OUTCOMES
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BE CAREFUL WHAT YOU WISH FOR: STRONG MARKETS HAVE SET UP A PRECARIOUS SITUATION

May 2023

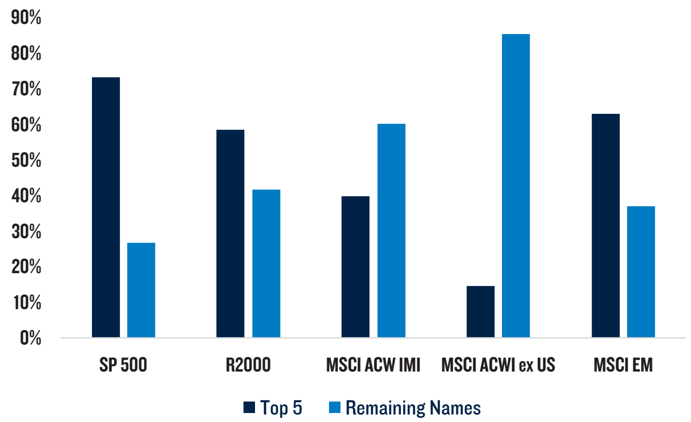
As I write this blog, markets are up strongly (Invesco QQQ up over 150 bps, the S&P 500 almost 100 bps YTD) on news there may be a deal to avoid the US defaulting on its debt. Let us, for now, ignore the frustration that such an event might even occur, and look at what is actually up this week in US large cap: Tech (Nvidia, Apple, Microsoft), the other tech – I mean Communication Services – (Netflix, Google, Meta), and the other, other tech – sorry, I mean Consumer Discretionary – (Amazon and Tesla). The rest of the index is…fine, with mixed results. What stands out is the narrowness of the market.[1] This has been a hot topic among industry PMs, so I looked into the make-up of markets for the year, around the world, and noticed a few things.

- **Five's a Crowd?** The top five names in the US Large Cap space are driving nearly 75% of the market returns YTD (Fig 1). These same names drive 40% of the total world equity markets (MSCI ACWI IMI)! It is not until we move down the cap space or away from the US that there is any sense of diversification within indices. Interestingly, Emerging Markets seems to be suffering a similar tech focus, driven by Taiwan Semi, Samsung, and Tencent.

- **Trouble in (Profit) Paradise?** Headlines have blared recently about the slowing down of consumer spending, highlighted by some startling data on household debt recently released by the NY Fed. Auto loan balances increased by $10 billion for the 1st quarter, student loans up $9 billion, and credit card debt didn't decrease (fig 2). That last part is particularly interesting, as commentators have noted, because consumers typically pay off their holiday debt in the first quarter – this is the first time in decades consumers have not done so.

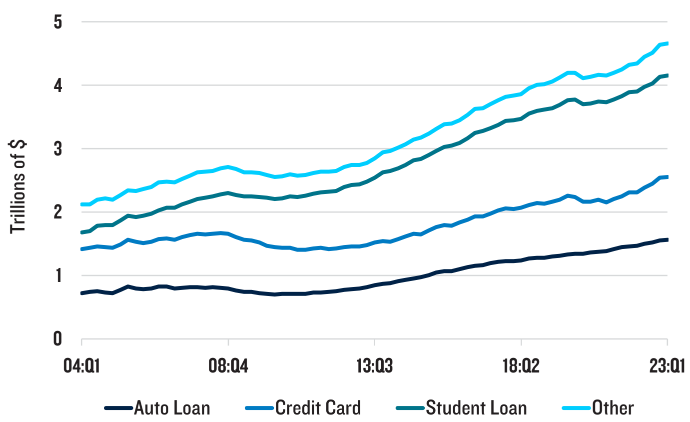
At the same time, debts moving to delinquency increased for credit cards and auto loans. Overall, delinquency rates are still low on an historical basis, but the trend is certainly upward. Consumers are also relying more and more on credit cards, with 35% of American's carrying credit card debt month-to-month[2], just as interest rates have spiked. As debts have risen, consumers have spent down their savings, which spiked during the pandemic (fig 3).

Figure 1: YTD Contributions to Index Returns



As of May 31, 2023 Source: Bloomberg

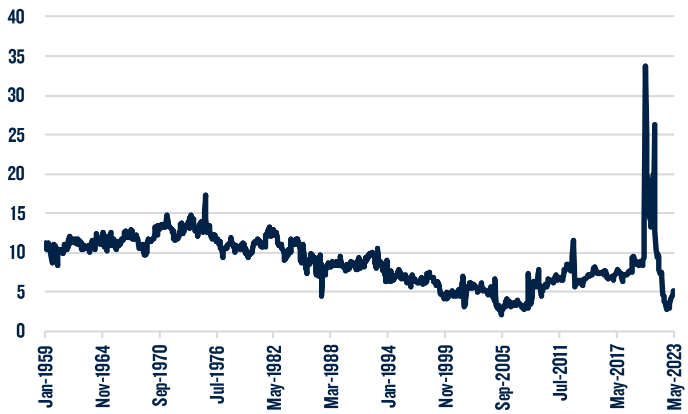
Figure 2: Non-Housing Debt Balance



As of May 31, 2023 Source: FRBNY Consumer Credit Panel/Equifax

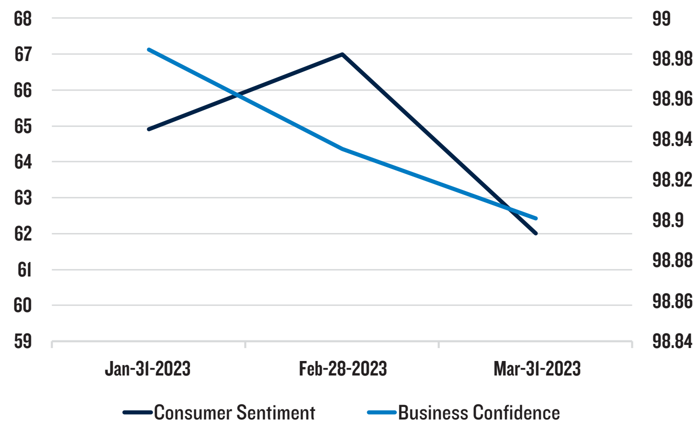
[1] All stock return and earnings data used throughout this note are as of May31, 2023 sourced from Bloomberg.
[2] "More Americans Carry Credit Card Debt From Month To Month Amid Inflation, Study Says", Fortune, May 31, 2023 https://fortune.com/recommends/credit-cards/inflation-has-led-to-a-credit-card-debt-crisis/

Figure 3: Personal Savings Rate



As of May 31, 2023 Source: Federal Reserve Economic Data

Figure 4: Consumer Sentiment vs. Business Confidence



As of May 31, 2023 Source: Federal Reserve Economic Data

It's not just consumers that are waving the white flag: Gold is up big this year, while a more diverse and economic basket of commodities is down. Both the supply side (businesses) and demand side (consumers) appear to be more pessimistic (Fig 4).

What is the take way, especially as it ties to the equities market? Loan defaults are up, savings rates are down, consumers are using credit cards and auto loans to spend money they don't have in a rising interest rate environment, manufacturers are depressed, gold is up, commodities are down – and equity markets are up? Yet most of the small number of stock leaders, such as Amazon, Apple, Google, Meta, are extremely consumer dependent – and are priced at high multiples (average of ~37x forward earnings estimates for these four). At the same time, the US Small Cap Russell 2000 index – the whole index – is priced less than Apple. My take? Markets overall have already priced in a recession, but stock indices, hiding behind a few large, profitable names, aren't reflecting that reality. If I had to guess, I'd predict equity indices transition to a risk off environment fairly soon, with the highflyers – still strong companies, mind – resetting to more realistic multiples. The equally weighted S&P 500 index (which of course still includes those same crowded names) has a forward P/E of ~15.5x, a number that seems both much more reasonable and better priced for a potentially shallow recession than the cap-weighted metric of ~20x. Diversifying away from the crowded few must offer more protection and better upwards gains once markets reflect the economic reality.

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