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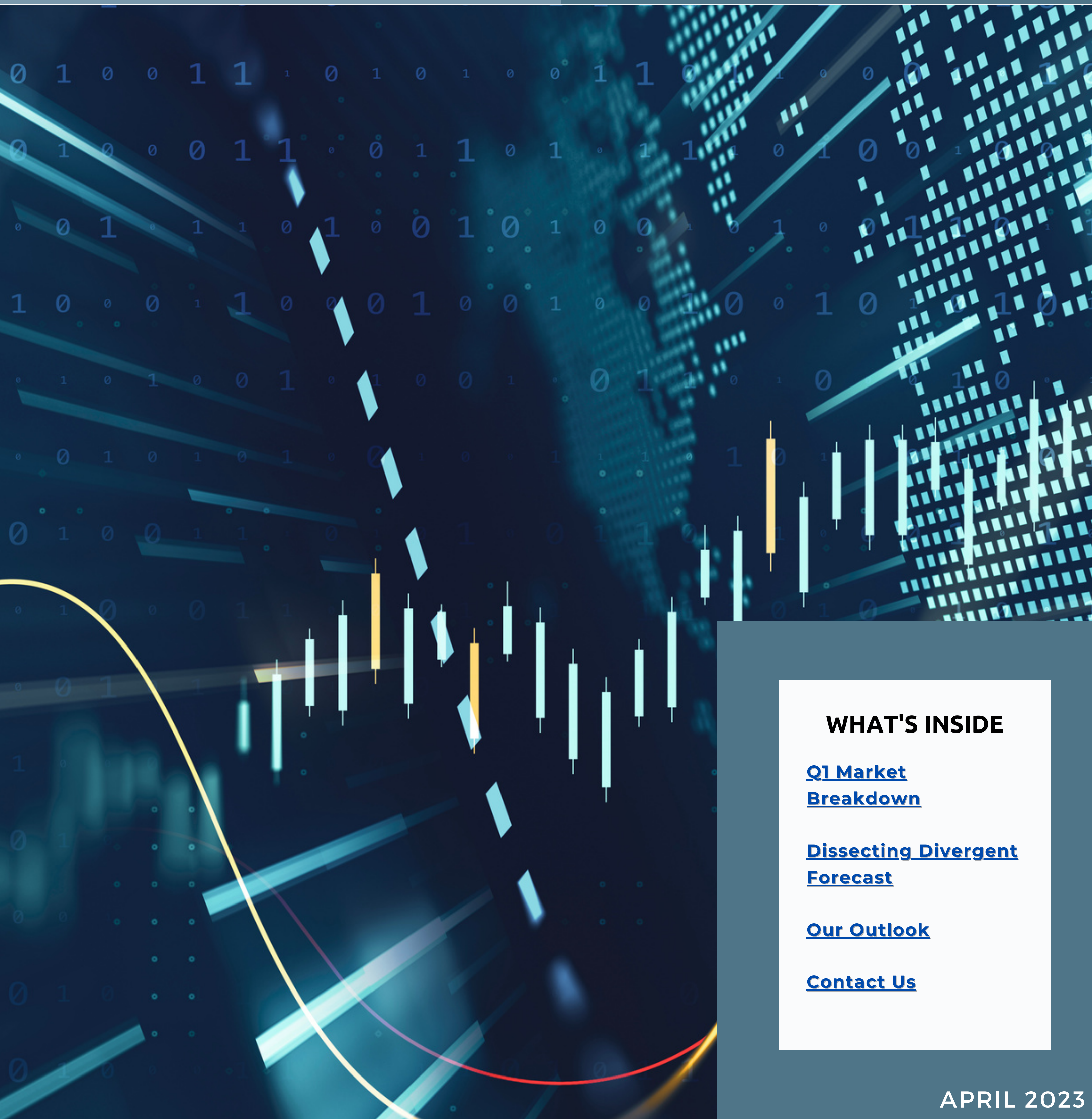
MORAN QUARTERLY ECONOMIC COMMENTARY



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The first quarter of the financial market brought many unexpected twists and turns. Congratulations are in order, if your Q1 predictions included a banking panic and a 39% surge in the FANG+ Index, including Facebook/Meta, Apple, Amazon, Netflix, Google/Alphabet, Microsoft, Nvidia, and Tesla. While market turbulence is typical in secular bear markets, the first quarter took many investors by surprise.

Q1 Market Breakdown: Surging FANG+ Stocks, Value Laggards, and Unforeseen Banking Panics

The new year started strong, with speculative growth stocks surging ahead. Indicators like the ARK Innovation ETF, Bloomberg Galaxy Crypto Index, and the UBS Profitless Tech Index help gauge investor speculation, and from January 1st to February 2nd, they rose by 42%, 49%, and 35% respectively. In contrast, high-quality, dividend-reliant value stocks lagged, with the Russell 1000 Value Index gaining only 1.0% in Q1.

There's no clear explanation for the spike in low-quality speculative stocks, which harkens back to the meme stock frenzy of early 2021. This trend suggests that investors have yet to reach the capitulation point typically signaling the end of bear markets.

In March, a sudden banking panic unfolded, with the second and third largest bank failures in US history occurring within four days. Panic-stricken depositors withdrew hundreds of billions from mid and small-sized banks, and the collapse of these institutions was astonishingly rapid. No bank analysts or experts foresaw this turmoil.

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Despite ongoing market volatility, most asset classes and stock indices remained unchanged by the end of the quarter, except for mega-cap tech stocks in the FANG+ Index. These stocks initially soared on hopes of a "soft landing" from the Federal Reserve and continued to rise during the banking crisis, as investors sought safe havens reminiscent of the 2020 pandemic.

The flight to safety saw investors flock to Utilities, Staples, and FANG+ stocks, as they did in 2020. These eight FANG+ stocks accounted for all gains in the S&P 500 index for Q1. Without them, the remaining 492 stocks in the S&P 500 would have been negative, making it challenging for stock pickers to outperform the index.

FANG+ stocks' high valuation multiples contribute to the S&P 500 Index's elevated P/E ratio, currently at 18.6x based on analysts' estimated earnings of $219 for 2023. This, coupled with flat earnings projections, suggests that the market anticipates a soft landing with no recession. However, factors such as rising labor costs, increasing interest rates, and tighter financial conditions imply shrinking profit margins. Q4's 12.7% profit margin still surpasses long-term averages, which historically revert to the mean.

Dissecting Divergent Forecasts: Equities, Bonds, and Commodities Signal Contrasting Economic Outcomes

While equities seem to predict favorable outcomes, other asset classes, including bonds and commodities, are pricing in more severe economic conditions. The inverted yield curve and expectations of falling interest rates indicate that the bond market is bracing for a moderate recession. Commodities like crude oil, copper, iron ore, and gold also point to a deeper recession.

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A significant discrepancy exists between the Federal Reserve's steady interest rate forecasts and the bond market's expectations for future rate cuts. The Fed's "dot plot" predicts a 5% Federal Funds Rate by January 2024, while the bond market anticipates a rate drop to 3.8%. These divergent forecasts imply vastly different economic conditions in the coming year.

Equity investors should carefully consider both outcomes. If the Fed's prediction is correct, it means inflation remains at 4-6%, well above the target 2%. The current S&P 500 multiple doesn't factor in sustained high inflation levels, as it seems to expect a return to 2% inflation soon. If inflation remains elevated, the P/E multiple could fall to 12-15x, a significant drop from today's 18.6x, as investors demand higher earnings yields to secure positive inflation-adjusted returns.

On the other hand, if the bond market is correct and the Fed aggressively cuts rates this year, investors should consider the potential catalyst for such a reversal. In our view, the Fed would likely pivot due to a moderate or deep recession, which would negatively impact earnings expectations. As such, investors should stay informed, monitor market conditions, and remain nimble in their investment strategies to adapt to the changing economic landscape.

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Our Outlook

As investors, we wonder how our analysis of the current investment environment affects our short-term market outlook. We anticipate elevated asset price volatility and foresee expensive growth stocks underperforming during the ongoing bear market.

We continue to find opportunities in low-valuation, high-dividend value stocks, as well as bonds and commodities. We advocate for a portfolio prioritizing high-quality companies with high returns on capital, moderate-to-low leverage, attractive valuations, and dividend yields to support share prices amid valuation multiple pressures.

In conclusion, our team remains vigilant in monitoring the stock market's fluctuations and adjusting our strategies accordingly. We recognize the challenges presented by the current market environment, and we are committed to helping you navigate these uncertain times. Please do not hesitate to reach out to anyone on our team with any questions or concerns you may have. Our priority is to ensure that you feel informed, confident, and supported in your investment decisions. Together, we will continue to seek opportunities that align with your financial goals and risk tolerance, positioning your portfolio for long-term success.

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