GAUGE SHIFTS HIGHER AGAIN AS MULTIPLE CATEGORIES GET AN UPGRADE

We’ve moved Corporate Earnings and Commodities to Favorable given the stalling contraction in profit margins and nascent turn in commodity prices. Monetary Policy (and the subsequent upward pressure on short-term interest rates), Inflation (too high for the Fed) and Valuation (elevated) remain key weights.

In this edition, we make a key upgrade to Corporate Earnings. Although it appears the S&P 500 will post its third straight drop in year-over-year earnings growth this quarter, the deterioration in profit margins appears to have stalled. Income derived from higher rates (via cash balances) is helping to offset other areas of weakness. This is important to the extent to which firms have resisted laying off workers even as earnings have fallen (while other cost cutting measures are proving effective). This, in turn, explains the resiliency of the U.S. economy in the face of higher rates and tightening lending standards.

We also upgraded Commodity Prices to favorable as it appears that a turn may be underway. A broad-based decline in the U.S. Dollar since last October and China’s efforts to stimulate its economy are likely contributing to the trend.

Headwinds for further strength since last October’s low are, in our view, the future of Monetary Policy and Valuation. The rate of inflation has clearly declined but it seems much too early for the Fed to declare victory and ease policy. Short rates may stay higher for longer than the consensus expects, which only further calls into focus the valuation backdrop. It’s difficult to describe the market as cheap by any metric, with equity valuations above long-term averages on both a trailing and forward basis. Consensus expectations for aggressive earnings growth in 2024 may also prove hard to achieve given that the economy is starting at full employment.

FAVORABLE or UNFAVORABLE?

This table shows the 16 factors we continually monitor to understand the current market environment for U.S. stocks. When there are 8 factors in each group, that is a neutral market environment. Though we are upgrading multiple categories to favorable with this writing, the gauge remains at a -4, Unfavorable (this value being the sum of +6 and -10) amid sticky inflation, restrictive monetary policy, stretched valuations, and deteriorating U.S. fiscal health.
Market Gauge (continued)

HOW DO WE DECIDE HOW TO CATEGORIZE EACH BUILDING BLOCK?

Administration: Are the White House priorities market-friendly? How do they view taxes, regulation, trade/tariffs, etc.?
Commodity Prices: Do commodity prices (e.g., gold, copper, oil) reflect economic growth or contraction?
Corporate Earnings: Are the earnings of U.S. companies growing? Are profit margins expanding?
Demographics: Is the demographic trend (population growth, average citizen age, worker-to-retiree ratio) positive?
Economic Growth: Did GDP grow or drop in the previous quarter? Are leading indicators rising or falling?
Fiscal Health: Is the budget deficit growing or shrinking? Is federal spending commensurate with long-run economic growth?
Fiscal Policy: Are the major policy initiatives from the White House and Congress pro-growth and market-friendly?
Global Trade: Are current attitudes pro-globalization and free trade or pro-nationalism and protectionism?
Inflation: Is there price stability around the Federal Reserve’s new target? Are we experiencing deflation or hyperinflation?
Liquidity: Is there more money or less money circulating in the financial system than there has been recently?
Monetary Policy: Are interest rates accommodative or restrictive? Are other central bank programs market-friendly?
Sentiment: Are investors broadly optimistic (a negative) or pessimistic (a positive) about the market?
Technical Picture: What is current price action telling us? What do market breadth, trend, and momentum look like?
U.S. Dollar: Is the dollar strengthening or weakening versus other world currencies? What are the factors causing the move?
Valuation: Do stocks look expensive or cheap vs. historical averages given the current environment?
War vs. Peace: What do the world’s geopolitical tensions look like? Are they inhibiting global economic growth?

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