Monthly Commentary

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Optical Illusions

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Harry Houdini, David Copperfield, and Penn & Teller are considered among the greatest magicians of all time. Magicians utilize a combination of sleight of hand, misdirection, and other techniques to create the appearance of executing seemingly impossible or supernatural feats. Recall seeing their tricks such as sawing a live person in half, escaping from an impossible predicament, or levitating (floating in air)? These skills are developed through practice, study, and the mastery of various techniques. The best magicians incorporate elements of storytelling, humor, and showmanship to enhance their performances and engage the audience. It is important to note that magicians are not actually performing real magic or exercising supernatural powers. Rather, performances are based on skillful techniques and principles of illusion designed to create a sense of wonder and amazement. The secrets behind their tricks are closely guarded, and the magician's code of ethics often prohibits revealing the methods used to perform illusions. In essence, they try to "fool us."

After nearly 8 months since the recent bear market low in October, investors might suggest the markets are performing their own magical feats as they appear to "levitate" or even "escape from their own challenging predicament" which still includes elevated inflation, interest rate hikes and inverted yield curves, consensus predictions of recession, banking sector stresses, Federal debt ceiling negotiations, and slowing economic activity. Despite these and other worries, the S&P500 is up nearly +18.1% since October 12, and +9.6% for the YTD through May (but roughly -11.1% below its all-time high on January 3, 2022).

That sounds exciting and encouraging for the casual monitoring of the stock market. Yet, most investors did not perform to that level, particularly since March. It remains our perspective that the 8 month "rally" is not the start of a new bull market. Simply, there is not a broad market advance underway. At the risk of sounding pessimistic (not our preference), there is a great illusion in progress. The illusion is observed in several popular market indexes including the S&P500 and Nasdaq 100. These indexes are constructed with greater weight given to the largest US companies because they are rising faster than other names in the index; currently, many of those are large technology companies. For instance, the five largest and arguably more expensive US companies make up 24% of the S&P500… the other 495 companies make up the balance. Two names – Apple and Microsoft – are now each greater than 7% weights, a feature not seen in over 40-years of data. What's more, 10 names (the largest weights or exposures) account for more than 100% of the Index YTD gain; the other 490 stocks are net negative on the year, and meaningfully so. If not for Tech and AI (artificial intelligence semiconductor chips), May was a down month. The number of stocks making new 3-month lows outnumbers those making new highs. And it's not just domestic stocks either as bonds, commodities and foreign were also weak. While these facts may seem uninteresting to clients or the casual observer, we highlight them because narrow participation is NOT a characteristic typically associated with the beginning of new and durable uptrends or bull markets. We believe additional churning and tug of war is occurring between the last cycle leaders and future leaders.

May 2023 Performance

SOX	15.3%	C. Discretionary (Equal Weight)	-5.6%
QQQ	7.9%	Shenzhen CSI 300	-5.7%
Technology (Equal-Weight)	6.5%	Financials (Equal Weight)	-5.7%
S&P 500	0.2%	Copper	-6.0%
Russell 2000	-1.1%	Commodity Index	-6.1%
Gold	-1.4%	C. Staples (Equal Weight)	-6.1%
JNK (HY ETF)	-1.8%	Utilities (Equal Weight)	-6.2%
Comm Svc. (Equal-Weight)	-2.0%	Silver	-6.3%
LQD (IG ETF)	-2.1%	Healthcare (Equal Weight)	-6.3%
Lumber	-2.2%	Bank Index	-6.3%
Dow Transports	-2.2%	Iron Ore	-7.2%
EEM	-2.4%	Steel Rebar	-7.6%
Homebuilders	-2.9%	Materials (Equal Weight)	-8.2%
Industrials (Equal-Weight)	-2.9%	Hang Seng	-8.3%
EuroStoxx 600	-3.2%	Regional Banks	-8.6%
S&P 500 (Equal-Weight)	-4.0%	Energy (Equal Weight)	-9.4%
Euro Luxury	-4.9%	WTI Crude Oil	-11.3%
Real Estate (Equal Weight)	-4.9%	Zinc	-13.0%
Euro Banks	-5.0%	Nickel	-13.2%
Aluminum	-5.6%	Macau Gaming	-17.2%

Since March when several banks failed due to heavy withdrawal of cash deposits that required them to sell quality bond investments at losses (bond prices fall when interest rates rise), a number of tech stocks provided the "illusion" of being safe like cash; they were the reliable winners of the past. They were the "heroes" in the bear market. A few names boosted the stock market, while (almost) everything else struggled. Performance for May reveals the narrow market action – very few winners and many frustrations.

Style	May	YTD
S&P 500	*+0.4%*	*+9.7%*
Large-Cap Stocks	-0.4%	+6.5%
Bloomberg Bond Idx	-1.1%	+2.5%
Avg US Stock Fund	-1.5%	+2.9%
Small-Cap Stocks	-1.8%	-0.8%
Mid-Cap Stocks	-2.7%	+0.0%
Foreign Stocks	-3.6%	+6.3%

Client Objectives (Stocks/Bonds)	May	YTD
20/80	-0.5%	+2.2%
35/65	-0.8%	+2.4%
50/50	-1.4%	+2.5%
65/35	-1.5%	+2.9%
80/20	-1.7%	+3.0%
95/5	-2.0%	+2.5%

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Another striking aspect of recent market performance over the last month is the relative calm level of volatility. As we enter this season of the year where trading volume typically declines, market liquidity is likely to diminish further. The drama around raising the US Federal debt ceiling will alter money supply available for spending or investing. The debt ceiling deal will raise the Federal debt limit thru 2024 in exchange for spending cuts. Don't be surprised if the markets react with a "buy the rumor, sell the news" scenario. That is, "buy the rumor" that the debt ceiling was successfully raised without default; only to "sell-off" when the actual deal is implemented. Why would this occur? A flood of new Federal debt will then be issued to finance government operations. Large amounts of new debt issuance (somewhat counter-intuitively) will tie up, pull-out dollars from the financial system that might otherwise finance consumption or investment by both businesses and consumers. Lack of new debt issuance over the last several months during the debt ceiling negotiation process actually increased net market liquidity and likely explains the YTD "reflation" of more speculative market areas. In essence, lack of money to invest will slow the prospect for market advances near term, and probably slow economic growth.

During the Great COVID Lockdown where money supply (M2) exploded and fueled the short bull market rise, it also created the current inflation challenge. Now, the opposite is underway because of the Federal Reserve's tight monetary policy actions. Growth of money supply at present is almost non-existent. Shrinking market liquidity implies that those indexes dominated by expensive top-heavy names may be on the edge of some bumpy performance. The same dynamics which allowed indexes to appear to levitate higher via just a few large stocks could disproportionately cause indexes to draw down, perhaps more than the average stock. Taking it a step further, while we believe the Fed is at or near the end of its rate hiking campaign (to fight high inflation) it seems unlikely that a return to cheap money (zero interest rates and low inflation) will occur anytime soon unless the economic backdrop deteriorates more abruptly than anticipated. It seems probable that markets will perform sluggishly while banks remain "under attack". That's because slow return-to-office work requirements plus higher interest rates, are together putting stress on commercial real estate loans; and thereby possibly hurting bank capitalization; banks are tightening lending criteria making loans harder to afford/get. Like gravity in the physical world, high interest rates act as a governor/regulator on economic growth and valuations in the financial world [low interest rates for 13+ years created illusionary or levitating high prices for many investments/assets].

Presently most mutual funds and portfolios are struggling to keep up with top-heavy indexes like the S&P500 and Nasdaq. By any measure, these indexes are historically expensive. Thus, now is not the time to chase recent (or previous era) areas of market strength. Dividend paying stocks, and even cash/MMFs (earning 5%+) are your friend. They often include higher quality, strong financial position names that provide cash returns during uncertain times. A diversified focus on value style stocks versus growth; international vs domestic; and shorter to intermediate duration over long is appropriate for both bonds and stocks. We believe current tactical positioning remains appropriate for the intermediate- to longer-term outlook.

So, be careful: there are many examples of "optical" illusions that exist in our world – used in marketing to make fruit and vegetables appear perfectly ripe; in product promotional phrases (BIGGY-size); pro athlete salaries; even as we feel the need to "keep up with the Joneses". Investors too should not be caught up by illusionary index gains. Allow magicians to perform and entertain with levitation. Investors should monitor and understand the bigger picture. We are not promoting a pessimistic outlook but believe that those looking only at what appears attractive on the surface will likely experience disappointment and heightened emotion if/when/as the market encounters challenges which should be considered part of the maturation of the bear market bottoming process. Remember, bear markets eliminate risk as new leaders are revealed. A new bull market will arise and prove its legitimacy after it is well underway. Its timing is completely unknown. Successful investors understand they are required to be invested at all times, even during tough times.

Charts: Top 5 stocks are over-represented relative to their earnings contribution in the S&P500 (below); large weight v net income weight reflects the degree of over-valuation (expensive). This is creating significant divergence between average stock and market-cap index. (right)