U.S. MARKET REPORT

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- We think there is a risk of a further 10% correction in stock prices. If that happens, we will use cash reserves for stock purchases.
- An upward spike in 10 Year U.S. Treasury bond yields put downward pressure on stocks during the past month.
- Earnings for the S&P 500 are growing this year as margins rebound, but growth is expected to slow sharply in 2024 as recession prospects intensify.
- There has been a lot recently written that we are moving into a strong seasonal period for stocks, but we think that's mostly happy talk with little basis in reality.
- After a disastrous 2022, the magnificent seven's strong performance continued through the third quarter of 2023. When it ends, we're not sure. But at current valuations, we suspect that a repeat of 2022's performance for these stocks is again on the horizon.

Over the next months, we think there is some risk of a correction in stock prices as the reality of a recession becomes clearer. Market commentaries from officials of the Federal Reserve, asset managers and other analysts have continued to largely coalesce around the idea that the economy will avoid a recession and experience a "soft landing," meaning low but positive growth. As we wrote in some detail in our July 2023 report, the theories of Robert Lucas Jr., Milton Friedman and Edmund Phelps provide some weight that a soft landing is possible. However, the base case remains that there will be a recession. The Fed has successfully set expectations that it will do whatever it takes to tame inflation, but this will most likely only mean that a recession will be mild but not avoided. Big spending by the Federal government from the $1 trillion infrastructure law passed at the end of 2021 is helping to elongate the economic party so far, but the music will end soon we think. The Fed's interest rate policies, raising the overnight bank lending rate 5.25% in a mere 16 months, are clearly being manifest in slower bank loan growth, a declining money supply and other indicators. Continued strength in the labor market, which is taught in economic textbooks as a lagging indicator, is a distraction from the reality of financial tightness, which will inevitably lead to some contraction.

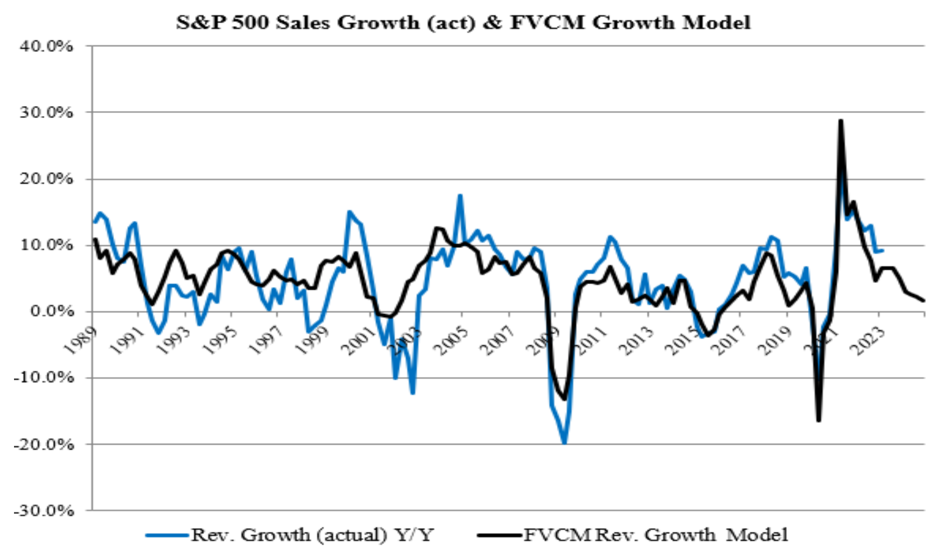
There has been a surge in the yields on 10-year U.S. Treasury bonds from 4.2% to 4.8% since early September thanks to good economic data, but we suspect that yields will be lower in six months, not higher. Late last week it was reported that nonfarm payrolls increased by 336 thousand in September, far more than the 162 thousand expected, and unemployment held steady at 3.8%. A few days earlier it was announced that the ISM Manufacturing PMI increased for the third month in a row to 49.0, nearly a neutral level after being below 50 for ten consecutive months. But upward blips in the PMI is not so unusual before recessions, and employment is a lagging, not leading, indicator (notice in Chart 1 how the unemployment rate doesn't reach its maximum until after the recession has already ended). Ironically, this good news regarding payrolls and the PMI has been bad news for stock prices as investors have taken profits out of fear that the Fed will have to tighten policy more than previously expected. Unfortunately, as economic data softens and yields start coming back down, we suspect that stock prices will remain under pressure in the near term as recession fears are heightened.

Chart 1

Source: Federal Reserve of St. Louis, FVCM

We expect sales and earnings for the S&P 500 to increase 2.3% and 1.5%, respectively, in 2024. These modest gains would follow our estimates that sales will increase 6.7% in 2023 while earnings will be up 13% thanks to a rebound in profit margins. Our revenue forecast is based on expectations that nominal GDP growth will continue to decelerate from 9.1% in 2022 to 5.7% in 2023 and 3.4% in 2024. At the same time, we are modelling little change in the dollar foreign exchange value going forward (a stronger dollar means weaker sales). In 2024 profit margins will likely contract somewhat as costs have to be spread upon a more slowly expanding revenue base. Our 2024 earnings estimate for the S&P 500 is 225.1, up slightly from 221.9 for 2023. The S&P 500 is currently trading at 19 times the 2024 estimate, and is not cheap. But, of course, that P/E ratio is distorted by the high valuations of the super large cap "magnificent seven" (see below). For example, the P/E for our client portfolios is only 12.7.

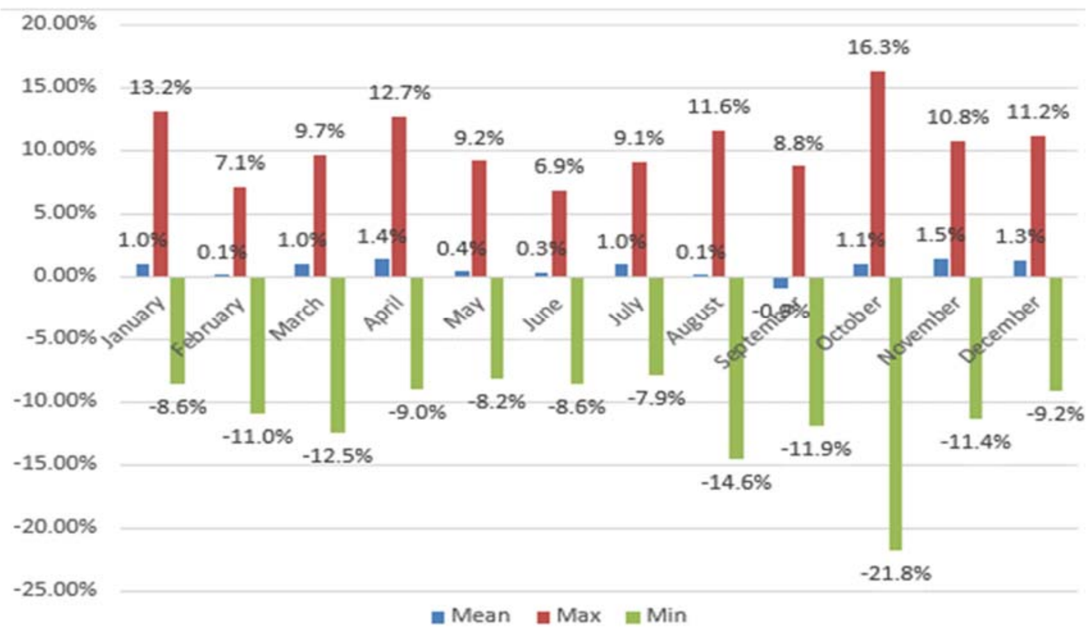
Chart 2



Source S&P Global, the Federal Reserve of St. Louis, FVCM

There has been much recently written in the financial press that we are moving from the weakest time of the year for stocks to the strongest. We've looked at the data and are sorry to report that this is weak soup. It is true that, based on data since 1970, September is the worst month of the year for the S&P 500 with an average return of -0.89%. However, the standard deviation of returns (which tells you +/- range from the average where about 2/3rd of all returns fell) was 4.5%! There was one month when stocks had negative 11.9% return in September, but there was also a month when returns were positive 8.8%. In comparison to this wide range of outcomes, we'd say that the -0.89% average does not convey much meaning. Similarly, the month with the best average return has been November at +1.5%. However, the standard deviation was also 4.5% and the range of outcomes was +10.8% all the way down to -11.4% (see Chart 3). What this analysis tells us, is that talk of seasonality tells us pretty much nothing. Let's focus on economic, business and stock fundamentals instead.

Chart 3 **Average/Min/Max Returns of S&P 500 by Month since 1970**



Source: Factset, Federal Reserve, FVCM

The stellar performance of the "magnificent seven" extended though the end of the 2023 third quarter, but that is a bull that we don't want to ride. As of September 30th, those seven stocks, Apple, Microsoft, Nvidia, Amazon, Meta Platforms (i.e., Facebook), Tesla, and Alphabet (i.e., Google), contributed 11.0% of the S&P 500's year-to-date total return of 13.1%, with 493 companies responsible for the remaining 2.1%. As we previously reported, the dominance of these seven companies on the S&P 500 performance reflects a frenzy that was touched off in January after Microsoft's announcement that it invested $10 billion in ChatGPT, the creator of a natural language artificial intelligence program. But keep in mind, in 2022 these same seven companies had big losses with total returns of Apple (-27%), Microsoft (-29%), Nvidia (-51%), Amazon (-50%), Meta Platforms (-65%), Tesla (-66%), and Alphabet (-39%). Because of the dominance of these big stocks on a market capitalization weighted index like the S&P 500, our portfolio returns can often be little correlated. We focus more on value and medium-sized companies that have potential for earnings growth over many years, rather than the popular, "hyped," high valuation stocks that can have intermediate periods of high volatility versus the rest of the market. We will stick with the fundamental, comparatively low volatility strategy we've been using since 1992 and continue to avoid the hype sequences.