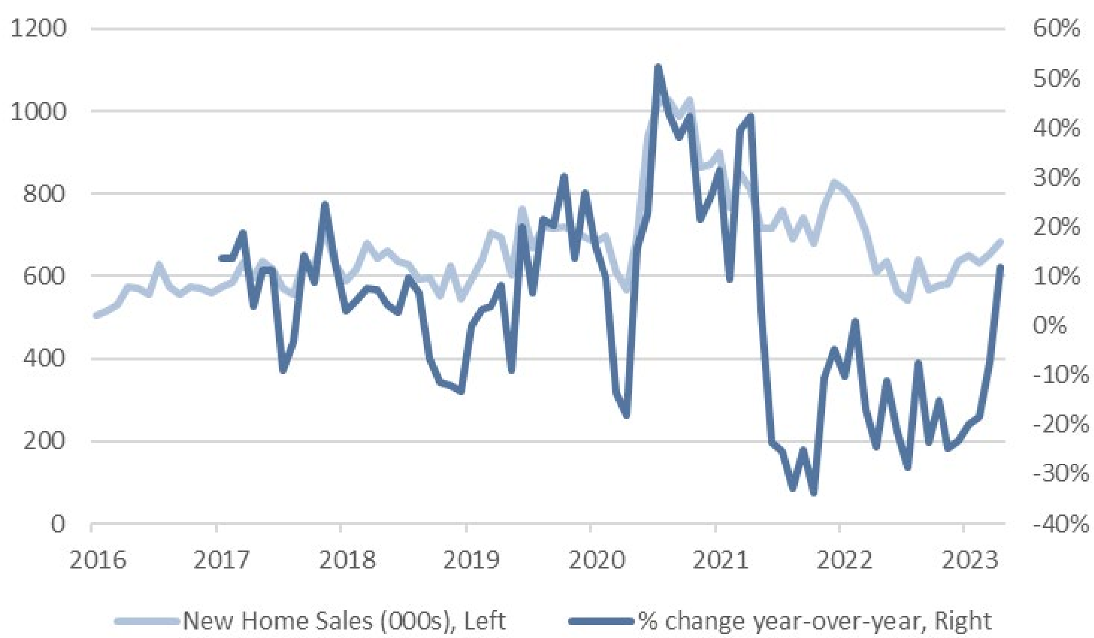
June 5, 2023

Economic Overview

May's economic data confirmed that recent banking sector turmoil and the debt ceiling standoff were only minor speedbumps on the persistent growth and inflation highway.

- Labor markets remain tight, and payrolls continue to rise rapidly (217k, 294k, and 339k in March, April, and May, respectively)
- Housing starts increased 2.2% month-over-month, and new home sales (one of the best leading indicators of the US economy) jumped to a 13-month high (Fig. 1).
- The feared banking credit contraction is, at worst, a slow burn rather than a sharp stop.
- Disinflationary pressures have stalled. Core PCE inflation was up 4.7% year-over-year and 4.3% annualized over the last three months.

Fig. 1: US New Home Sales



Source: Bloomberg, Mill Creek.

Most Federal Open Market Committee (FOMC) members continue to lean into another Fed Funds hike in June based on the strength of the economic data and market participants certainly now expect a more hawkish Fed than they did just a few weeks ago. The market implied Fed Funds Rate for December 2023 was 5.5% at the beginning of March, fell to 3.75% during March's banking turmoil, and has now risen to 5% (Fig. 2).

Fig. 2: Market-implied Fed Funds Rate, December 2023

Source: Bloomberg, Mill Creek.

Fixed Income and Equities

Interest rates rose across the yield curve in May as market participants priced in a resilient economy, higher inflation, and a hawkish-leaning Fed. The 10-year Treasury yield rose from 3.4% at the end of April to about 3.6% at the end of May. Investment grade and high-yield corporate credit spreads increased modestly during the latter stages of the debt ceiling standoff but finished the month slightly lower than they started.

The main equity story was narrow leadership within US equities. As we discussed last week, mega-cap growth is responsible for nearly all the gains in the US market this year and was the only broad part of the global market that performed well in the second quarter. As of mid-May, only 28% of the equities in the S&P 500 had outperformed the index versus an average of 49.7% between 2007 and 2022.

The significant performance dispersion has resulted in a similarly large valuation dispersion between large growth companies (mainly in the technology and consumer discretionary sectors) and literally everything else. For example, mega-cap growth stocks now trade 1.5x and 2.3x the forward price-to-earnings (P/E) and price-to-sales (P/S) ratios, respectively, of the total US market.

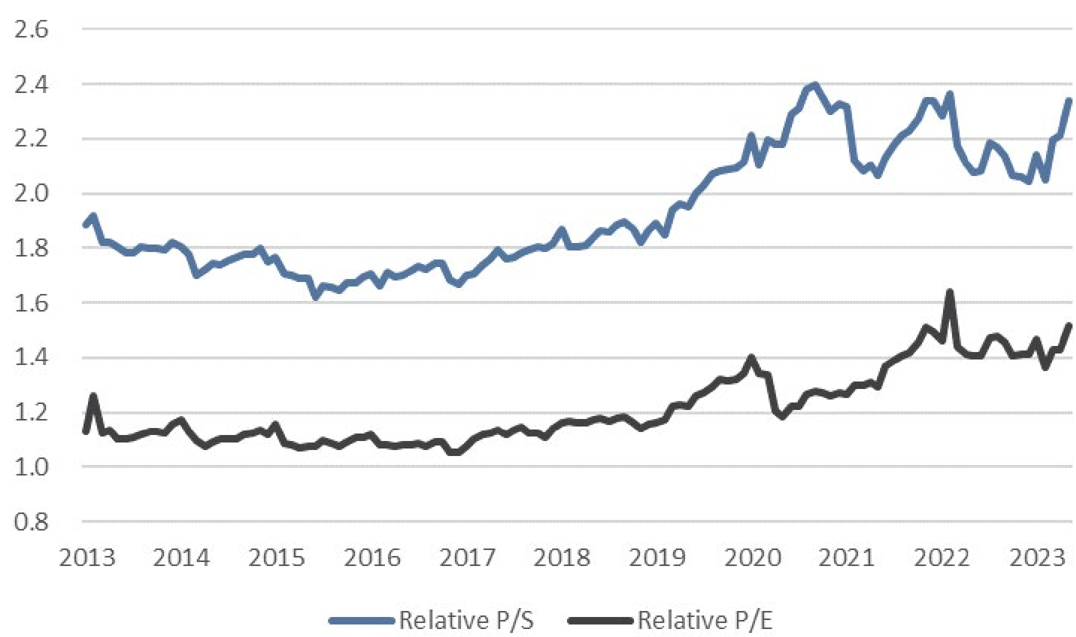
Several of the characteristics of the current cycle likely remind readers of the mid-to-late 1990s. Dare we call the current exuberance *irrational*?

A quote from Scott McNealy in 2002, reflecting on the dot com mania of the late 1990s, provides some perspective:

'At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?'

It's a rhetorical question of course. For context, the current tech darling NVIDIA trades 36x current P/S and 21x forward P/S, up from 10x in the fall of 2022.

Fig. 3: Relative Forward P/E and P/S Ratios, Mega Cap Growth vs. US Total Market



Source: Bloomberg, Mill Creek.

A Forthcoming Pause

While many FOMC members have struck a hawkish tone, it is notable that both Fed Chair Powell and his new Vice Chair Phillip Jefferson recently communicated a desire to pause rate hikes at the June FOMC meeting. On May 30, Jefferson said:

"A decision to hold our policy rate constant at a coming meeting should not be interpreted to mean that we have reached the peak rate for this cycle. Indeed, skipping a rate hike at a coming meeting would allow the Committee to see more data before making decisions about the extent of additional policy firming."

This framing of the cycle allows the FOMC to look through the current data but also signals that additional rate hikes are on the table if they are needed. We think the majority of the FOMC will get behind that message. **What does it mean for markets?**

1. The market has been expecting the Fed to pause and then lower interest rates near the end of 2023. At this point, the opposite is more likely to happen – a pause followed by additional hikes as dictated by economic data.
2. Higher-for-longer will be a headwind for equity markets and other risk assets as the prospect of tighter monetary policy hangs over investors through the summer and into the fall.
3. The yield curve will likely remain inverted for the remainder of 2023.
4. Perhaps counterintuitively, the Fed has reinforced its inflation-fighting credentials by signaling that additional hikes are possible after the pause. We expect the 10-Year Treasury yield to remain fairly range bound in the 3.5-4% range.

QUICK LINKS

- Concentration Conundrum
- Watch the Replay: Inside 'The Bogle Effect'
- Relative Strength of the Tech Sector May Wane as the Year Continues

This week's contributor: Michael Crook, CAIA

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