



Rolling Recession, Interest Rates and Indexes

One of the pleasant outcomes from the Federal Reserve's recent aggressive rate increases is that after 12 years of historically low rates, we are finally finding reasonable rates for short and intermediate term fixed-rate investments. At the moment, money market funds, government bonds and CDs are all yielding in the 4 to 5 percent range which is great news for fixed-income buyers and balanced accounts. Our belief is that interest rates will likely remain higher for longer than most expect. This seems to be in line with Fed Chairman Powell's recent comments suggesting it might take years to combat inflation.

This year, equity investors have enjoyed a generally positive stock market trend even in the face of higher rates. Unemployment has stayed low, the Federal Reserve appears to have inflation under control, and the economy is continuing to grow, albeit at a slower pace. Entering the year, there were two schools of thought on the economy: one was a "hard landing" where the U.S. economy would experience a severe recession; the other, a "soft landing" where the economy would slow but continue to grow at a modest pace. We fell on the side of a soft landing or, at worse, a mild recession. What we have ended up with is a "rolling recession" where the general economy continues to grow but individual industries [and the stocks within them] do not.

This may be good news for some public companies, but not all stocks have risen. In fact, if you are not in the right industries, you might not be up for the year at all. For example, communication services and technology stocks are both up over 30%, while the rolling recession has kept consumer defensive, energy, financial services, healthcare and utility sectors down for the year.

The rolling recession has made the markets narrow with a small number of companies performing well. The seven largest companies in the S&P500 – Apple, Microsoft, Alphabet, Amazon, NVIDIA, Tesla, and Meta Platforms – account for over 25% of the index. All are either in the communication services or technology sector and possess artificial intelligence technologies. If you take these companies out of the index, the S&P500 is barely up for the year. The last time we had this much out-performance in these sectors and a narrow market it did not end pretty. Remember the dotcom meltdown. We do not think we are setting up for a market crash because these companies are all profitable.

However, we do feel that the stock market winners will broaden as the economy works its way through this rolling recession.

We mentioned earlier that the stock market had a generally positive trend for the year. Depending on the index, you will find very different performances, just like you find between different industries. For example, the Dow Jones Industrial Average (DJIA) and the S&P500, both tracking large US companies, have performed very differently this year even though their long-term performance is similar. Year-to-date the DJIA is up a little more than 3% year to date while the S&P500 is up double-digit.

The two indexes have behaved differently because of the way the indexes are constructed. This is easy to see when you highlight two companies from different industries with very different returns: UnitedHealth Group Inc (UNH) which is down 9.5% for the year, and Apple, Inc. (AAPL) up over 43%. The DJIA is a price weighted index so the company with the higher stock price affects the index more than a stock with a lower stock price. UNH has the highest price of any stock in the DJIA and makes up about 9.8% of the index. AAPL with a lower price is 3.6% of the index. This means UNH has almost three times the effect on the index as a similar move in AAPL. In contrast, the S&P500 is market-cap weighted; the bigger the company, the more of an effect it has on the index. AAPL is the largest company in the S&P500 based on its total size. It makes up 7.5% of the index. UNH, being a smaller company, is only 1.3%. AAPL has over five times the effect on the S&P500 as UNH. In summary, markets indexes tell a story but not always the entire story.

This has been a very interesting year in both the bond and stock markets. Bonds are more attractive than they have been in years, while the stock market has become narrow. Going forward we see interest rates staying higher for longer and the stock market widening out. During this time, it is important to stick to one's discipline and not let emotion drive your decisions. Trimming positions that have become over-weighted and being patient with good companies that have not moved forward this year will pay off in the long run.

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