Monday, May 13, 2024

SUMMARY-

I. Dow leads stock rebound for third straight week.

II. Earnings results and positive guidance propels equities higher.

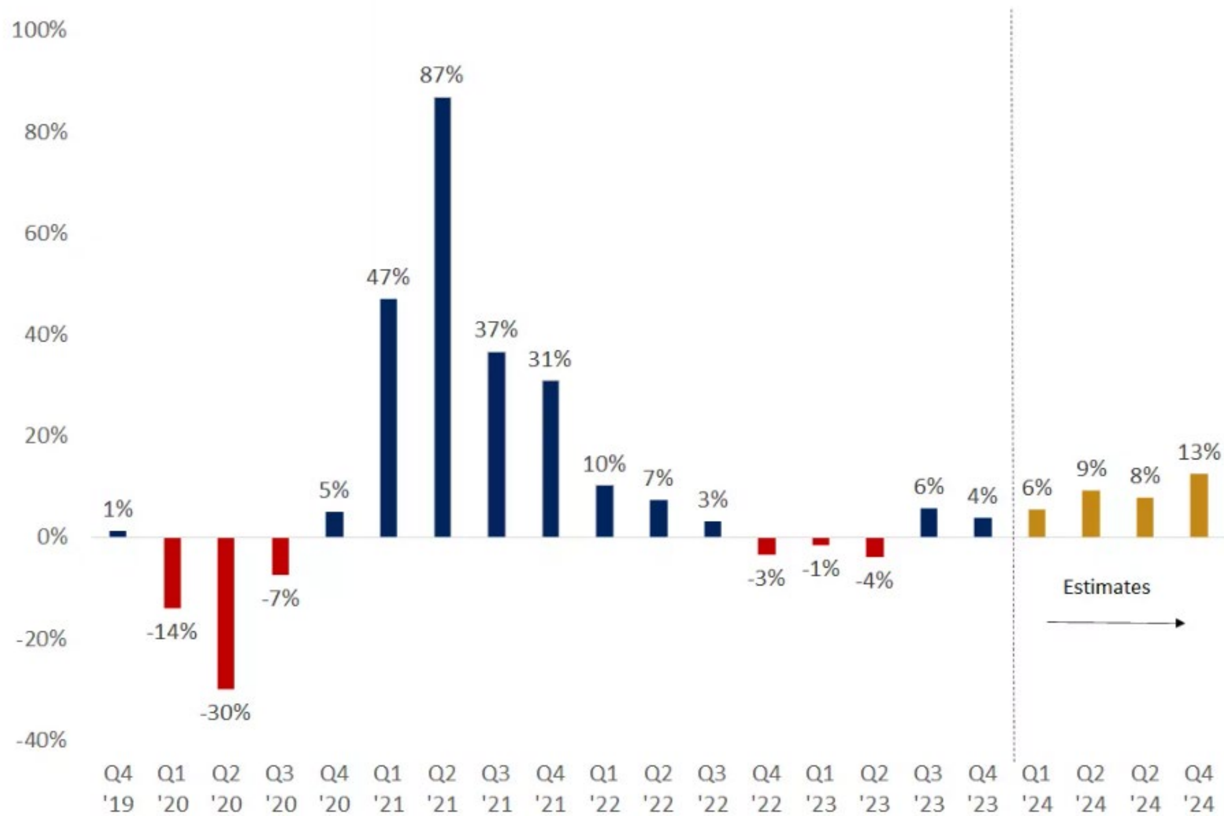
III. Volatility and bond yields ease but new inflation data will set tone for this week.

IV. Resumption of disinflation could trigger market broadening out once again.

Good morning:

First quarter earnings season neared a wrap-up last week with a third straight winning week recovering much of April's modest pullback in equities. Leading major averages higher was the Dow that added 2.2%, about double that of the NASDAQ that gained 1.1% by Friday's close. As of now, about 90% of S&P 500 companies have reported their Q1 results which have exceeded analyst estimates by 8.5%. This is the biggest upside surprise since the third quarter of 2021, and an increase in profits of 5.5% from last year. The drop in inflation over the past year has helped many company's input costs leading to both revenue and earnings growth. Along with solid results, earnings estimates for the rest of the year were also generally positive leading to expectations for accelerated profits through year end.

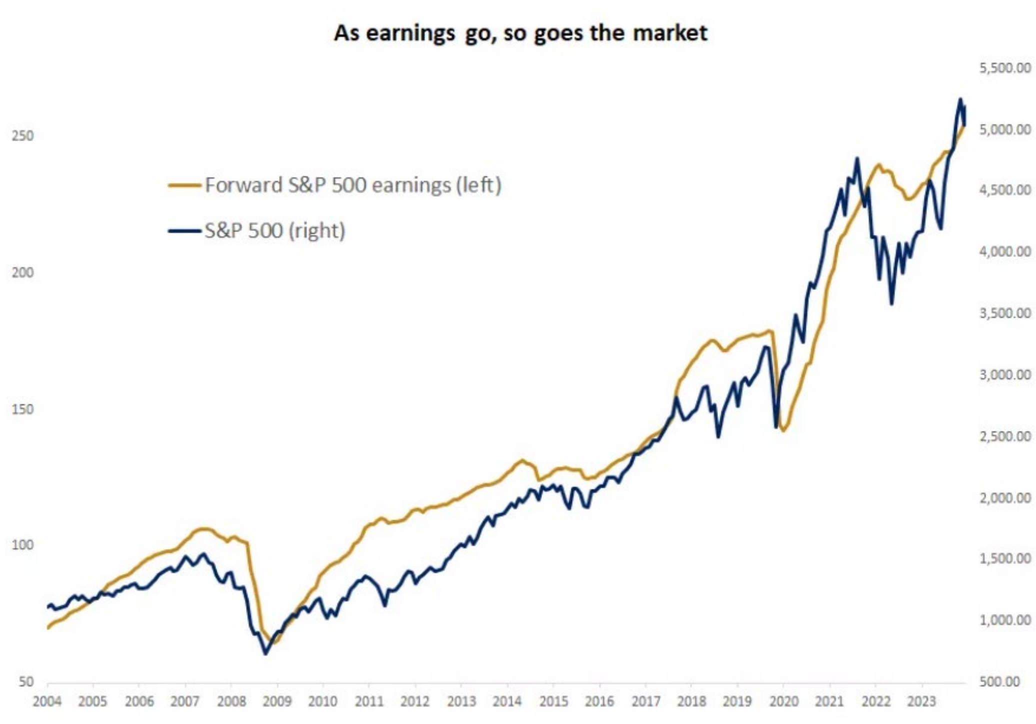
Earnings are on track to accelerate through 2024



Source: FactSet

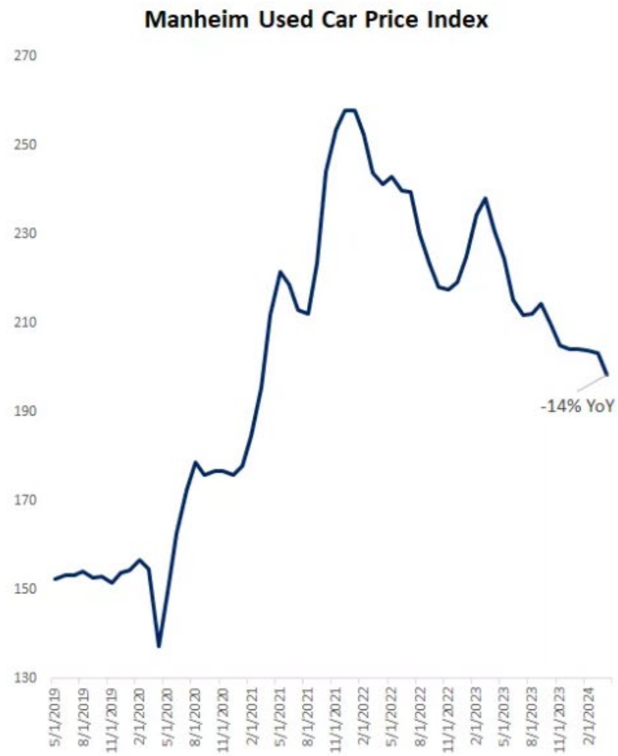
Looking at specific sectors, communication services, consumer discretionary, and technology continue to stand out for their strong growth, but other areas are also delivering solid results, namely industrials, financials, and consumer staples. The only three sectors that are seeing earnings declines for the quarter are energy, materials, and health care. Artificial intelligence remains a key theme that continues to benefit the mega-cap tech and the Magnificent Seven stocks specifically, but the benefits to the enablers of this technology could over time spread to those companies that can *apply* AI to improve existing processes or to enter new markets. Many portfolio managers are focusing on looking for such companies that stand to benefit from AI but are not currently trading at such outsized valuations as the leading AI chipmakers themselves.

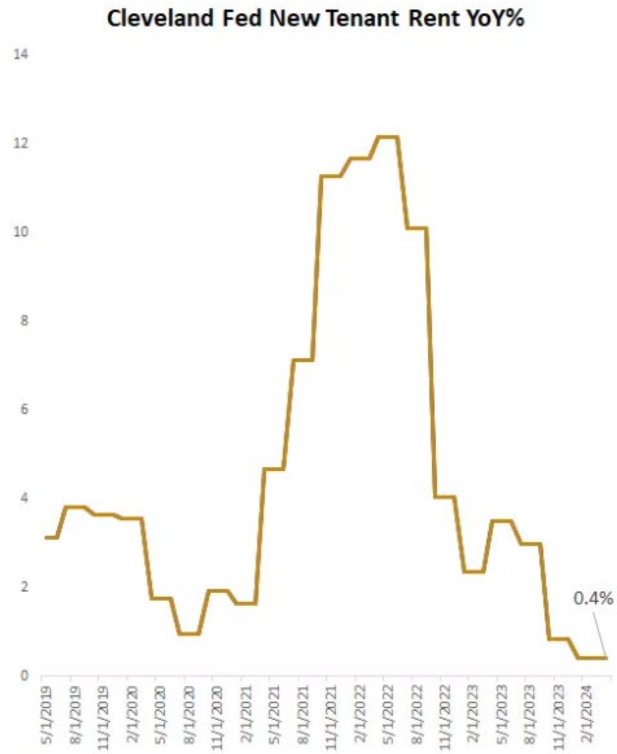
Market volatility measurements like the VIX also declined for the third straight week as fears of a broader correction dissipated. However, with a great deal of uncertainty about the Fed's upcoming policy moves, along with likely worries about this fall's presidential election, we may see volatility return to the stock market in the months ahead. Fortunately, the solid underpinning of both economic and earnings growth should provide a stable foundation for equities to continue to outperform. As the S&P 500 Index trades near a record high, it may be easy to suggest a correction is justified or near. However, market valuations in the long run follow earnings, which are also now near record highs.



Source: FactSet

This week will be highlighted by several key economic reports. Tuesday's PPI report will reveal price increases at the wholesale level and is often seen as a leading indicator of what consumers will pay down the road. This is followed by Wednesday's CPI report that will measure the rate of price increases paid by consumers in April. After several months of stickier inflation data, leading to significantly revised forecasts for Fed cuts in 2024, this report could trigger the biggest market reaction in either direction. Data from last week suggesting that economic growth and the labor market may be softening was perceived as likely what policymakers want to see. This led to further yield declines in the bond market which is again now pricing in two rate cuts for the year. It has been clear for the past few months that getting inflation down from the current 3.5% level to the Fed's 2.0% target rate will be difficult, and perhaps take far longer than hoped. With oil prices back below $80/barrel, wage growth softening, used car prices on the decline, and rent inflation near 0%, the ingredients appear present for inflation to continue its descent. As Chairman Powell stated previously, inflation just needs to be on a *trajectory* towards 2.0% for them to initiate a rate cut, and not actually achieve that level for them to commence easing. Obviously, markets would greatly welcome this news.





Source: Bloomberg

If inflation remains stubbornly at current levels, cash-rich mega-cap tech companies could continue to outperform since these companies are quite profitable and less reliant on debt financing. However, if the disinflation trend resumes, we could see various lagging areas of the market return to favor. Over the past three years, the S&P 500 is up 25%, while mid-cap stocks are up 10%, and small caps are down 6%. Value-style investments and dividend-payers could also do well as many trade at far cheaper valuations than growth stocks. As we continue to highlight, we see recent market results as a prime example of why it remains critical to not try to time short term market swings that can turn on a dime. Instead, we believe in sticking to a longer-term asset allocation-based portfolio model, relying heavily on diversification, professional active money management, with a strong bias towards the highest quality companies and securities. The quote below from famed billionaire investor Warren Buffett emphasizes his highly successful philosophy for investing in high-quality companies.

Have a great week!

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