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Ellumination Newsletter

"Separating fact from fiction since 1998. The antidote to Wall Street."

New all-time highs for stocks?

July 17, 2023

We've repeatedly reminded everyone that pessimism prevailed as the stock market started 2023. Recession forecasts were everywhere. It was consensus thinking that we'd experience a recession in 2023 and that the stock market would fall. The following paragraph was in our 2023 Outlook Ellumination:

"As this letter is being drafted the S&P 500 stands at 3818. (December 19, 2022) The most optimistic downside target we are seeing is 3600. The lowest target we've seen is from Dan Niles of the Satori Fund. He's talking about 2400 as a downside target, by mid-year. We've seen any number of managers that think we'll see downside targets in the 3000-3400 range, before the market starts to turn back up. How low the stock market goes depends entirely on whether or not we have a recession, and how deep that recession turns out to be. Our take is that downside targets of 3000-3400 currently make the most sense for the bear case."

There was only one bull that we know of at that time. That was Tom Lee of FSInsights.com. Tom was forecasting that the S&P 500 would rise to 4500, while everyone else was forecasting doom and gloom. Tom has been right so far and recently raised his 2023 year-end price target to 4850, conceding that 4900 is just as likely. Last Thursday, Goldman Sachs forecasted that the U.S. stock market will hit a new all-time high before the end of the year. The previous high for the S&P 500 was 4818, in January 2022. On the same day Peter Essele, head of portfolio management for Commonwealth Financial Network raised his target to 5000, another 11% gain from last weeks close.

This morning Ed Yardeni, head of Yardeni Research, said he believes we are already in a new bull market and the S&P 500 could "*potentially climb 20% in the next 18 months… to 5400*". (Source: CNBC.com)

Present circumstances cause us to ask two questions:

1. How did everyone get it all so wrong?

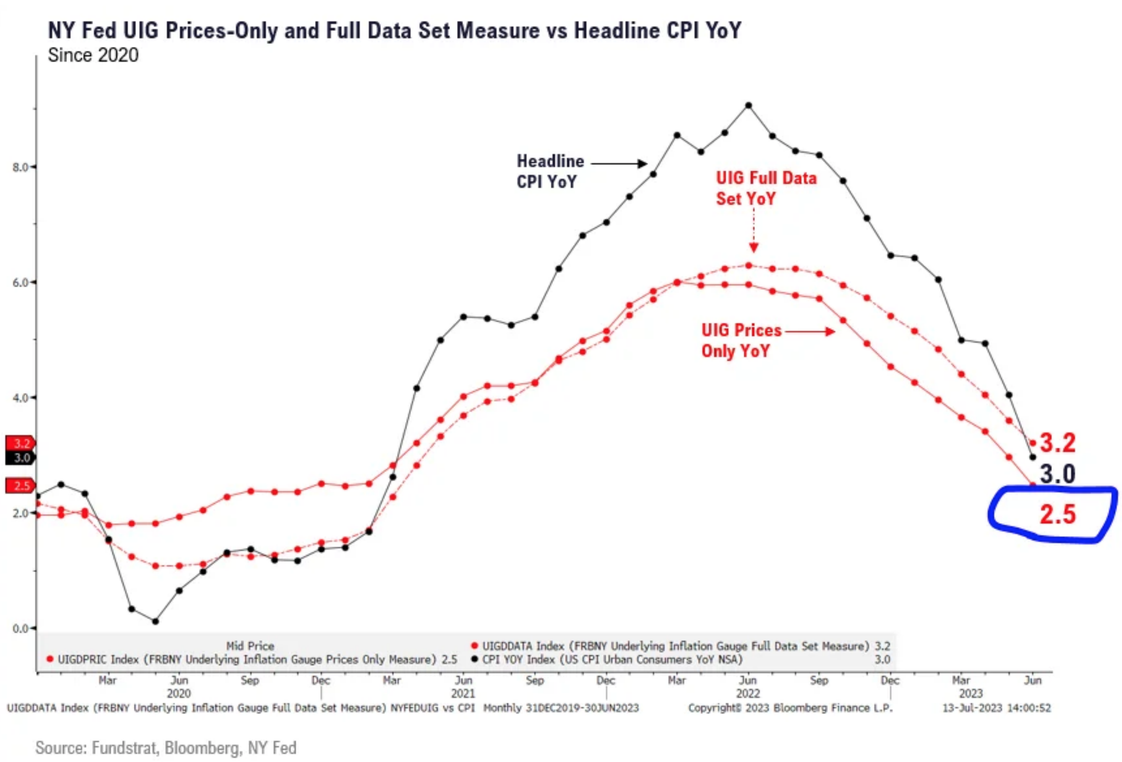
2. Is the new bullishness actually warranted?

In retrospect the answer to the first question seems simple. Everyone expected the Fed to raise rates too much, too fast, and throw the economy into recession. Given the hawkish tone of the Fed at the time, it wasn't an unreasonable expectation. In that December newsletter we included the following quote:

"Usually, recessions sneak up on us. CEOs never talk about recessions," said economist Mark Zandi of Moody's Analytics. "Now it seems CEOs are falling over themselves to say we're falling into a recession... Every person on TV says recession. Every economist says recession. I've never seen anything like it." (CNBC.com)"

Now its looking more like the Fed might have gotten it just right. Inflation is coming down quickly. Employment remains robust and consumer confidence is hitting new highs. On Friday the University of Michigan's consumer sentiment index came in at 72.6, the highest reading since September 21, and up from 64.4 in June 2023.

Here is a chart that clearly shows what is happening to inflation. Headline Consumer Price Index (CPI) is down to 3%. The Fed's Underlying Inflation Gauge (UIG) is down to 3.2%. The Producer Price Food Index (not shown) actually dropped year over year. That is the first sign of deflation.

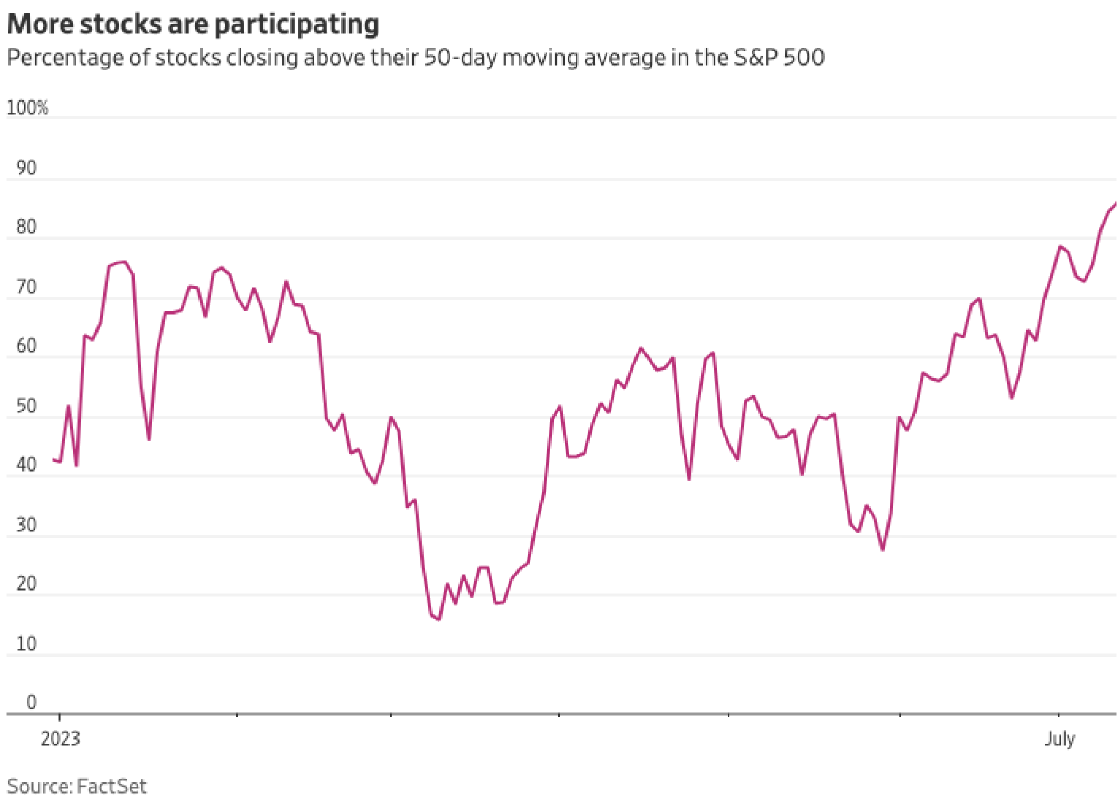


Source: FSInsights.com, July 14, 2023

Despite the fact that the S&P 500 and the Nasdaq 100 have been rising, bearish sentiment and rhetoric lasted well into Q2 of 2023. The U.S. economy grew only 1.1% in Q1 of 2023. That's not exactly inspiring. The Fed's rhetoric and tone remained extremely hawkish. That's not been inspiring either. The Dow Jones Industrial Average closed last Friday at exactly the same level it was at on December 1, 2022. That's not inspiring either!

Affirming that the new bullishness is warranted is still a matter of opinion, but there is broadening support for the perspective. It's widely known that most of the gains in the market were coming from seven stocks, including Apple, Microsoft, Nvidia, Amazon, Meta, Tesla, and Alphabet. The rest of the market was being left far behind. A market that is advancing because of only a few stocks is not a healthy market. That is another factor that has kept many skeptical as the S&P 500 and the Nasdaq 100 have moved up. In a recent letter to our Mendocino account owners, we said: *"If the rally is to continue it must broaden out and include much more of the overall stock market."*

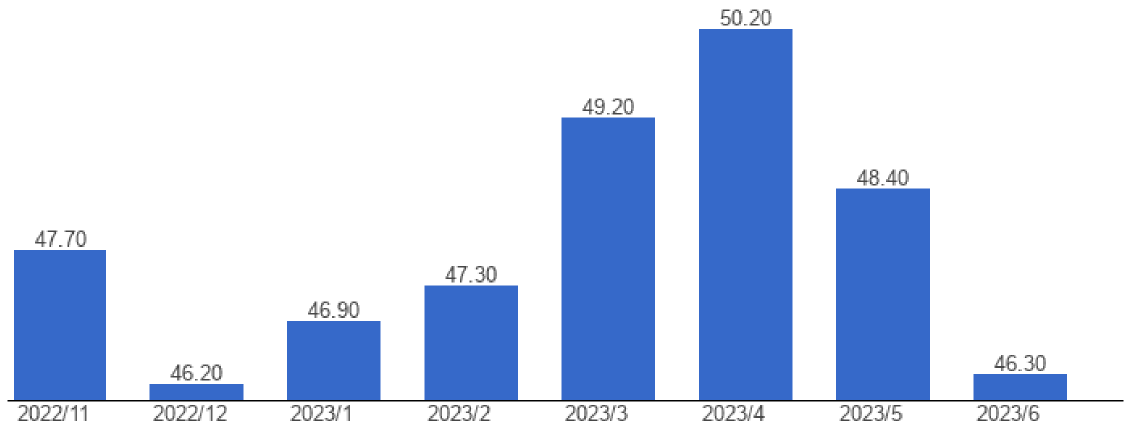
That is now happening. At the end of May less than 30% of stocks listed on the S&P 500 were above their 50-day moving average. The easy way to understand that, without being a market technician, is that over 70% of stocks were still in downward trends. See the chart below. In the past 6 weeks that has changed dramatically. As of last Friday's close, over 85% of stocks listed on the S&P 500 were advancing over their 50-day moving average. That's what you call a broad-based bull market.



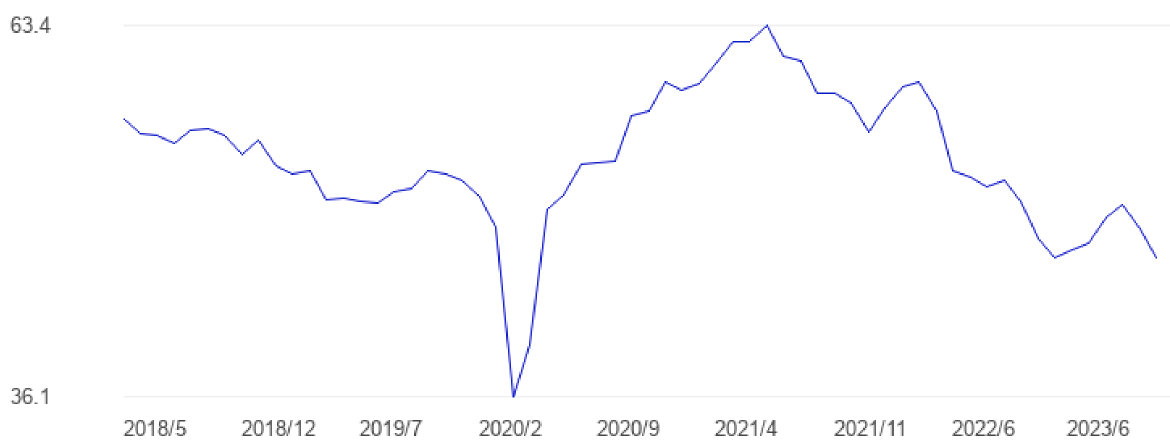
(Source: Wall Street Journal, July 14, 2023)

Yet fears of recession still linger. The Manufacturing Purchasing Managers Index (PMI) literally measures the pace of manufacturing in the U.S. Any number over 50 indicates that manufacturing is expanding. Any number under 50 indicates that manufacturing is contracting.

These charts clearly show the manufacturing PMI in decline. The bar chart shows the 7 months starting in November 2022 and ending in June 2023. This PMI struggled to get to 50 in April 2023 and has declined sharply since. The line chart below shows the PMI peaking in April 2021 and in a declining trend ever since. We read almost every day that the economy is in decline, and this is what is being referred to.



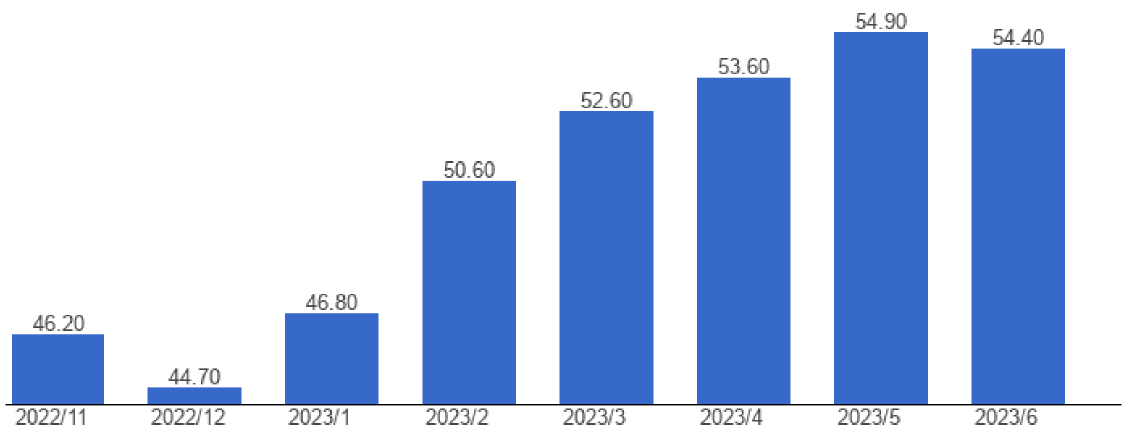
Longer historical series



Measure: index points
Source: Markit Economics

The Services PMI paints a somewhat different picture. It takes into account the business conditions in the services sector, such as employment, production, new orders, prices, and inventories. It also peaked in April 2021 and then fell to a low of 44.7 in December 2022. Since then, it has recovered and held above 50 for the past five months.

Recent values



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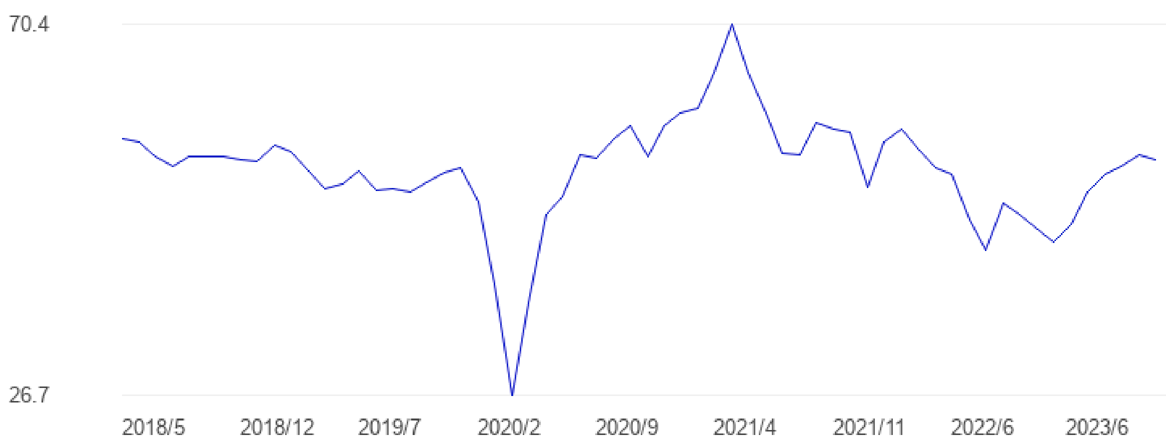

Measure: index points
Source: Markit Economics

Yardeni interprets the situation this way, " *I think the market was kind of overjoyed with a disinflationary soft-landing scenario. That seems to be what we are in. I've been thinking for quite some time that we're in a recession, but I argued that it's a rolling recession, not an economy wide recession. Now I think we're in a rolling recovery."*

Neither Yardeni, nor Lee, believe that the market will continue straight up from here. They expect corrections along the way. Lee's team thinks we may see one as early as next week. Technical indicators are showing much of the market to be quite stretched. FSInsights.com also fears a potential government shut down in October. Government funding is set to expire on September 30th, based on the recent debt ceiling deal between Biden and McCarthy. There are multiple reports that *"Republicans are pushing appropriations bills that come in at less than the levels to which Biden and House Speaker Kevin McCarthy, R-Calif., agreed.*

Democrats are warning this is putting Congress on a collision course with a funding lapse." (Source: GovernmentExecutive.com)

FSInsights.com did a webinar last week. A slowdown/correction in late July or August is on the table. But they'd be surprised if it is more than 3 to 5%. A potential government shutdown in October looms larger as a threat to markets—but it may not happen. Taking Yardeni's longer view may be the better way to go, using any corrections as buying opportunities.

To be fair, not everyone agrees with Lee, Essele, and Yardeni. Morgan Stanley's Mike Wilson remains the best-known bear on Wall Street, having recently reaffirmed his year-end price target for the S&P 500 at 3900, and an earnings decline of -16%. He does forecast a sharp rebound in earnings for 2024, and an EOY 2024 price target of 4200. Citigroup downgraded the S&P 500 on July 10th and set a new EOY 2023 target of 4000. This is what "makes markets". For every buyer there is a seller. For every seller there is a buyer.

Our own take at this point is:

- A correction would be welcome to knock some of the froth off the market. As Yardeni said this morning, *"I would like to see a civilized bull market here. I don't want this thing getting out of hand. And so, I am concerned about a melt-up because melt-ups are usually followed by meltdowns."*

- Tech, and particularly AI has done all the heavy lifting so far. If the bull market is to continue it needs to keep expanding.

- Marty Zweig coined the phrase "Don't fight the Fed". The Fed is almost done, and so far they haven't broken anything.

- Marty Zweig coined the phrase, "The trend is your friend, don't fight the tape". The tape is moving up.

- Marty Zweig coined the phrase, "Let profits run, take losses quickly". We've never argued with that.

- Buy the dips until the trend clearly changes.

All the best,

Paul

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Disclosure and Disclaimer - Updated last on December 11, 2019 by Paul Krsek:

All return calculations for the S&P 500 were done using https://dqydj.com/sp-500-return-calculator/unless otherwise noted.

All charts used in this newsletter are from Stockcharts.com and annotated by 5T Wealth, LLC

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