International stocks in the MSCI EAFE index were up the most in April and for the year at 2.5% and 11.5% respectively. Meanwhile, emerging market stocks lost -1.1% in the month but are still sporting a gain of 2.8% for the year. Yields on the Barclays US Aggregate Bond Index were basically flat but the index posted a 0.6% return in the month bringing the year-to-date gain to 3.6%. The yield on the 10-year Treasury bond is currently 3.5%.

Although the S&P 500 index returns have been strong, just a few mega-cap stocks are behind most of the gain. These stocks include Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla. Alphabet, Amazon, Meta and Microsoft reported what were considered favorable earnings but EPS growth was still negative for the quarter. Of the companies in the S&P 500 that had reported earnings as of April 28th, total earnings were down -2.4% from the same period last year. Also, 77% were reported as beating earnings estimates but those estimates had been lowered from the beginning of the quarter. Zacks sums it up as quarter one is coming in “better-than-feared”.

Economic Growth in the first quarter increased at an annual rate of only 1.1% after adjusting for inflation according to the “advance” estimate released by the Bureau of Economic Analysis last week. This is much lower than the 3.2% of third quarter and 2.9% of fourth quarter and it was lower than what analysts expected. Strategas Research notes that we may be starting to see cracks in the economy. Pending home sales were down -5.2% in March. If corporate profits continue to fall, business may curtail their spending on capital expenditures, travel, advertising and hiring. Unemployment is still low but jobless claims have risen. Wages are rising at a slower rate than prices which affects purchasing power. Consumers have been compensating by saving less and borrowing more which may become unsustainable.

Inflation is also still a concern even though it has been coming down from highs. Over the past several years, the money supply has been significantly expanded and the federal government has spent borrowed funds at unprecedented levels. Both actions are inflationary, so the task of getting inflation under control may be more difficult than projected. The Fed’s main tool for fighting inflation has been raising interest rates. The Fed meets in May and is expected to hike rates another 25 basis points and then pause. Some investors anticipate that the Fed will begin cutting rates beginning in the third quarter. Stock prices seem to be holding up partly in anticipation that the Fed will ease later in the year in response to the economy entering a recession at that time. Even the Fed’s projections for full year GDP growth indicate that they are anticipating a recession in the second half of the year.

The inverted yield curve also continues to signal a coming recession with short-term yields higher than long-term yields. In a recession, analysts expect that yields will fall across all maturities although more so at the shorter end. Because of this, strategists are advising investors to start buying longer term debt instruments (even though they are currently yielding less than the shorter-term securities) so that investors can lock in the yields for longer periods before yields fall.

The positive returns in stock prices over the last seven months have been advantageous for investors. However, the economic backdrop remains murky. If we enter a recession, earnings would likely be negatively impacted. For stock prices not to fall, that would mean Price/Earnings ratios would again be stretched and reside above historical averages. We continue to encourage investors not to try and time the market by trading in and out and instead invest according to risk tolerance. However, this could be an attractive time to make gifts of appreciated stock or to rebalance if stock allocations have drifted higher. If you have questions about the strategy for your account, please contact your advisor.

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