Economic & Market Outlook

Executive Summary

~ The global stock market (MSCI All Country World Index) is up 9.0% year-to-date, but the average stock is flat. In fact, over half of all global stocks have lost money this year.

~ The US and global stock market's advance is almost entirely attributable to seven stocks. The stock market's leadership has never been more concentrated.

~ The US economy continues to perform well, despite the Federal Reserve's aggressive monetary policy. This poses as challenge for the Federal Reserve who want's assurance that their policy measures will keep inflation from reigniting.

~ During the COVID era, households and corporations were able to refinance and term-out debt at abnormally low rates, which has reduced the efficacy of the Federal Reserve's policy measures.

Where's the Bull Market

The technical definition of a bull market is a 20% gain in the index. We don't know who came up with this arbitrary definition, but it stuck. Last year, global equity markets bottomed out on October 12th, 2022. Since then, they have rallied 20.3% (through 10/5/23), and year to date, they are up 9.0% (through 10/5/23). We are "technically" still in a bull market, but it sure doesn't feel like one.

Here is a quick decomposition of the global equity market. Non-US stocks, big and small, account for 38% of the global equity markets. They are up +3.2% on the year, positive, albeit lackluster. US stocks account for 62% of the global equity market. Within the US, small-capitalization stocks are down -0.6% on the year, and mid-capitalization stocks are barely positive at +0.8%. Obviously, it is the larger US stocks doing all the heavy lifting.

So, let's break down the S&P 500, an index comprised of the 500 largest US companies. Year to date, the S&P 500 is up +12.3%. We can separate the S&P 500 into two indices, the S&P 100, and the S&P 400. The S&P 100 is a mega-cap index that tracks only the largest 100 companies in the US. The S&P 400 tracks the companies ranked 101-500 in size. Year-to-date, the S&P 100 is up +18.8%, while the S&P 400 is up +1.5%. The conclusion we jumped to in the prior paragraph needs revision. Mega capitalization stocks, not large capitalization, are propping up both domestic and global equity markets.

But why stop there, we can break things down even further. Let's create two indices: the S&P 10 and the S&P 90. The first represents the return of the 10 largest stocks in the US and the second represents stocks 11-100. Year to date, the S&P 10 is up +36.7%, while the remaining 90 other mega capitalization stocks are up +7.8%. Even within the mega capitalization index, there is a glaring dichotomy between the largest companies and the smallest. Both the US and global stock markets are being propped up by a handful of the largest US companies.

It is difficult to stress how rare this is, but you are in luck because Nate Geraci quantified it for us. Geraci compared the price return of the ten largest stocks to the price return of the index since 1990. If the year were to end today, the world's largest 10 stocks (all US companies) would set a record in terms of their contribution to index performance. The ten largest stocks account for 95% of the index's returns. Said differently, stock performance has never been this concentrated amongst a handful (2%) of the largest companies (S&P 500).

At 95% Contribution, 2023 is an Outlier

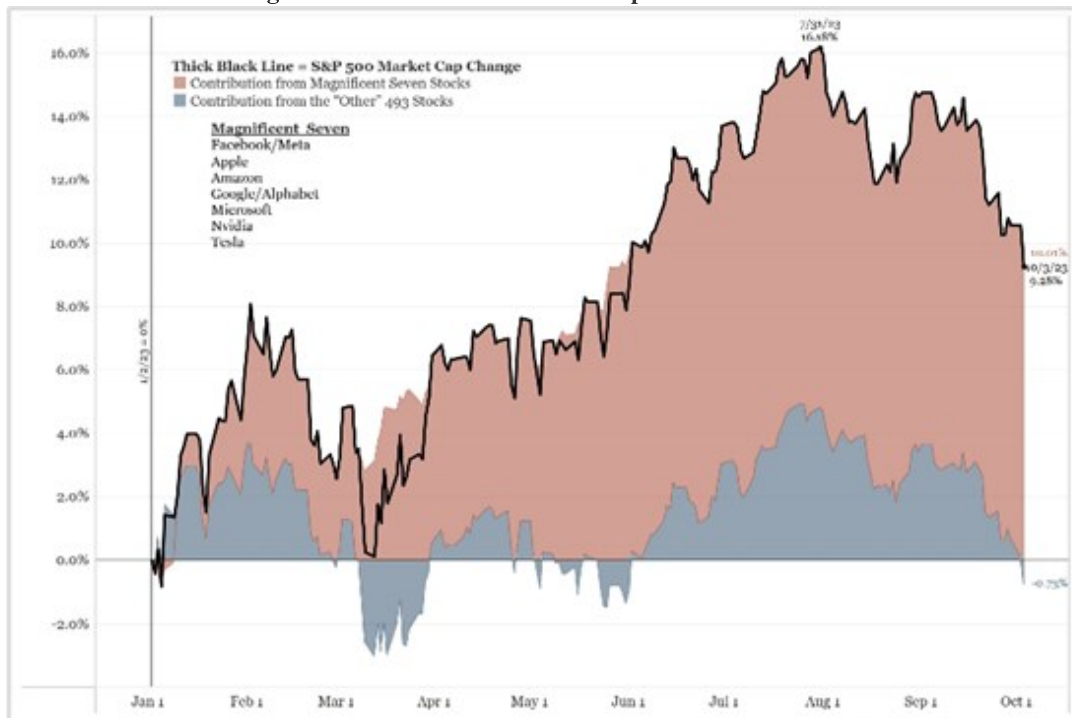
Top 10 Stock's % of S&P Performance					
2007	78.7%	1991	28.6%	2010	19.6%
2020	58.9%	2006	27.6%	2012	19.2%
1999	54.5%	2016	26.6%	1997	19.1%
2021	45.0%	2003	23.6%	2013	17.6%
1998	36.8%	1995	22.3%	2009	15.5%
1996	33.9%	2014	22.2%	1992	14.9%
2017	33.3%	2004	21.1%	1993	12.2%
2019	32.8%	2005	20.5%		

Source: Nate Geraci

At the onset of 2023, the ten largest companies in the world were: Apple, Microsoft, Amazon, Google, United Healthcare, Johnson and Johnson, Exxon, Berkshire, JP Morgan, and Nvidia. Without these ten companies, the global equity markets and the S&P 500 would be up only +4.3% and +4.0% respectively.

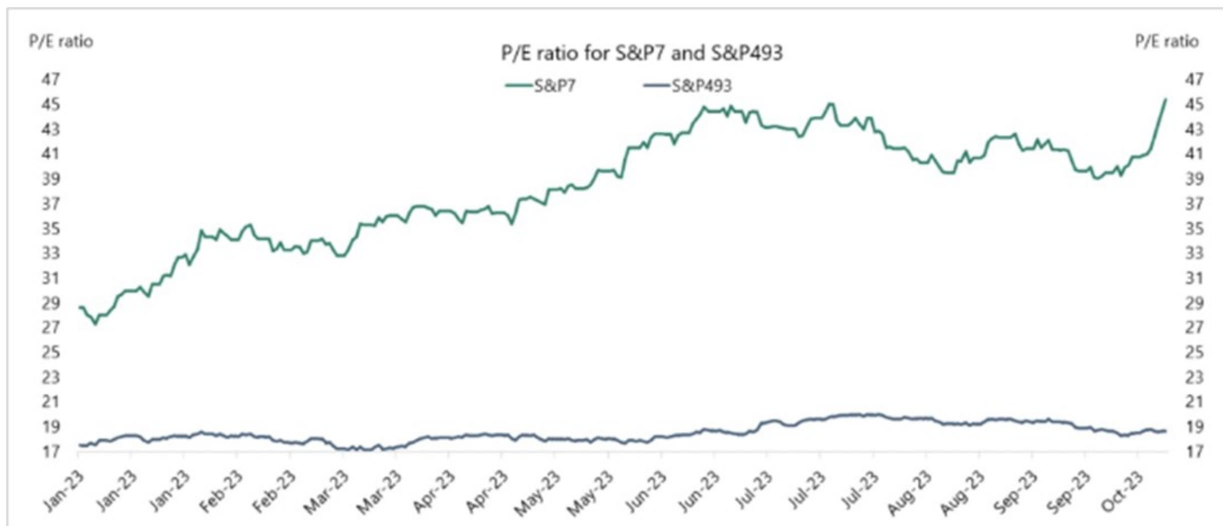
If you want to cherry-pick further, the real leadership has been among seven growth stocks. Five of these stocks (Apple, Microsoft, Google, Amazon, and Nvidia) are among the largest ten companies in the world. The two other major contributors (both prior members of the top 10) are Meta/Facebook and Tesla, both of which rank within the top 20 companies worldwide. The seven grouped together have been coined the "Magnificent Seven." Jim Bianco, a market strategist, has a great chart decomposing the market performance with and without the Magnificent Seven through 10/3/2023. The conclusion is like that of ours about the top 10 stocks, index performance has been extremely concentrated, and without the benefit of the Magnificent Seven, domestic and global equity markets would be negative year-to-date.

Magnificent Seven Stock's YTD Impact on the S&P 500



Source: Bianco Research

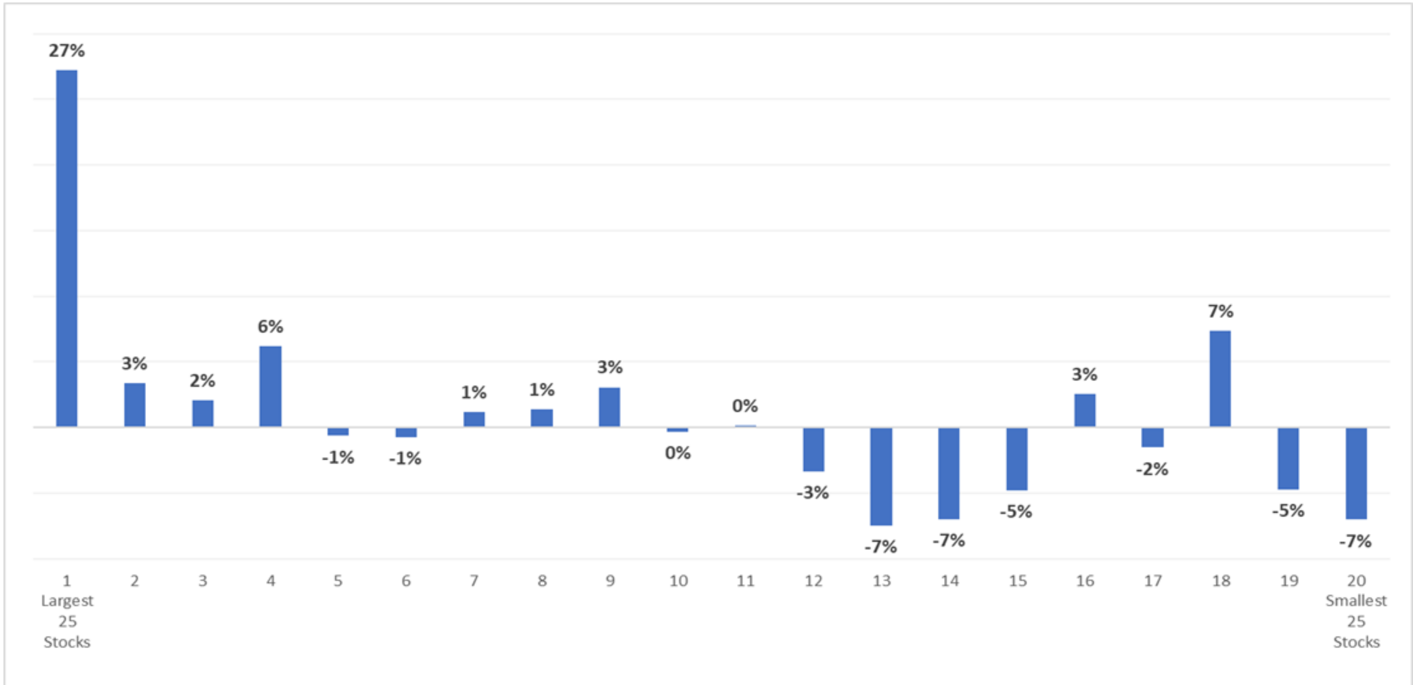
The Magnificent Seven's PE Ratio Has Grown from 29x to 45x.
The Other 493 S&P Constituents Haven't Seen Their PE Ratio Move.



Source: Apollo Group

We normally don't like highlighting observations/studies about return concentration. In any given year, a handful of stocks will contribute disproportionately (positively or negatively to the market averages), but this year is unique. What makes 2023 so rare is that the stocks that have moved the most in percentage terms also happened to carry the most weight in the index. What are the odds? To help illustrate our point, we broke the S&P 500 into 20 groups. Group 1 was the largest 25 stocks (by weight) when 2023 began. Group 2 was the second largest 25 stocks… Group 20 was the smallest 25 stocks. The percentage above each bar in the chart is that group's average return for the year. What stands out?

Only the Largest Stocks Have Had Meaningful Moves

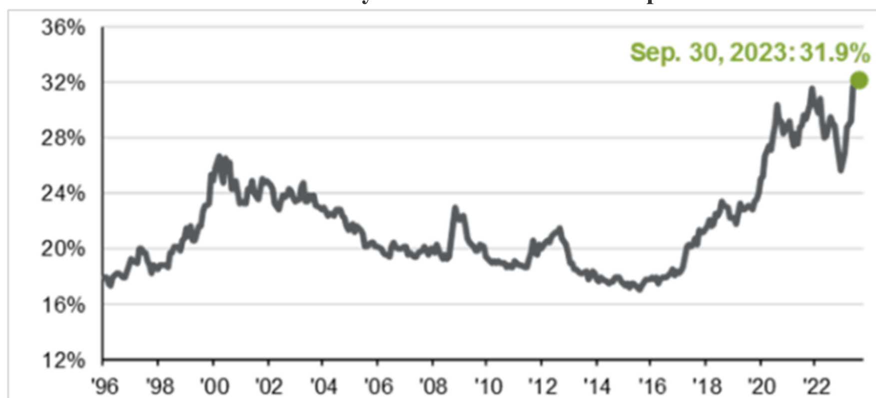


Source: Annandale Capital, Bloomberg

The unfortunate reality is that most stocks haven't done anything year to date. The median S&P constituent has lost -1.1%. If you look at the global indices it is the same story, -0.4%. Said differently, if you owned an equal-weight portfolio of all US stocks, you would be down on the year. If you owned an equal-weight portfolio of US large caps, like S&P 500 constituents, you would be down on the year. It hasn't been enough to own the "magnificent seven," you have needed to own them in size, which the market capitalization-weighted index does. To that end, we ask "Where is the bull market?" The answer appears to be in a handful of the world's largest stocks and nowhere else.

Our portfolios own a broad basket of stocks. We strive to own profitable yet undervalued stocks across differing geographies and market capitalizations. This approach significantly benefited us in 2022 but has obviously hurt this year. Newer investors may be wondering why we don't just own the S&P 500 or better yet, the Magnificent Seven. With the benefit of hindsight, we wish we had, but it is easy to construct portfolios in retrospect and going into 2024, we have no plans of increasing our exposure to mega-cap US equities.

The S&P 500 is Heavily Concentrated in the Top Ten Stocks

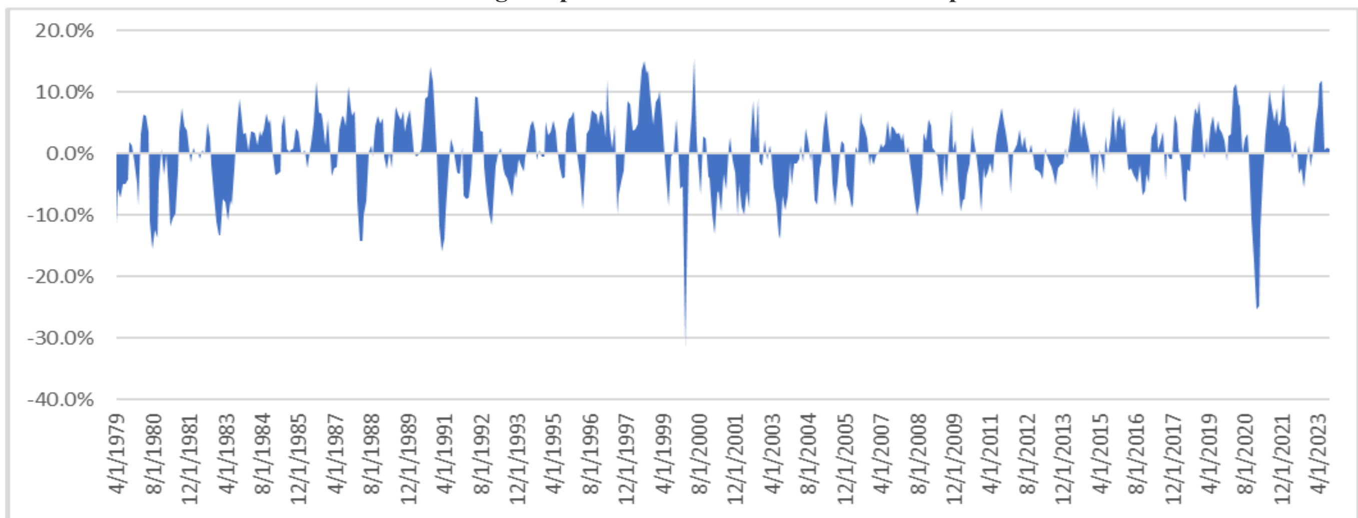


Source: JP Morgan

At present, the S&P 500 is highly concentrated relative to history. The top 10 stocks account for 31.9% of the index's weight but contribute only 21.9% of the index's underlying earnings. 28.7% of the index is information technology stocks and this is an understated figure, as it fails to include many other technology giants who have been given different classifications. For instance, Alphabet (Google) and Meta (Facebook) are both classified as communications companies. If you reclassified those companies, technology's share would jump to 34.0%. The index's weighted average market capitalization is $673 billion. And obviously, it is an index of US-domiciled companies. In short, the S&P 500 is a proxy for US mega-cap stocks with an emphasis on technology.

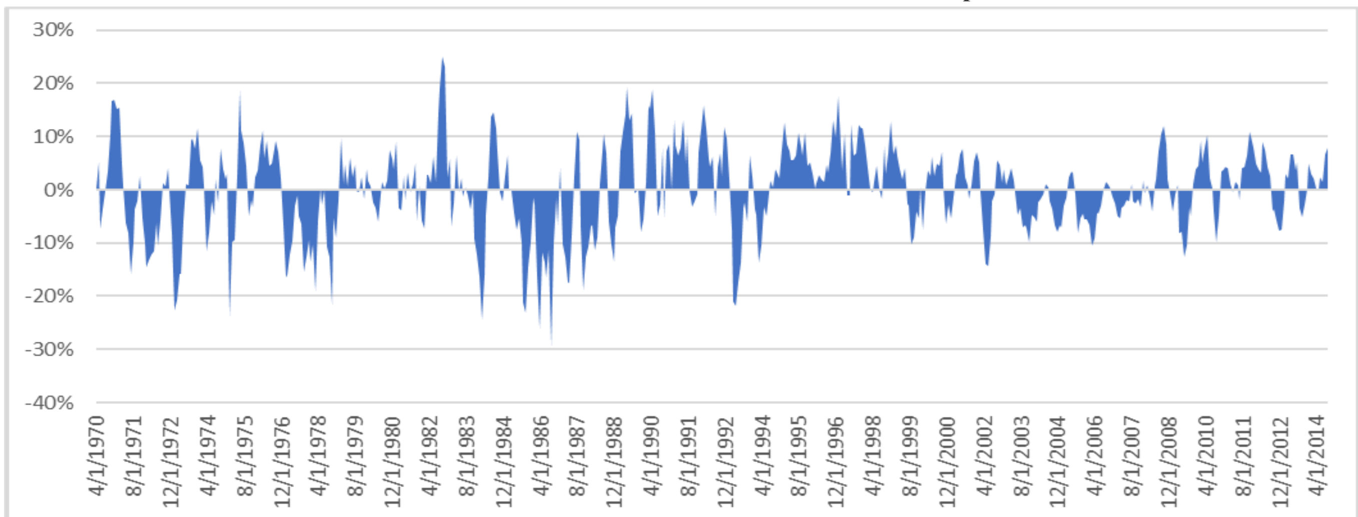
When we manage equity portfolios, our principal goal is to earn the equity market risk premium (the long-term return on stocks) in the most consistent manner possible. Given this objective, would we be better off owning the S&P 500 or a more diversified basket of stocks? To us, the answer seems obvious. Different sectors outperform at different times. The same holds true for geographies and capitalizations. Furthermore, there is no empirical evidence that over time large-cap US stocks persistently outperform smaller stocks or that US stocks outperform ex-US stocks. If this is true, then holding a diversified basket of stocks (that work at different times), should lead to better risk-adjusted returns (i.e., more consistent outcomes). To that end, we have supplied two graphs. The first is the 12-month performance of US large caps minus the 12-month performance of US small caps. The second chart is the 12-month performance of US stocks minus European, Australian, and Far East (EAFE) stocks. The winner over a given 12-month period is a coin toss, and there are no clear signs that over the long run either subset persistently outperforms the other. Harry Markowitz famously said, "diversification is the only free lunch in investing."

12-Month Returns of Large Capitalization Stock Minus Small Capitalization Stocks



Source: Annandale Capital, Bloomberg

12-Month Returns of US Stocks Minus International Developed Stocks

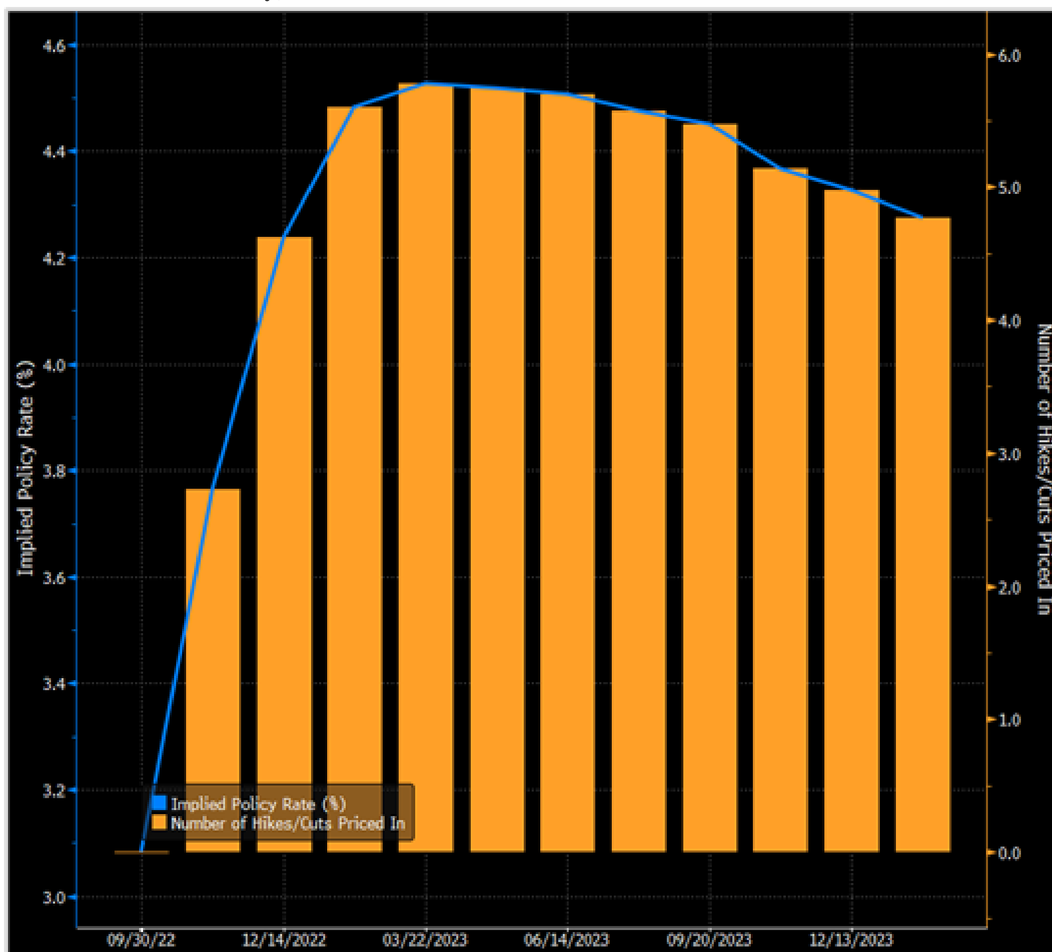


Source: Annandale Capital, Bloomberg

Here is some additional data, but of lesser importance. Think of it as the icing on the cake. Small stocks and overseas stocks offer far better valuations than mega-cap US stocks. Stocks outside the US trade at 12.5x current earnings vs 17.8x for US stocks. The overseas dividend yield is 1.7% greater than the S&P 500's. The current spread in valuations is two standard deviations beyond its historical average. It's the exact same story for small caps. The Russell 2000 (small-cap index) trades at 12.5x earnings (exclusive of non-earners). This compares to its historical average of 18.1x. The valuation spread between small caps and large caps is also a two-standard deviation event. The last (and only time) small caps traded at such low, relative valuations was the year 2000. Over the subsequent 10 years, they outperformed large-cap stocks by 4.2% per year. We also failed to mention that smaller, profitable companies have persistently returned more than larger companies over long holding periods. To be clear, we aren't advocating abandoning US mega-caps, we just think it would be foolhardy to limit your portfolio to just that.

The Fed's Conundrum

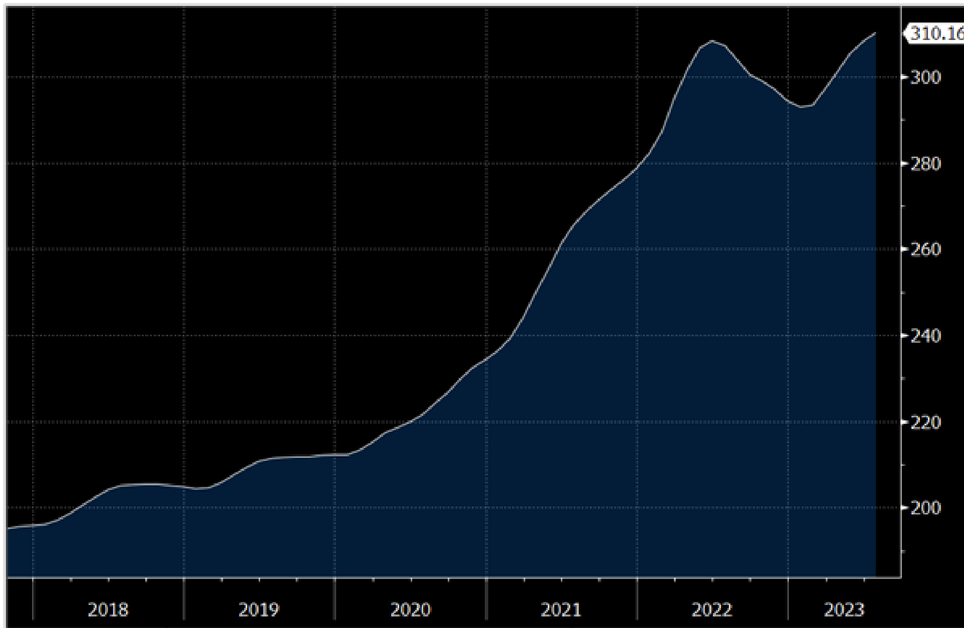
A Year Ago, the Market Was Pricing in Rate Cuts by May of 2023.
Today, it Remains Unclear Whether or Not the Fed is Finished



Source: Annandale Capital, Bloomberg

"The Fed is going to hike rates until something breaks" is a common refrain you hear in our industry. It is easy to understand why. Every hiking cycle over the past 70 years, with one exception (1994-1995), ended in a recession. When interest rates rise, it raises the cost of borrowing, which encourages more savings (at the cost of spending) and slows business investment. Said differently, higher rates should slow economic activity, which in turn leads to less inflation. But this cycle is proving to be a head scratcher. In under two years, the Fed has hiked the Federal Funds Rate by 5.25%, making the 2022/2023 hiking cycle the most aggressive since Paul Volker's reign in the 1980s, but there are very few signs our economy is cooling. That's not how things are supposed to work according to traditional economic theory.

US Housing Prices Hit Record Highs in 2023

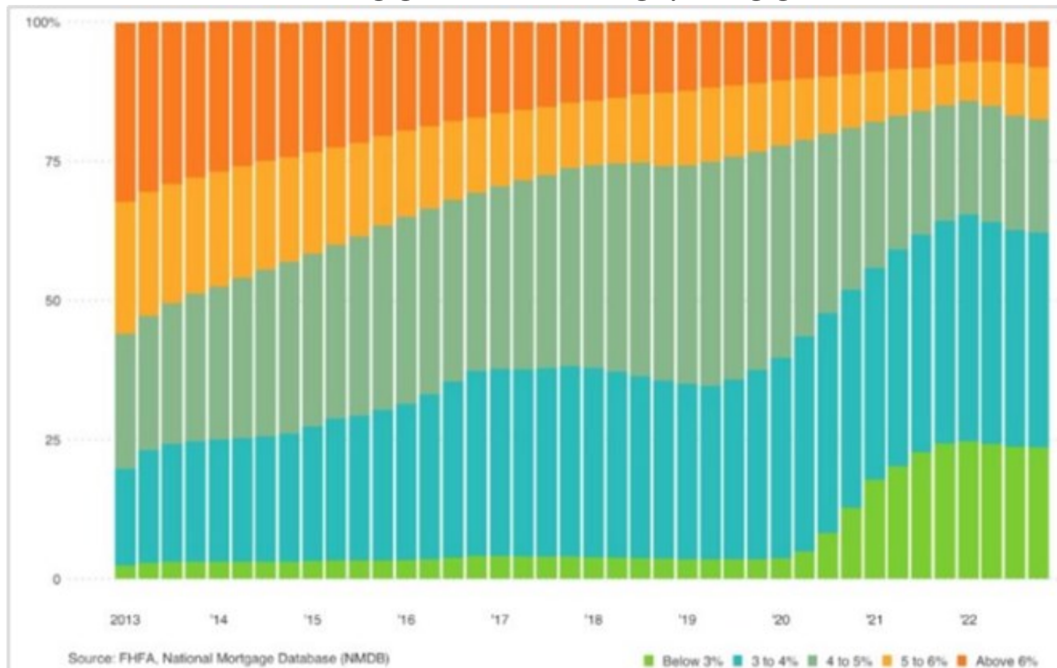


Source: Annandale Capital, Bloomberg

Take the housing market. It is highly sensitive to changes in interest rates as the typical real estate transaction is heavily debt-financed. Had you told us two years ago that the average 30-year fixed rate mortgage would reach 7.9% in 2023, we would have said a looming housing recession is a virtual certainty. Yet, today housing prices sit at all-time highs, so what gives?

After the great financial crisis, the adjustable-rate mortgage market largely disappeared. Today it accounts for less than 5% of all outstanding residential loans. These are the individuals who would feel today's rate hikes most acutely, but for the most part, they are non-existent. More importantly, when COVID hit, mortgage rates plummeted, leading to a massive refinancing boom. Liberty Street Economics estimates that between the second quarter of 2020 and the fourth quarter of 2021, 14 million mortgages were refinanced, of which less than a third were cash-out refinancing activities. The share of mortgages with sub-4% rates jumped from roughly 38% to over 60%. Today, less than 9% of fixed-rate mortgages outstanding carry a rate above 6%. 82% of mortgages are sub-5% and 62% are below 4%.

Share of Mortgage Loans Outstanding by Mortgage Rate



Source: Liberty Street Economics

As expected, higher interest rates have reduced demand for housing. Mortgage applications have fallen to their lowest level since 1966, but the reduction in housing supply has been even greater, as homeowners who took out mortgages before 2022 are handcuffed by their low rates. Active inventory (homes listed for sale) sits 45% below pre-COVID (2017-2019) levels. Right now, the average home spends only 48 days on the market, whereas homes sat on the market for 60 to 65 days pre-COVID. It is also worth noting that mortgages are amortizing forms of debt. The longer individuals remain in their existing homes, the more equity they build, assuming housing prices remain constant. The combination of mortgage handcuffs and higher housing prices has been a net positive for household balance sheets.

A similar story is playing out in the corporate world. Unlike mortgages, corporate bonds are non-amortizing forms of debt. When a bond matures a "bullet repayment" or lump sum payment is made for the entirety of the loan. Most corporations meet this payment obligation by refinancing their old debt with a new debt issuance, which poses a problem if interest rates are materially higher when it comes time to refinance. But corporations, like homeowners, took advantage of abnormally-low interest rates during COVID-19 to term out debt maturities and lock in low rates.

For instance, the $1.3 trillion high-yield bond market, which represents the riskiest of corporate borrowers, saw issuance of roughly $800 billion in 2020 and 2021. In other words, about two-thirds of high-yield issuers refinanced when rates were at record lows. The average high-yield bond carries a 5.8% coupon, which is nothing by historical standards. The US investment-grade corporate is almost five times the size of the high-yield market and it sits in an even rosier seat. Per Bloomberg, the average corporate coupon is only 3.9% (lower than today's 10-year Treasury) with a weighted average maturity of 10.6 years. Said differently, the average investment grade issuer has 10 and a half years of fixed-rate financing locked in at 3.9%.

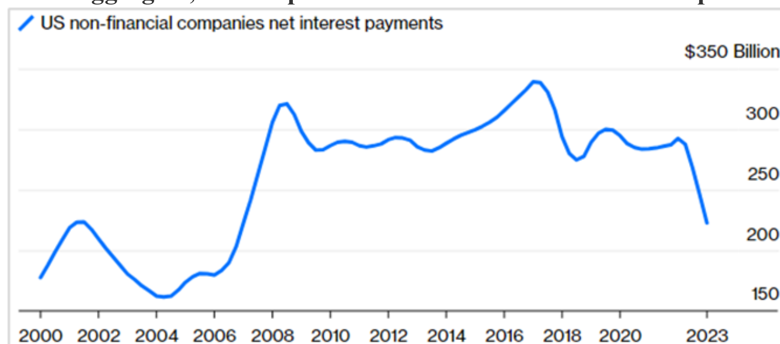
The Cost of Debt in the High Yield Market is 5.9%

The Cost of Debt in the Investment Grade Market is 3.9%

Source: Annandale Capital, Bloomberg

It is also worth noting that US corporations, entered 2022 and 2023 flush with cash. During COVID, corporates raised excess funds via long-term, low-cost debt and/or equity, so that they could weather the COVID recession that never materialized. As the Fed pushed short-term interest rates above 5.0%, that cash became a meaningful driver of earnings. This is particularly true for many large capitalization US corporates who have more cash than debt on their balance sheet. For instance, Google recorded almost $3 billion in interest income and only $314 million in interest expense. But income generated on balance sheet cash isn't limited to tech giants. Over the past 12 months, car makers Ford and General Motors were able to offset close to 100% of their interest expenses with income earned on their cash balances.

In Aggregate, US Corporates Have Lower Net Interest Expense

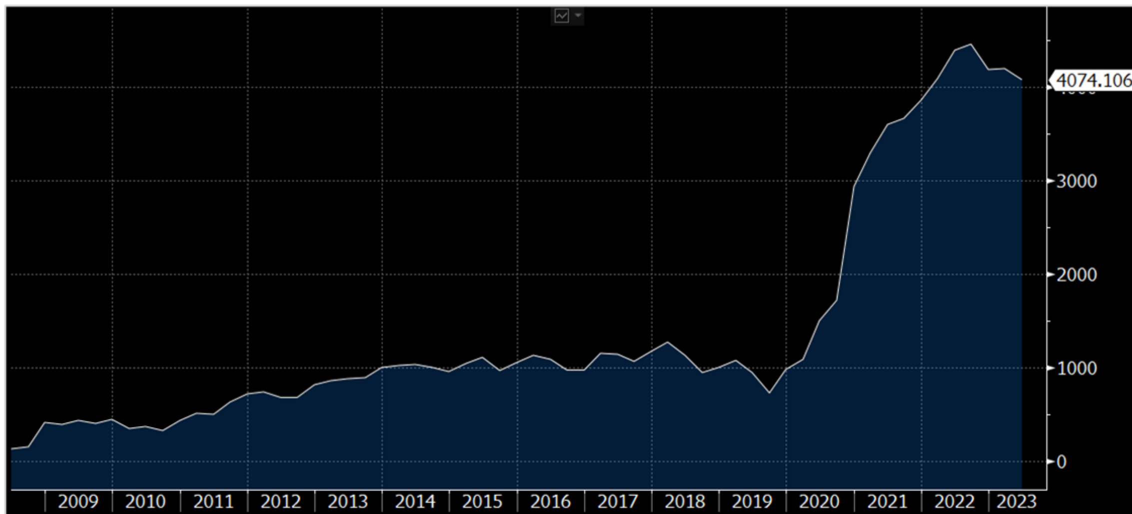


Source: Bloomberg

What about the state of the US consumer? If higher rates reduce the demand for goods and services, this is the part of the economy we need to worry about, as consumer spending accounts for almost 70% of the US gross domestic product. Fortunately, consumer spending has held steady despite interest rates on credit cards hitting their highest levels on record (data goes back to 1994). The latest personal consumption expenditures report showed 3.9% year-over-year growth excluding food and energy. If you include food and energy, consumer spending grew 3.5%. What's more, the weekly Johnson Redbook data suggests consumer spending at retail stores may have accelerated in the month of October.

Before this tightening cycle began, consumer balance sheets were at their healthiest levels in decades. The average US household's net worth is 7.8x their disposable income, up from 7.0x pre-pandemic. This is due in part to higher home prices, the largest asset held by most consumers, and a rebound in equity markets. Consumers are also flush with cash, US household cash and checking deposits sit at $4.1 trillion compared to around $1.0 trillion in 2019. And while the US savings rate has fallen to 3.9%, the excess cash sitting on consumer balance sheets has barely budged. Furthermore, debt service payments as a percentage of disposable income continue to sit near historic lows (excluding data aberrations driven by the pandemic like payment moratoriums).

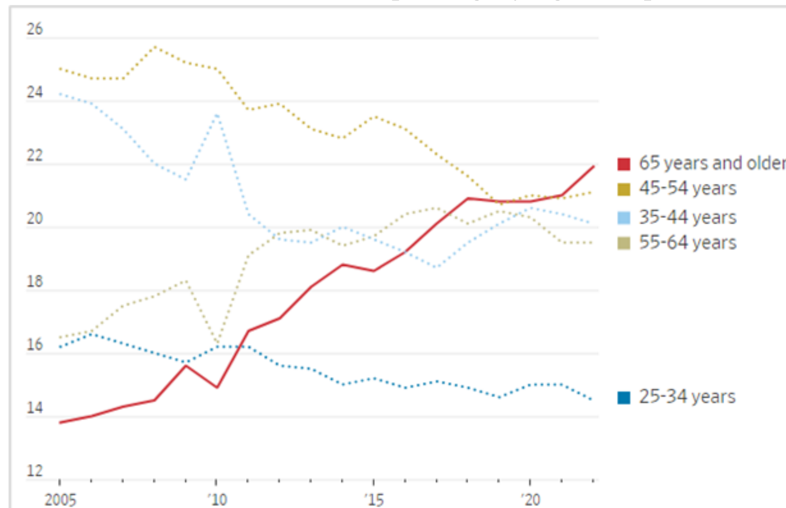
Household Cash & Checking Deposits sit at $4.1 Trillion



Source: Annandale Capital, Bloomberg

We would also point to the driving force behind consumer spending. Per the WSJ, "Americans ages 65 and up accounted for 22% of spending last year." 42.5% of consumer spending is from individuals 55 and older. These demographic cohorts are unique in that they can afford to spend and even run-down excess savings. "Americans ages 70 and older now hold nearly 26% of household wealth. Baby boomers alone have now amassed $77.1 trillion in wealth… they have less consumer debt, minimal student debt and are more likely to own their homes outright."

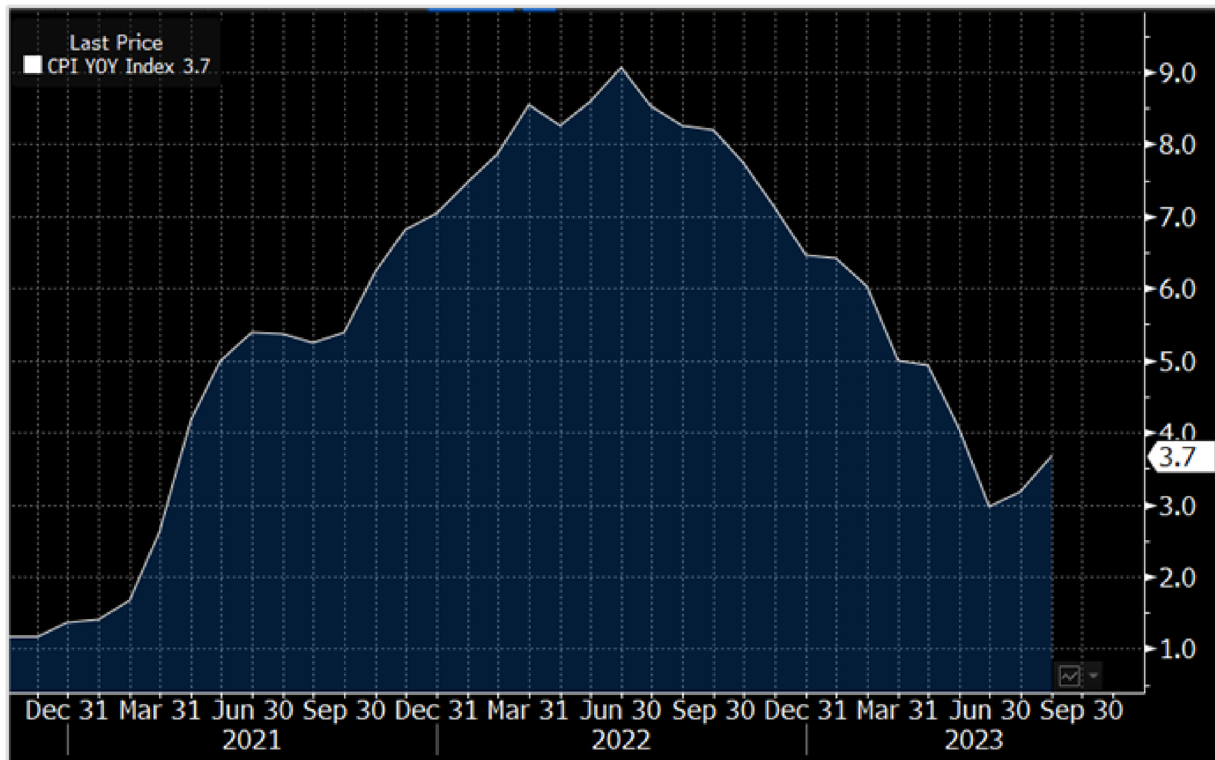
Share of Consumer Spending, by Age Group



Source: Wall Street Journal

We could continue to go line by line through the different channels of our economy, but the message doesn't change. Despite the torrid pace of rate hikes, there are little to no signs that tighter monetary policy is slowing economic growth. The proceeding decade of near-zero interest rates allowed individuals and corporations to shore up their balance sheets, term out debt maturities, and build cash buffers, which has reduced the efficacy of monetary policy. But this does not imply things can't get worse going forward. Monetary policy (in this case, rate hikes) operates with a lag, and that lag varies in length from one economic cycle to another, which poses a problem for policymakers like the Federal Reserve.

Inflation is Falling. Will the Decline Continue?

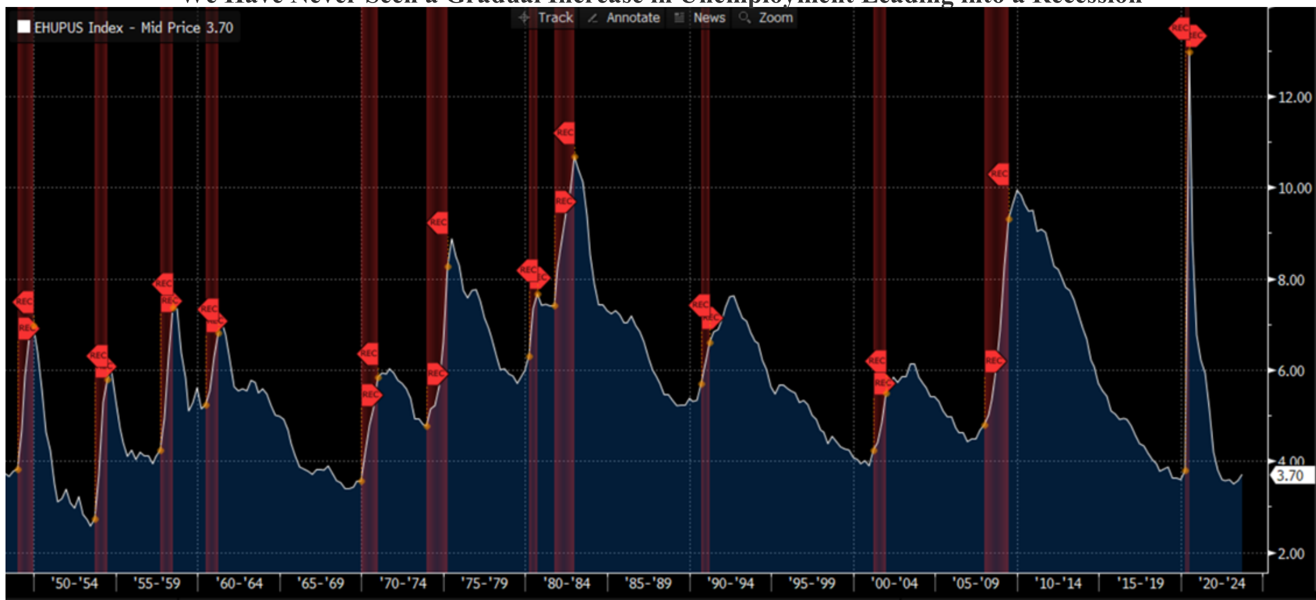


Source: Annandale Capital, Bloomberg

To date, the Fed has witnessed its desired outcome, lower inflation, but the Fed doesn't know if inflation's decline is attributable to their policy or other factors. The decline from 9.1% to 3.7% inflation could largely be the result of easing supply chain pressures, which have little to do with Fed policy. What if in a few months, we discover inflation expectations are anchored, there are no longer supply chain pressures, but the economy is still running hot? This is what the Fed wants to avoid. They want assurance that inflation won't reignite from the demand side of our economy, and the only way to achieve that assurance is to see signs of slack in our economy.

The labor market is the ultimate arbiter of whether Fed policy is working. When you create slack in the labor market, wage growth slows, and if wage growth is slowing, you can feel reasonably confident demand-driven inflation is off the table. Chairman Powell has consistently said, that *"weakness in the labor market is a necessary step in restoring price stability."* We wonder if he would even consider rate cuts, absent a pick up in the unemployment rate. The problem again has to do with long and variable lags. We know Fed policy takes time to transmit through the real economy, and to date, we haven't seen the negative side effects of higher interest rates. Compounding this problem is the Fed's focus on unemployment data as their preferred barometer of success. Economic downturns hit labor markets last. Layoffs are often used as a last resort measure, and this may be particularly true following COVID when labor was hard to come by. Said differently, by the time you see unemployment spike, we may already be deep into the recession and there is no turning back.

We Have Never Seen a Gradual Increase in Unemployment Leading into a Recession



Source: Annandale Capital, Bloomberg

We don't know what lies ahead for our economy six months, one year, or even three years down the road. Will the Fed's commitment to fighting inflation result in a hard landing, soft landing, or no landing? We don't know, and neither do they. At present, there are multitudes of money managers building portfolios predicated on one of those scenarios occurring. We think this is guesswork. We find it more fruitful to exercise humility and simply react to what the market has to offer rather than attempt to predict what's next.

The good news is economic prognostications are not a prerequisite to making smart portfolio decisions. Consider the following setup in the fixed income markets. Right now, the mortgage market and the investment-grade corporate bond market offer very similar returns. Mortgages yield 5.7% and corporates 6.0%. If interest rates (across the curve) climb 1.0% over one year, mortgages will lose -0.8% and corporates -0.7%. If interest rates fall by 1.0% over a year, then mortgages will return 12.0% and corporates 12.8%. But there is one key difference; mortgages are implicitly backed by the Federal Government and do not carry credit risk. If for some reason, a hard landing does occur, you face the real possibility that investors demand a higher return from bonds that carry the possibility of default. Credit spreads widening will hit corporate bonds but not mortgages. So why would you buy corporates over mortgages in today's market? Mortgages give you an almost identical return if we have a soft landing or no landing but will outperform considerably if we have a hard landing. This is just one obvious example of reacting to what the market has to offer rather than making portfolio decisions based on forecasts.

Conclusion

If you take anything away from our commentary, let it be this; great investing isn't about divining the future.

Very few people, if anyone, can consistently forecast the economy, and even fewer can translate those forecasts into actionable investment ideas. Who would have guessed that the 10 largest stocks would have carried the global stock market in 2023? Who forecasted an abnormally strong economy on the heels of eleven rate hikes? Or that in the presence of a strong economy, small-cap stocks would have negative returns year to date?

Great investing is about following a disciplined process and maintaining appropriate diversification across sectors, capitalizations, and geographies even when it is painful to do so. Great investing is about understanding the risks you are taking relative to your prospective rewards, and to do this you must be able to recognize what is already priced into an investment.

As always, we appreciate your support and welcome any questions you may have.

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