The Fed Taps the Brakes Again, Investors Take Note

It's reasonable to attribute the second quarter's strong close to the pause in rate hikes announced by the Fed in mid-June. Q3 built on that strength as investors anticipated an extension of that pause at the July meeting. Alas, that proved to be wishful thinking as the pause became a mere skip, the Fed announcing a 25bp bump in the Fed Funds rate. Several sessions later the market posted its most recent short-term high in July, from where the market (S&P 500) has peeled off almost 5% in the first weeks of August while the NASDAQ is off more than 8%. Investors have focused on a number of concerns, all considered within the context of uncertainty over the Fed's timeline and ultimate target rate as it addresses what appears to be a slowing in the decline of inflation.

First among those concerns is the glaring lack of breadth in this year's market advance delivered courtesy of the *Magnificent 7* ("M7"), as they're called. They are familiar names: Microsoft, Apple, Google, Nvidia, Meta, Tesla, and Amazon. The outsized advance of those mega-cap stocks propelled the NASDAQ to a return of 40% at its July peak, more than double that of the S&P 500. The P/E multiple of those seven at their peak is nearly double that of the remaining 493. That explains why the market (S&P 500) appears to trade at or near the high end of its historical range. As you might expect, that raises concerns about valuation. However, among the other 493 there are a vast number of fair-valued, even undervalued, issues.

Reported earnings, by most accounts, have been deemed better than expected. But, what about those expectations? Consensus estimates for 2023 point to an increase of only 1-2% over 2022. While that's a low bar, the YoY *decline* of earnings in the first half has created some suspense for investors. Earnings performance in the second half is predicted to be positive with the bulk of those returns landing in Q4. 2024 earnings are forecast to improve by 11%. Investor enthusiasm has cooled in the near term as we await news of results for the second half. Looking further out, will the higher earnings (the denominator) forecast for 2024 justify the recent increase of the numerator (price) of the M7 and the broader market? Investors are obviously rooting for an increase in the denominator to support the current multiples.

July's rally has prompted a number of analysts to abandon their negative outlook for the economy and the market with some even announcing the arrival of the next bull market. We're not buying it. We still remain broadly diversified and balanced with representation in a number of M7 names and advise clients to focus on maintaining sufficient liquidity for a lengthy period of uncertainty as to where and how the economy lands. As for the Fed? While they will still evaluate the incoming data and cast their vote meeting by meeting, recent data hints of greater resilience in the economy to the effects of tightening. That increases the likelihood that we'll see at *least* one more rate increase before year-end, perhaps as soon as the September 19-20 meeting. With meetings in October and December, uncertainty could reign through year-end if inflation remains sticky as it is today. Stay tuned.