Outlook, Q3 2024
Traub Capital Management
July 2, 2024

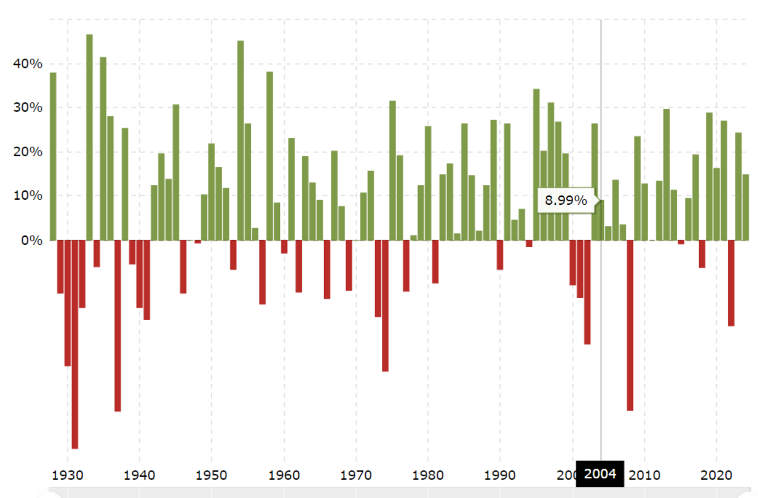
Bull Market Alive and Well with Room to Run

Since hitting a low point of 3,368 on October 10, 2022, the bull market in US equities is alive and well. The October low point was down 30% from the previous S&P 500 high of 4,808 reached on December 27, 2021. The widely followed index closed the current quarter at 5,460, up 62% from the low and up 14% from the previous peak. It took just over two years to recover from that peak. The average time it takes for the S&P to recover from its previous peak is about 1.3 years, so this time the recovery has been strong, but took an extra eight months.

Since the S&P 500 Index was created in 1957, there have been ten bull markets (defined as a rise to a point higher than the previous peak). Stock markets do not follow a time clock, but each and every one of the bull markets since 1957 have lasted at least 24 months.

Though the clock does not drive returns in equity markets, there are two things that do. First are the economic fundamentals. These are also alive and well, as we will detail below. Second is classic behavioral finance pattern where bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria (when nearly all investors are very optimistic, that often coincides with a market peak as investors are "all in" and there is less buying power left to push the market any higher.) Our assessment is that as of the past quarter, pessimism and skepticism have passed and we are now into the optimism phase, but markets are not yet euphoric. This assessment is also detailed below.

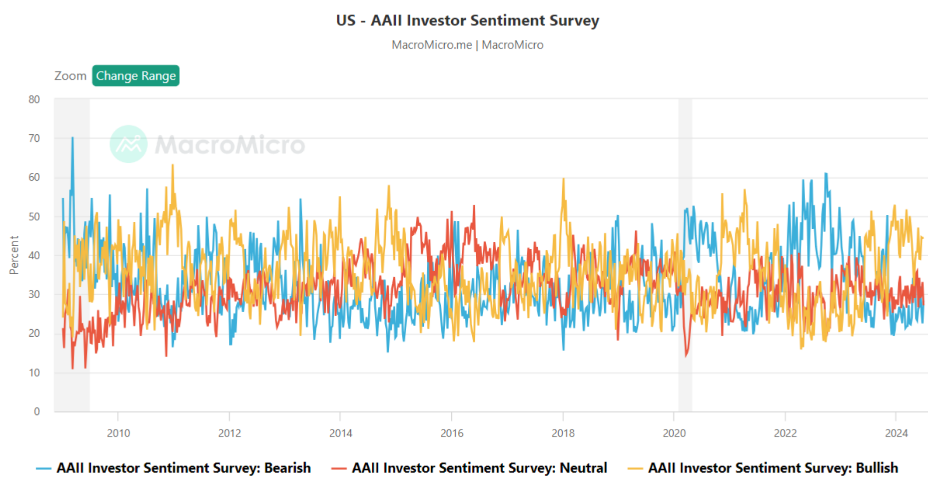
Yet, in spite of the run up so far, the equity markets have further room to run. At the end of June, the S&P 500 was up 15% for the year. This seems like a lot. The return of the S&P, however, has a lot of variation. See Figure 1 below with the S&P return from 1929, not including dividends:



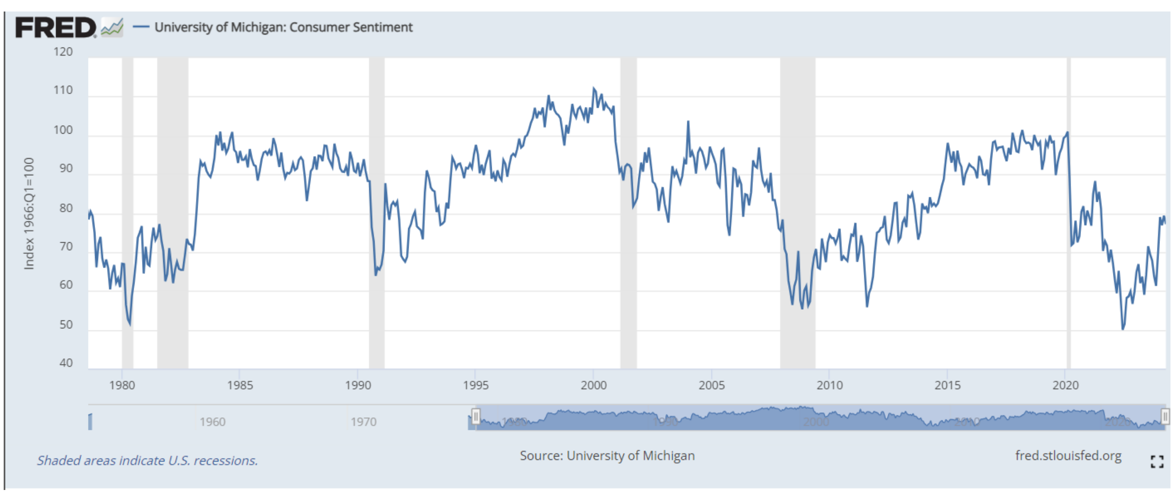
Annual returns over 15% occurred in 36 of these years or 38% of the time. So seeing an equity market return of over 15% is hardly unprecedented. We see this market maturing on optimism, giving the market further room to run.

Maturing on Optimism

Reliable measures of investor optimism are hard to come by. Below is the measurement from the American Association of Individual Investors. You can see there is a great deal of variation, but over on the right you can see the marked recent increase in the yellow line (bullish), and a concomitant decrease in the blue one (bearish).



Here is a chart from the University of Michigan on Consumer Sentiment:



Since hitting a low in June of 2022, it is up considerably, but the reading is far from the highs seen just before the 2000 tech bubble burst and just before the dramatic downturn in 2008.

Our own informal measurement is the number of optimistic headlines in the financial press. These are up markedly since February and the number of skeptical headlines has shown a reflective decline.

The conclusion is that the market has room to run and is far from euphoric. The increases we project are driven by economic fundamentals, which continue to improve as noted below.

Economic Fundamentals this Year so Far (and next)

Precise data for the US Gross Domestic Product (GDP) are issued quarterly. GDP was up 1.3% in Q1. We expect it to be up 2.7% for 2024, 3.3% for 2025 and another 3.5% in 2026. These projections are well above the Wall Street consensus. Our optimistic projections are based on the continuing high and improving levels of employment and thus the continuing low level of unemployment. Unemployment has run under 4% for two and a half years. This is the longest run since the 1960's that has featured a "full employment" economy.

The US population also continues to increase - by more than 20% just in this century. More people with more jobs means more personal income. More personal income means more personal consumption expenditures which drive corporate earnings. Personal consumption has increased fully 37% since the end of the pandemic and is up 1.7% through May of this year.

We expect labor productivity to be up 1.9% this year and more than 1% in both 2024 and 2025. Wages are increasing at a pace which is a bit higher than inflation, but the increased productivity is keeping overall labor costs well less than overall inflation.

Increased personal spending and net labor cost changes running less than inflation add up to increased corporate earnings. As we have detailed in past outlooks, we do not believe that the data collected on productivity properly reflects the impact of technology change. We believe that technology change is fundamental to our society and that it has been increasing for the last 20 years at a rate unmatched since the widespread adoption of the internal combustion engine in the 1920's. We further believe the positive impact of that technology change is not well captured in the work force labor productivity data and that our assessment of that positive impact is almost universally overlooked and underappreciated by Wall Street economists.

As a result, our forecast of corporate earnings is considerably higher than the consensus. Our target for corporate operating earnings for Q2 2024 is up 11.3%. This is contrasted to the consensus of Wall Street analysts of 8%[1]. Our forecast of S&P 500 operating earnings grows from $229 for the past 12 months to $290 for 2026. Wall Street analysts' consensus is for growth of 6% in 2025[2]. In contrast, we are looking for earnings to increase more than 10% in 2025 and a further 10% in 2026.

Better earnings will form a positive surprise factor going forward. This positive surprise will add to growing optimism resulting in further support for the current bull market.

Debunking the Derailers

Almost every economic projection that you will currently see is focused on inflation, the election and on the Federal Funds rate set by the Federal Reserve (Fed). Most

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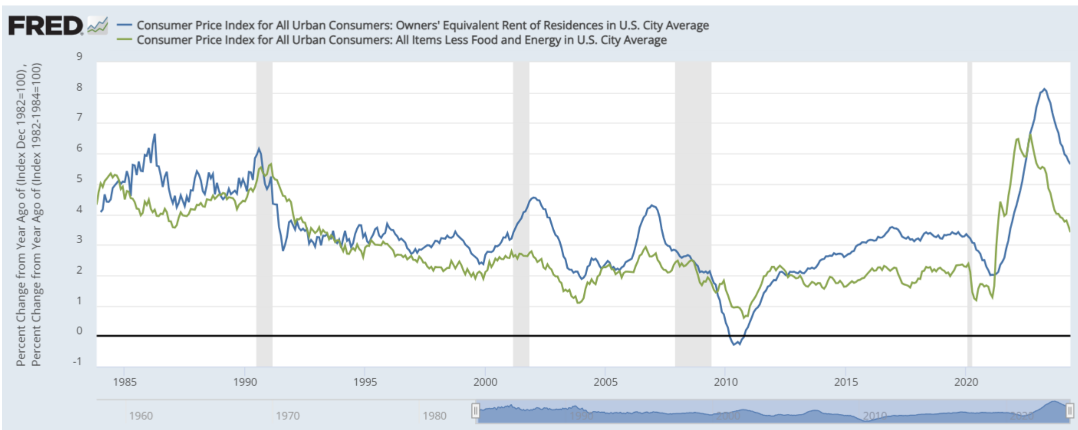
[1] Factset
[2] ibid

every economic projection sees inflation, the Fed and the election as forces to derail the stock market gains. Let us look at these in turn.

Our view of inflation is less sanguine than the consensus and the outlook of the Fed – both of which project inflation to be at 2% by mid-2025. We disagree. As outlined in a number of our previous outlooks, we believe that the inflation genie is out of the bottle and that it is very hard to get back in. As such, we believe inflation will be very sticky and will hold to nearly 3% through 2026.

One of the largest determinants of our measure of inflation is a housing cost proxy known as "Owner's Equivalent Rent". Owner's Equivalent Rent comprises fully 25% of the inflation index. The Owner's Equivalent Rent and inflation is shown below[3]:



The measure of rent is shown in blue and the measure of inflation is in green. You can see that every time that inflation gets to the level of 2%, the measure of rent is well under 3%. Rent decreases very slowly because leases are generally renewed just once a year. You can look at the graph and you will see that when the growth of rents is decreasing, the slope of the decrease is basically the same for the current decline as it was for the decline in the '90's, in 2002, and for the decline starting 2008. This rate of decline is about 2.8% per year. The current measure of rent increase is 5.6%. To get to under 3%, it will take another year (5.6 minus 2.8). We think that even if the Owner's Equivalent Rent gets down below 3%, inflation will remain sticky at about the 3% level through 2026.

Just as we have for years doubted the mainstream forecast of "recession pretty soon", we have doubted the mainstream forecasts of "inflation at 2% pretty soon". We have been right so far and we continue to doubt the mainstream forecasts. Our view of inflation is significantly higher than the Wall Street consensus and significantly higher than the Fed forecast. Both the consensus and the Fed show inflation down to 2% by the middle of 2025 at the latest.

In our Q1 outlook, we thought we would see three reductions in the Federal Funds rate this year. The consensus via the futures market at the time was for six cuts. Our outlook for Federal Funds rate cuts decreased to two by the Q2 outlook. The consensus held to the six cuts but spaced them out into 2025.

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[3] Federal Reserve Bank of St. Louis

Today, we think that two rate cuts may be in the cards for 2024, but maybe just one. For 2025, we would expect another one or two since we believe that inflation will hold higher than the consensus. In our opinion, one of the most important factors for equity returns is the level of the Federal Funds rate and not just the number of rate cuts. The Federal Funds rate is about 5.25%. As outlined in last quarter's outlook, interest rates in the 4% to 5% range have been the average and "normal" level for the last 45 years and the S&P 500 increased by more than 5,200 percent in that time. The important fact regarding the Federal Funds rate is that the Fed is not simply continuing to increase it while waiting for inflation to get back to 2%. We believe that inflation will level out at about 3% and that the Federal Funds rate will come down a little, but that corporate earnings will be fine under that scenario as long as the Fed does not simply keep raising. Continued raising looks pretty remote at this point.

The Rising Tide

A rising tide lifts all boats. And while it may seem that there is an entire ocean of investing options, the analogy does not hold. The S&P 500 Index presently is a very concentrated set of holdings, where the top 10 stocks comprise about 37% of the entire index. This is the highest concentration in decades, if not ever. These ten stocks are up over 25% this year, but the other 490 stocks in the index have grown just 2.7%.

And this is not a recent phenomenon as the strong gains in the market over the last quarter and really over the last few years have been largely driven by a handful of the largest stocks. In Q2, while the S&P 500 was up 4.3%, the equal-weighted Russell 1000 index ETF was DOWN 3.0%. Yes, despite a strong quarter for the "market", the average stock (of the largest 1000) was down notably! And despite the strong 15% return of the S&P 500 this year, the average stock in the Russell 1000 was up just 2%. And looking longer as in three years, the S&P 500 has returned 5% annualized, while the average stock in the market is up just 1%.

While the media would have you believe that the S&P 500 is a diversified, easy to own portfolio, this simply is not the case today even though it has been historically. Rather, it is a portfolio heavily weighted to under a dozen holdings. While it is always nice to hold a very concentrated position in equities that go up a lot, it is very risky, because those equities can also go down a lot.

Witness the S&P 500 index itself. In the 16+ years from February 1966 to August 1982, the S&P 500 showed an annual return of only 5%. But a better (and much safer) investment was holding cash (like a money market fund), as during that period it yielded a 7% annual return. In the nine-year period from April 2000 to March, 2009, the S&P declined an average of 6% per year. Again, even holding low yielding cash was a superior investment and small-cap US stocks outperformed the S&P by 5% PER YEAR on average for those nine years.

We believe that a diversified portfolio will yield more gain with less risk than a very concentrated one. Unlike the last 15 years where only owning the S&P 500 might have been a rewarding decision, we expect the next decade will show the benefits of diversification into other asset classes such as mid-cap, small-cap and non-US stocks. We would hate to see a repeat of a nine year or sixteen-year period when holding cash beats the S&P 500. As such, we recommend a diversified portfolio holding, not a concentrated one and we will not hesitate to recommend an increased position in cash, a shift to higher dividend stocks, or to increase the position in bonds when we believe that economic conditions dictate.

Election

It would be hard to write an economic outlook without taking a look at the upcoming elections. The nation, of course, will be electing a new president in November. In Congress, every seat is up for reelection.

In the Senate, there are 34 seats up for reelection. The Democrats presently hold and will defend 23 of those seats. Of these 23 seats, three are generally projected to be toss-ups and one is very likely to switch to the Republican side.

The Republicans hold and will defend 11 seats up for reelection. None of these are considered to be toss-ups and none will be likely to switch.

There are 100 seats in the Senate. Presently, the Democratic Party holds 47 of these and generally counts on support from four members registered as independent. This breakout represents the narrowest of majorities. In the election, control of the Senate is likely to switch from the Democrats to the Republicans, but the margin will be very small as it is today on the other side. Most polls indicate that control of the House of Representatives is similarly a toss-up.

We at Traub Capital maintain an independent assessment of the political landscape and do not favor one party over the other. Our assessment is strictly on a financial, rather than a political basis. This assessment is that with either party in the White House, the control of Congress will be sufficiently divided and contentious and that a divided Congress will prevent passage of virtually any substantial legislation. This includes substantial changes to the income tax code as well as substantial changes to the various entitlement programs, or substantial expansion of governmental regulations in all fields. We expect that the same knife edge control of the legislative branch will mean that uncertainty will lessen regarding redistribution of wealth. The election will, of course, also reduce the uncertainty of control of the White House. Markets do not like uncertainty, so less of it on all fronts will support further market strength.

Conclusion

Our conclusion at the end of the second quarter of 2024 is exactly the same as our conclusion at the end of the first. Namely:

> "The economy is stronger than the consensus expectation. Corporate earnings are stronger than the consensus expectation. Inflation is higher than the expected consensus and the stock market is higher than the expected consensus. However, the health of the economy, the gains in corporate earnings, the sticky inflation, and the gains in the stock market (albeit we expected somewhat less gain at this point in the year) are roughly in line with our expectations. We expect all of these trends to continue through 2024 when the general consensus will catch up to the reality. The markets will continue to climb the "wall-of-worry". Our forecast for the markets was on the high end and we expect for 2024 to finish up at a level higher than we see today."