Wellington Shields

July 2024

Quarterly Market Strategy Report

Politics Ahead

The stock market's performance in the first half of the year was strikingly similar to the action seen in the first half of 2023. The benchmark S&P 500 index rose 14.5%, a bit less than the 15.9% gain in the first half of 2023, but still a healthy performance. And once again, the tech-heavy Nasdaq Composite index was the best-acting index, even if this year's 18% gain in the first six months was less than the 32% increase seen last year. And, as in 2023, the stellar performances of the S&P 500 and Nasdaq Composite indices were tied to big gains in a relatively small group of large capitalization stocks, particularly those linked to artificial intelligence.

In comparison, the Dow Jones Industrial Average, despite hitting an all-time high on May 17, 2024, has delivered a mere 3.8% rise year-to-date, and the much broader Russell 2000 index was virtually unchanged, up 1% at the end of June. At mid-year, the Russell 2000 index is trading more than 16% below its November 2021 peak, in stark contrast to the S&P 500 and Nasdaq Composite indices which produced a string of record highs in June. It remains a market of haves and have-nots.

THE CONCENTRATION DEEPENS

Large capitalization stocks kept getting bigger in 2024 and by the last week of June, Amazon.com, Inc. (AMZN - $193.25) became the fifth US company to exceed the $2 trillion valuation mark. It thereby joined the rarified air enjoyed by Google's parent Alphabet Inc. Class C (GOOG - $183.42) and Class A (GOOGL - $182.15) valued at $2.26 trillion and $2.258 trillion, respectively, Nvidia Corp. (NVDA - $123.54) valued at $3.04 trillion, Apple Inc. (AAPL - $210.62) valued at $3.23 trillion, and Microsoft Corp. (MSFT - $446.95) valued at $3.32 trillion.

These five stocks currently represent more than 35% of the S&P 500 index. This is remarkable since it was less than a year ago when Bloomberg reported that the top ten largest stocks in the S&P 500 represented a then record 32% of the S&P index. As the concentration of value in a small number of stocks increases, it makes it more difficult to outperform, or even perform in line with, the S&P 500 index unless your portfolio was overweighted in these companies.

Summary

We do not believe the classic economic cycle of expansion and recession has been completely eliminated, but it is clear that fiscal stimulus, not just through spending packages passed by Congress, but federal spending done through government agencies, has boosted the economy this year.

But while spending is good for the economy it has also pushed the US debt-to-GDP ratio to 123% as of September 2023. This is a big concern over the longer term.

A new generation of investors, experiencing a historic transfer of wealth, has entered the markets with new investment ideas and goals. The popularity of Bitcoin and meme stocks are two examples of this.

More importantly, this market concentration is reminiscent of the Nifty Fifty stocks of the early 1970s and the Dot-com stocks of the late 1990s. Both of these bubble markets, led by a small group of growth stocks, eventually ended in tears. Note also that the peaks of these two bubbles (January 11, 1973 and March 24, 2000) were 27 years apart and we are now more than 24 years from the 2000 top. This time spread may be significant since it suggests a new generation of investors has entered the financial markets with new investment ideas and goals. The popularity of Bitcoin and meme stocks are two examples of this. And this new generation is experiencing a historic transfer of wealth. A New York Times article* recently discussed "the greatest wealth transfer in history" indicating that over the next 20 years $84 trillion in assets is set to change hands from Baby Boomers to the next generation. It is a trend worth monitoring.

For all these reasons, markets are apt to remain volatile. But over the longer term, it is wise to be thoughtful in one's investment decisions and maintain a diversified portfolio focusing on stocks with predictable future earnings streams.

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RECESSION ON HOLD

Meanwhile, the US economy continues to outperform expectations in 2024 and the long-awaited recession is yet to materialize. The labor market has stayed resilient and so has the consumer, even though consumer sentiment remains at recessionary levels. Small business sentiment continues to show concerns about future revenues and cost of goods, but sentiment is up from previous lows. Housing is showing signs of weakness due to rising home prices and substantially higher mortgage rates which is making housing less affordable for many. Still, GDP for the first quarter was recently revised upward from 1.3% to 1.4%.

The Federal Reserve's favorite inflation benchmark, the personal consumption expenditure deflator (PCE) ticked down from 2.7% year-on-year in May to 2.6% in June; while core PCE, which strips away food and energy prices and is the key metric on the Fed's radar, fell from 2.8% year-on-year to 2.6%. This was good news for economists since it opens the door for a possible rate cut in the month of September. The one caveat for inflation would be if crude oil prices continue to rise and this increases the cost of gasoline, heating oil, and private and public transportation.

We do not believe that the economic cycle of expansion and recession has been eliminated completely, but it is clear that fiscal stimulus, not just through spending packages passed by Congress, but federal spending done through government agencies, has boosted the economy. And while spending is good for the economy it has also pushed the US debt-to-GDP ratio to 123% as of September 2023. The Congressional Budget Office estimates that the 2024 deficit will be $2 trillion, or 7% of GDP, which is nearly double the 50-year average of 3.7% of GDP. Unfortunately, this uncontrolled deficit spending could mean that the next recession will be worse than it would have been otherwise.

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EARNINGS AND VALUATION

Corporate earnings, reported as earnings per share, have been mixed but are generally better than most forecasts. Much of this is due to efficiency gains but some of this is due to the record level of stock repurchases. According to S&P Dow Jones, a total of $236.8 billion was spent on stock buybacks in the first quarter, up from $219.1 billion in the previous quarter. This was also up 10% from $215.5 billion in the first quarter of last year. The largest 20 companies in the index were responsible for 50.9% of the buybacks in the first quarter, slightly down from last quarter's rate of 54%, but still above the historical average of 47.5%.

The companies with the biggest buyback campaigns in the first quarter were Apple, Meta Platforms Inc. (META - $504.22), Alphabet, Nvidia, and Wells Fargo & Co. (WFC - $59.39), in that order. The impact of stock buybacks is two-fold. It lowers the number of shares outstanding, which will increase "earnings per share" without any change in revenues. And it also decreases the supply of stock, which theoretically increases the stock price.

The S&P 500 trailing 4-quarter operating multiple is now 24.9 times which is well above all long- and short-term averages. The 12-month forward PE multiple is 21.1 times which is substantially above its long-term average of 15 times or its 10-year average of 19.5 times. When 21.1 is added to inflation of 3.3%, it sums to 24.4, which is also above the top of the normal valuation range of 14.8 to 23.8. By all measures, the equity market is at valuations seen only during the 1997-2000 bubble, the financial crisis of 2008, or the post-COVID-19 earnings slump. This is a reason to be watchful particularly with uncertain elections ahead in the UK, France, and the US.

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* The New York Times, "The Greatest Wealth Transfer in History Is Here, With Familiar (Rich) Winners," May 14, 2023.

Stock prices are as of June 30, 2024

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