FVCM

U.S. MARKET REPORT

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July 28, 2023

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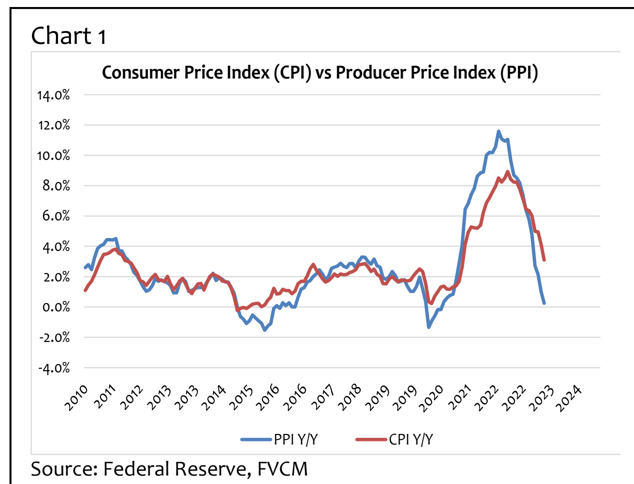
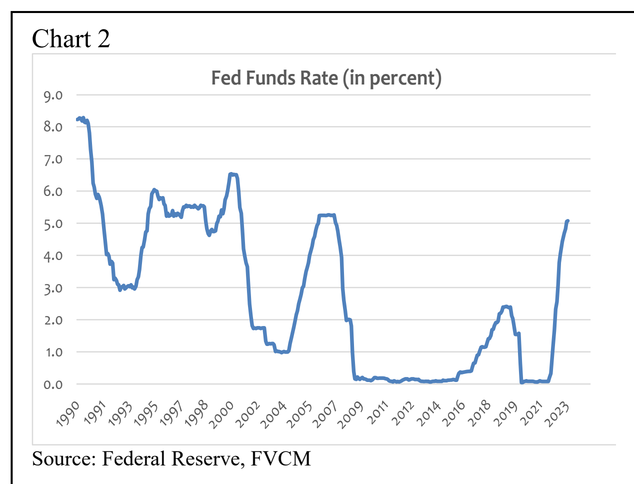
Main Points:

- Data accumulating that inflation is cooling quickly
- S&P earnings should benefit from margin expansion
- Stock valuation is high, but there may be a good reason
- Narrow leadership S&P performance concentration
- Indicators flash recession but contraction may be avoided

Inflation has been the primary problem facing the markets. Favorable data has been accumulating on that front. The consumer price index (CPI) increased a less than expected 0.2% (month-to-month) in June. On a year-over-year basis, the CPI was up only 3.0%, far below the 8.9% peak in mid-2022. That good news was followed by the report that the producer price index (PPI) increased only 0.1% in June and was up only 0.2% on a year-over-year basis. The continual improvement in inflation, especially producer price inflation, reflects a return to more normal operations following the pandemic. For example, big delays and high costs in commercial shipping have eased considerably, and the resumption of normal manufacturing operations, including in China, have relieved many of the supply stresses that impacted global manufacturing. Also, people are now fully out and about and service businesses such as the airline industry and restaurants are back nearly in full swing. Besides the return of manufacturing and services supply, credit for lower inflation goes to the Federal Reserve, which has been aggressive in tightening monetary policy and clear in its pronouncements that reducing inflation is priority number one. The Fed has thus far raised the overnight Fed Funds lending rate from 0% to 5.25% in just 16 months. In comparison, over the past 30 years, the next biggest increase was 4.25% over 24 months starting back in June 2004. The Fed has also been shrinking its balance sheet and allowing the money supply to contract.



Source: Federal Reserve, FVCM

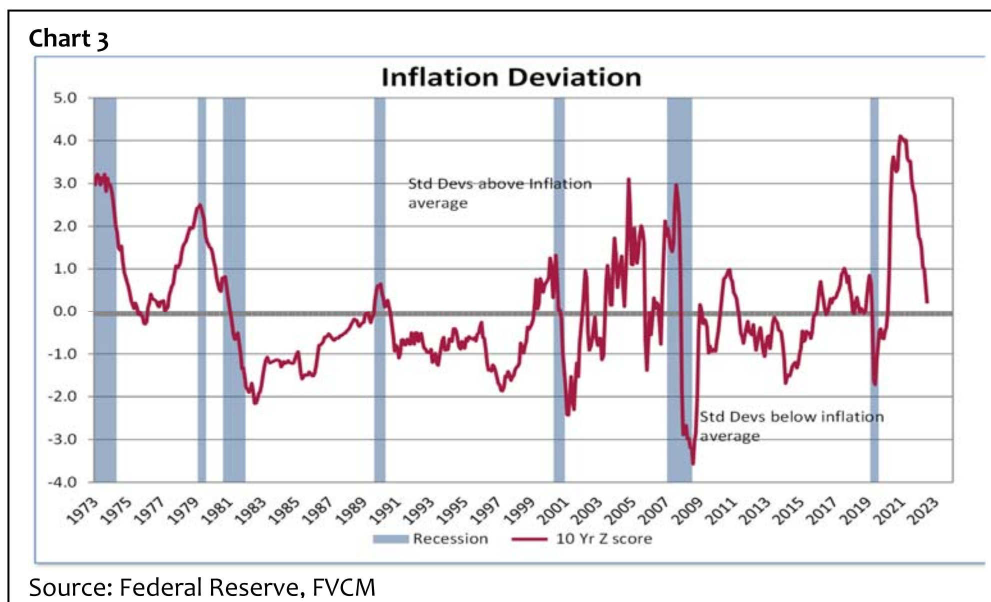


Source: Federal Reserve, FVCM

Because of sharply rising producer prices and contracting profit margins, earnings for the S&P 500 fell in 2022 despite an 11.9% increase in revenues. In contrast, margins and profits are expected to rebound for all of 2023. Sales for the first quarter of 2023 were up a very strong 9.1% compared to the first quarter of 2022. Operating earnings for the quarter increased only 6.4% to 52.54, as the profit margin narrowed slightly to 11.6% from 11.9%. Earnings for the second quarter of 2023 have just begun to come out, but we expect the profit margin to stay steady at 11.6%, which is an improvement from the depressed 10.9% margin for the second quarter of 2022. Similar improvement is expected for the remaining quarters of 2023 and for the full year we expect operating earnings to be 218.45, up from 2022's depressed 196.95.

Based on its recent price and our 2023 earnings estimate of 218.45, the S&P 500 has a P/E ratio of 20.9, which is obviously quite high. The stock market is trying to tell us something. By our analysis, this high P/E ratio is discounting two trends: 1. Continued earnings growth into 2024, and 2. That inflation will continue to fall sharply towards 1%. If inflation falls in this way and earnings continue to rebound, the current valuation makes sense according to our inflation-P/E regression model, otherwise not so much. Could inflation come down that much? During the 10 years prior to the pandemic, inflation in the U.S. averaged 1.8%. With the recent spike in inflation, the 10-year average is up to 2.6% and the standard deviation is 2.3%, meaning that inflation stayed within +/-2.3% of the 2.6% average more than 2/3rds of the time during the past 10 years. The inflation Z score chart below shows that inflation recently was 4 standard deviations above the mean but is falling fast. If inflation continues to decelerate at this pace, it would be less than 1% by year-end 2023. That seems extreme and we're not making that prediction, but the valuation of the S&P 500 would seem to suggest that we're heading in that direction.

Chart 3

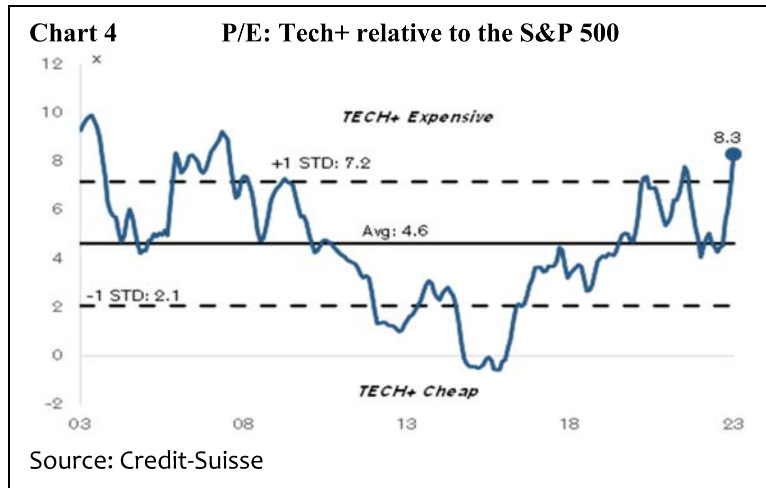


Source: Federal Reserve, FVCM

The performance of the S&P 500 during the first half of 2023 was dominated by the "magnificent seven." The S&P 500 was up 15.9% during the first half of 2023, but that performance was driven by these seven gigantic companies: Apple, Microsoft, Nvidia, Amazon, Meta Platforms (i.e., Facebook), Tesla, and Alphabet (i.e., Google). Those seven companies accounted for 12.2% of the overall gain, while all the remaining 493 companies accounted for only 3.7% of the gain. This stunning performance was triggered by Microsoft's

January announcement that it invested $10 billion in ChatGPT, the creator of a natural language artificial intelligence program. Artificial Intelligence has been under development for many decades, and it is not entirely clear that these natural language programs (Alphabet subsequently presented its own) will translate into immediate profits or whether they will, at least initially, be more of a cost center. Either way, these stocks have benefitted from all of the hype and the P/E of the tech sector is now more than one standard deviation above the mean. The seven individual names listed above look even more extremely valued. We would caution anyone considering the purchase of these shares at this point.

Chart 4 P/E: Tech+ relative to the S&P 500

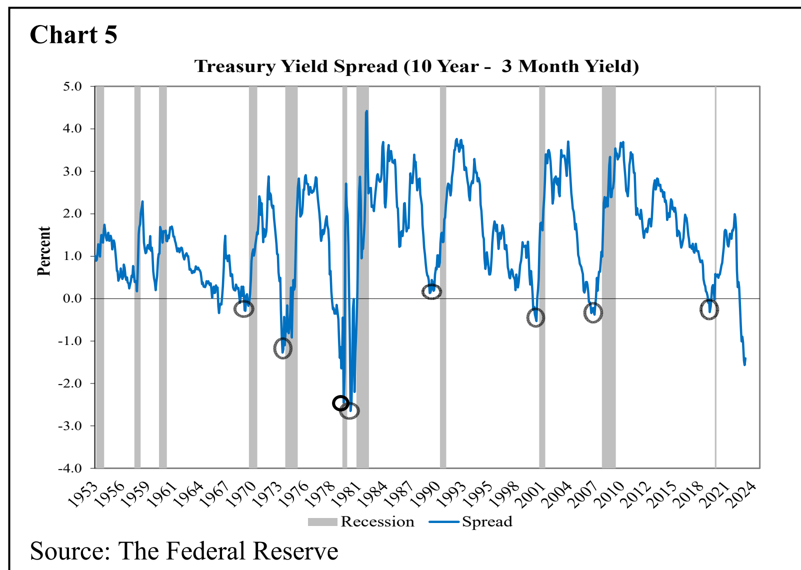


Source: Credit-Suisse

There continues to be speculation among market professionals about whether a recession can be avoided with a "soft landing," meaning low but positive growth. We are doubtful, but there is one interesting theory that may support the soft landing crowd. Bob Farrell, a famed Wall Street strategist who studied under the famous Benjamin Graham at Columbia University, had 10 rules for the stock market. Rule number 3 is that there are no new eras—excesses are never permanent. This rule would certainly seem to apply to the magnificent seven stocks and their performance this year. But, it would also seem to apply to the concept that we can avoid a recession since the Fed's monetary policy has been aggressively tight over the past months and in consideration of the strongly inverted yield curve. As shown in Chart 5 below, an inverted yield curve—when the yield on the 10-year U.S. treasury bond is lower than the yield on the 3-month U.S. treasury bill—has been a near perfect indicator for recession. Right now, the yield curve is more inverted than it was prior to the 2008/9 great recession. Hence, Bob Farrell's rule would suggest that this era is like all past eras and a recession has already arrived or is soon on its way. But there is one interesting theory that is worth pondering:

Robert E Lucas Jr. was a Nobel Prize winning economist whose theories may support the idea of a soft landing this time. Lucas argued that it is naive to try to predict the effects of a change in economic policy on the basis of relationships observed in historical data. Lucas believed people rationally adjust their expectations and behavior based on their changing understanding of the impact of economic policy. This reality was demonstrated in the 1970's with regard to the Phillips Curve, which says there is a tradeoff between inflation and unemployment. According to that theory, the Fed should be able to loosen monetary policy and drive down the unemployment rate so long as it was willing to accept a higher inflation rate. But two other economists, Milton Friedman and Edmund Phelps, correctly predicted that inflation and

unemployment would both rise in response to the loose monetary policy. They believed that workers expectations of price inflation would adapt to the Fed 's easy policy and demand higher nominal wages. As Friedman and Phelps predicted, the inflation rate rose from 2.5% in the 1960s to about 7% in the 1970s. At the same time unemployment rose from about 4% to above 6%. Now consider that we could experience something similar but in the opposite way. The common expectation is that the current tight monetary policy will bring inflation down but, in accordance with the Phillips Curve, the tradeoff will be higher unemployment (recession). But just as worker expectations quickly adapted in the opposite way in the 1970s, this time around we could get both lower inflation and lower, or at least not materially higher, unemployment. In other words, the Fed could successfully engineer lower inflation without triggering a recession so long as its anti-inflation credentials are credible and workers expect inflation to fall. This, of course, would be very Bullish for stocks and would explain the rise in stock prices this year. We will have to wait for the data to see whether this interesting hypothesis plays out this way, or whether Bob Farrell's rule #3 remains true.



Source: The Federal Reserve

We remain invested in equities and bullish on America and the stock market. Naturally, short-term movements are unpredictable. As already mentioned, we are avoiding the magnificent seven for now as they appear to be in the midst of a speculative frenzy and over-valued. The spike upward in the seven this year has been sharp, and a decline in these stocks could be even sharper. However, there are other areas of the market, particularly cyclical stocks like Industrial manufacturers and Energy stocks, that are attractively valued and have excellent potential for the year or two ahead. We think steady wins the race and a prudent strategy is to hold attractively priced stocks for investment, and gradually add to positions. The weighted price-earnings (P/E) of our portfolios is 13.9, far below the 20.9 for the S&P 500. The U.S. economy has shown amazing resilience and we expect inexpensive stocks will perform very well as the Fed completes its moves to bring inflation down to levels acceptable to investors and everyday consumers. Confidence in the economy will help broaden the number of companies that interest investors, and many neglected stocks will begin to shine.

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