BLBB Advisors
FINANCIAL GUIDANCE SINCE 1964℠

QUARTERLY *review*

1ST Quarter 2024

Economic Update

Waiting for Rates to Reverse, Investors Embrace Risk

In the midst of the global financial crisis, legendary investor Warren Buffett offered this well-known nugget of advice: "Be fearful when others are greedy and greedy when others are fearful." Some 16 years later, Buffett's advice is still relevant. While we do not recommend a fearful approach to investing, we do believe it behooves investors to pay attention to the warning signs beginning to emanate from the U.S. economy and financial markets. The exorbitant amount of debt imposed on the U.S. economy over the last 15 years is another source of concern.

Pricey Stocks, Eager Buyers

Whether you call it greed, irrational exuberance or optimism, S&P 500 stocks are expensive—trading at an average price of 23.17 times earnings for the trailing 12 months in mid-March, up from 17.62 the same time last year. But these rich valuations have done little to dampen the enthusiasm of investors. On March 20, the Federal Reserve's decision to hold rates steady, with indications that it will cut rates three times before the end of the year, pushed the S&P 500 Index to its 19th record high in 2024, surpassing 5,200 for the first time ever, according to Dow Jones.

Stock prices generally reflect expectations for future earnings, and the general consensus appears to be that the future looks bright. "There is a lot of good news priced into the market," according to a Reuters interview with Michael Arone, the chief investment strategist at State Street Global Advisors.[1] Investors are predicting that inflation will cool down enough to convince the Federal Reserve that it's time to start cutting interest rates later this year, which could boost corporate balance sheets by reducing the cost of borrowing.

Of course, it is also possible that investors are ignoring the red flags and "screaming alarm" that say the market is significantly overvalued, as Investor's Business Daily reported in February.[2] At the time of that report, the S&P 500 was trading at more than 20 times projected earnings for the 12 months ahead, which is well above its five-year average price-to-earnings (PE) multiple of 18.9 and its 10-year average of 17.7.

There are essentially only two developments that can drive these types of steep increases in PE ratios. One is declining earnings, which does not appear to be happening according to preliminary earnings reports for 4Q23. The other is soaring stock prices, which is definitely happening. On March 19, the price of the S&P 500 Index was 31% higher than it had been just twelve months earlier.

However, while stock prices were steadily climbing during the first quarter of 2024, volatility remained subdued. Wall Street's most closely watched fear gauge, the CBOE Volatility Index (VIX), closed out in February at 14.33, just slightly below its average for the preceding 12 months.

What is driving this stark disconnect between stock valuations and market volatility?

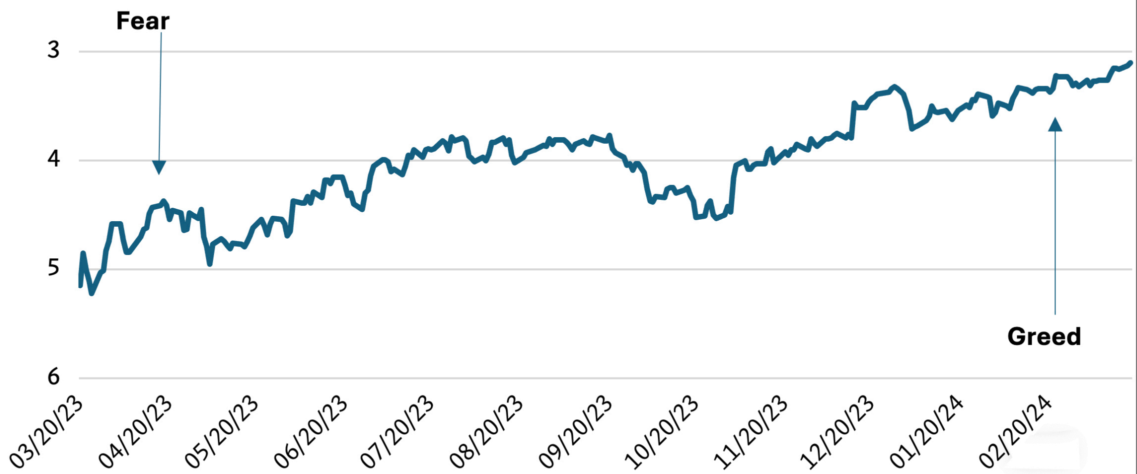
"Investors have become so used to stock prices always rising over the past 20 years that the old idea of buying low and selling high has been replaced by a faith in buying high and buying higher," BARRON'S explained in late January 2024.[3] "Chalk it up to the Fear of Missing Out."

CNN's Fear and Greed index, available on its website, paints a vivid picture of emotions that are driving the equity market today.[4] The bond market is also sending strong signals, as illustrated in the chart below.

Bond Investors Embrace Risk

March 2023 to March 2024

The Y axis on this chart has been reversed to illustrate an increased appetite for risk. Higher numbers toward the bottom show a wider spread between yields on high-risk (junk) bonds and Treasuries reflecting "fear." Lower numbers toward the top indicate a narrow spread reflecting "greed."



ICE BofA US High Yield Index Option-Adjusted Spread, Percent, Daily, Not Seasonally Adjusted

Source: Federal Reserve Bank of St. Louis
The ICE BofA Option-Adjusted Spreads (OASs) are the calculated spreads between a computed OAS index of all bonds in a given rating category and a spot Treasury curve. An OAS index is constructed using each constituent bond's OAS, weighted by market capitalization. The ICE BofA High Yield Master II OAS uses an index of bonds that are below investment grade (those rated BB or below).

Stubborn Inflation, Looming Debt

The backdrop to all this unbridled market enthusiasm is a U.S. economy that is fundamentally healthy but has some concerning symptoms.

The first is persistent inflation, which came in higher than expected in the first two months of this year. Consumer prices were up 3.2% in February versus the same month last year. But the shortfall did little to dampen animal spirits or lower expectations of rate cuts later this year. Also, the good news is that inflation has eased significantly since hitting a 40-year high in June of 2022.[5]

One of the key factors in the Fed's eventual decision to cut interest rates will be wage and salary growth. Average hourly earnings for all employees on private nonfarm payrolls edged up by 5 cents to $34.57 in February 2024, following an increase of 18 cents in January, according to the Department of Labor.[6] Another factor is the price of oil, which reached a four-month high on March 18 due to strong demand from the U.S. and China and announcements from Iraq and Saudi Arabia that they will trim exports over the next several months.

The view of the U.S. economy from 30,000 feet is not much more attractive. In late February, the Conference Board abandoned its longstanding warning that the U.S. was heading toward a recession, despite that its Leading Economic Index (LEI) was down for the 23rd consecutive month in January. That marked the second-longest decline in 60 years (the longest was during the global financial crisis). A senior analyst at the Conference Board explained that the recession forecast was called off because six of the 10 components that make up the LEI were positive contributors for the six months ending January 31.[7]

Finally, there are clear indications a looming debt crisis has finally caught the attention of everyday Americans. A report from the University of Michigan shows that consumer sentiment is closely aligned to good news and bad news about national debt.[8] In fact, the massive $34 trillion the U.S. has amassed in debt and the ever-present threat of a government shutdown inspired Bloomberg to release a mini documentary called America's Looming Debt Spiral. It shows "how the path back to fiscal prudence is getting harder—and that time may be running out."[9] The video is available on Bloomberg's website.

Finding Growth Opportunities

Despite these headwinds, ongoing geopolitical tensions, and uncertainty surrounding the upcoming U.S. presidential elections, we are not hunkering down.

In anticipation of the rate reductions that are coming sooner or later, we are broadening our exposure to intermediate-term corporate bonds and shorter-term Treasuries, locking in favourable yields in many of our clients' fixed income portfolios. In the equity market, we are selectively increasing international equity exposure as economic growth projections in developed economies outside the U.S. are strong, risks appear manageable, and valuations are relatively attractive.

One of the most valuable skills any financial professional can offer is investing with confidence, neither greedy nor fearful, when alarm bells are ringing. To that end, BLBB continues to actively seek out new growth opportunities, defend portfolios against existing and emerging risks, and help our clients move one step closer to their long-term financial goals.

If you would like to discuss this economic commentary or address any other matters associated with your portfolio, do not hesitate to reach out to your BLBB financial advisor (215-643-9100).

1 https://www.reuters.com/markets/us/us-stocks-may-not-be-bubble-pullback-could-be-near-2024-03-13/

2 https://www.investors.com/etfs-and-funds/sectors/sp-500-investors-ignore-screaming-alarm-saying-the-is-overvalued/

3 https://www.barrons.com/articles/stock-market-volatility-protection-d13eccfa

4 https://www.cnn.com/markets/fear-and-greed

5 https://www.bls.gov/opub/ted/2022/consumer-prices-up-9-1-percent-over-the-year-ended-june-2022-largest-increase-in-40-years.

6 https://www.bls.gov/news.release/pdf/empsit.pdf

7 https://www.conference-board.org/topics/us-leading-indicators

8 https://news.umich.edu/sentiment-rises-with-debt-ceiling-resolution-and-slowing-inflation/

9 https://www.bloomberg.com/news/videos/2023-09-28/america-s-looming-debt-spiral

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