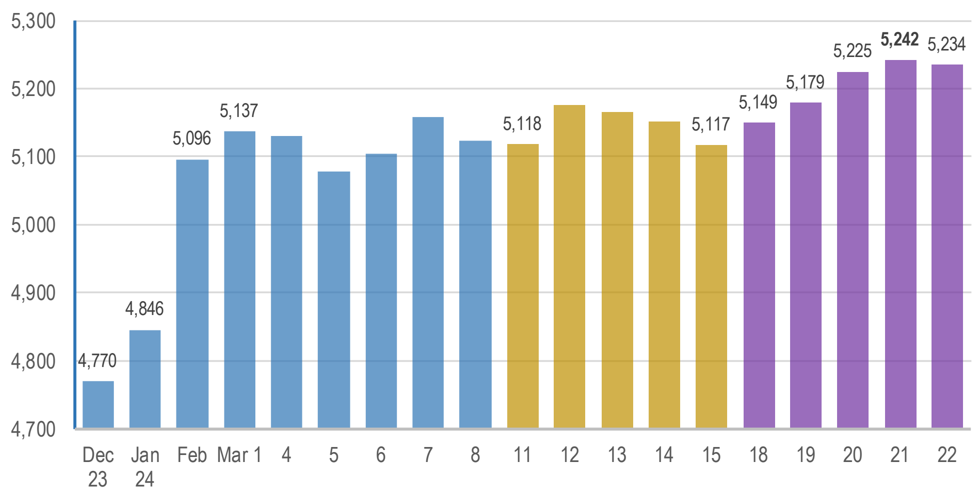
Rotation in Process

Weekender

March 23, 2024

Good morning and welcome to the *Weekender* for Saturday, March 23, 2024. It was another record-breaking week for the tech-heavy Nasdaq, while the S&P 500 and Dow closed slightly off their recent all-time highs. For the week, the S&P 500 was higher by 2.3%. The index trades at 21.7 times 2024 earnings estimates, yielding 3.2% in free cash flow. By comparison, the US government's two-year bond yield is 4.6%. The risk premia for stocks is negative and in very unusual territory. By contrast, the Nasdaq 100, including the largest technology companies in the United States, trades at 27.2% and generates a free cash flow yield of only 2.7%. We believe equities are very expensive. Investors have bid up equity prices, expecting earnings in the second half of 2024 and all of 2025 to grow by double digits, propelled by the fuel of artificial intelligence.

S&P 500 Index Levels
(Source: Bloomberg)



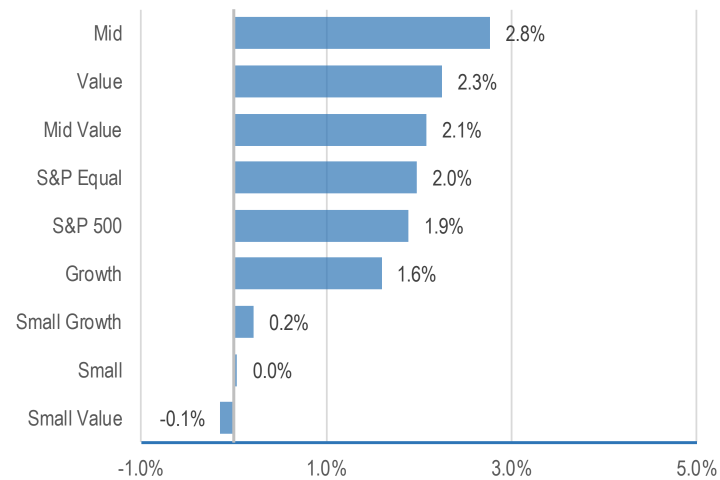
While we remain fully invested, we believe inflation, interest rates, over-levered consumer balance sheets, and spent savings are straining consumer budgets, which will all conspire to lower economic output in the quarters ahead.

For several months, we have discussed our expectations that buying demand will begin to rotate away from names close to peak valuations in favor of those that trade at a discount. Such a rotation has been slow, but it now seems underway. Comparing month-to-date returns shows outperformance in value versus growth and the equal-weighted S&P 500 versus its market value-weighted partner.

Index Month-to-Date Returns

March 1 - 22, 2024

(Source: Bloomberg)



The market for initial public offerings opened up last week when Reddit listed its shares. Its shares were priced close to the top of expectations and rose 48.4% on Thursday, the first day of trading, before settling a bit by the end of the week. Although Reddit has existed for decades, it has never been profitable. Most analysts expect it to eke out a minimal profit in 2024. Looking farther ahead to 2025, analysts believe the company will earn $128 million, a price-to-earnings multiple of 57.1 times. IPOs have been scarce for the last few years. While it's too early to tell if a resurgence is in the offing, if investors have an appetite, there is a backlog of punters waiting.

Pandemic winners Lulu Lemon and Nike have had some difficulty recently. Dedicated customers have checked their inventory and found they don't need more. They aren't alone. A large swath of retail is undergoing a two-part shift. Almost all buyers are moving away from full-price specialty products and toward value, where retailer margins are the thinnest. In more general terms, their demand across the board is softening. Shrinkage, the palatable way of classifying theft, continues to be a rising concern among retailers. Five Below reported earnings last week. They were particularly concerned about the rise in theft in their stores. Dollar General made similar comments the week earlier. Amongst less organized criminals, self-checkout enables many to walk out with products that were not scanned or paid for. It's increasingly likely that self-checkout's days are numbered, at least in some stores.

Retailer woes are manifest in the high-yield debt markets, where the yield on retail debt is now at 5.4%, almost double the 22-year average of 2.8%. Higher debt costs are adding to a general softening of margins in the space.

Economic Narrative

It was a light week for economic data, most of which we will discuss in more detail next week. As a prelude, labor markets remain strong, and consumers are resilient. Most notable is a resurgence in the real estate and new automobile markets. In the face of mortgage rates that are approximately double their pre-pandemic levels, houses are selling well again, and home prices continue to be firm in most parts of the country. While new car sales are still approximately two million units lower than their pre-pandemic levels, they are selling for close to the manufacturer's suggested retail prices (MSRP), supporting auto company margins and profits.

Next week's *Weekender* will have an extended analysis of the real estate and automobile sectors.

The Federal Reserve met last week and chose to hold rates where they were. In the comments, they signaled that inflation's tick higher in recent months is due to beginning-of-year data anomalies, which we believe carries some validity. However, what isn't an anomaly is that the economy, although slowing from solid growth in the last half of 2023, remains robust, and the labor market is fully employed. Interest rates are the most restrictive they have been in a generation. Lower interest rates will increase consumer spending, especially on things like real estate, automobiles, and durable consumer items, risking a pick-up in inflation in the months following rate softening.

Even so, the Fed is aching to lower rates as soon as the data can justify it. Right now, the Fed is courting

Goldilocks. Everything is just right. However, the long and variable lags from monetary policy that economists always discuss are likely to be more prolonged and more variable this time around due mainly to the continuing presence of the pandemic-era stimulus that remains.

We believe a higher unemployment rate is all the Fed will need to justify lower rates a few times by the end of the year. Unemployment rose from its nadir of 3.4 in January 2023 to 3.9% last month. The increase came mainly from a jump in the labor force as more workers came off the sidelines and decided to engage. That's a good thing. However, the Federal Reserve will feel justified in softening its restrictive stance if unemployment rises even a little.

Conclusion

That's all for this *Weekender*. Have a wonderful week.

Disclosure Statement