Animal Spirits

Given the mostly dire 2023 predictions delivered by notable economists, strategists, and other market commentators at the end of last year, it is reasonable to say that the 15.9% first half return of the S&P 500 was not expected. Despite recession expectations, the regional bank crisis, and debt-ceiling negotiations, equity markets grinded upwards. Consensus expectations from several Wall Street firms pointed to the Federal Reserve's aggressive rate hiking campaign, paired with quantitative tightening, as reasons to stay in cash or Treasuries, and avoid risk assets. The majority of returns this year, however, are from technology stocks and other higher risk equities, which propelled the Nasdaq to a first half return of 31.7%, its best start to a year since 1983. The impact of the mega-cap technology stocks is evident when comparing the 15.9% return of the S&P 500 to the 6.0% return of the S&P 500 Equal Weighted Index or the 3.8% return of the Dow Jones Industrial Average. The seven largest technology/growth companies in the S&P 500 now account for 28% of the index versus 20% at the start of the year. The first half returns can partly be attributed to a recovery in prices from 2022, but the continued momentum in technology stocks is driven by cost cutting campaigns, enthusiasm around artificial intelligence potential, and a perceived "flight to quality" by many investors.

The term "Animal Spirits" as applied to the financial markets was coined by British economist John Maynard Keynes. He used the term to describe how human emotions can impact financial decisions and consumer confidence, specifically in times of stress in the economy or financial markets. Animal Spirits characterizes the investor emotions that can drive prices down in a panic and inflate prices in exuberance. These decisions can sometimes be irrational and detached from actual fundamentals, ultimately leading to a herd mentality for investors. Clear examples of this were the "dotcom" bubble in 2000, the 34% Covid plunge in March 2020, and more recently, the 33% Nasdaq correction in 2022 following excessive stimulus and quantitative easing. Animal Spirits also explain the modern-day bank run on Silicon Valley Bank and contagion to other regional banks, as well as the current volatility in safe assets, like U.S. Treasuries, not seen since the financial crisis. When considering that most market return this year is from high quality companies that generate strong cash flow, provide leading products and services, and have a competitive edge in innovation – like Apple, Microsoft, and Nvidia, for example – it is hard to argue that irrational exuberance has completely taken over. Conversely, the extreme triple digit first half returns for Nvidia, Meta (formerly Facebook), and Tesla, as well as an 83% surge for Bitcoin, argue otherwise. Market returns over the next several months will likely be characterized by a clash in exuberant Animal Spirits against the ever growing "wall of worry".

RMC last wrote about the market climbing a "wall of worry" in 2018, as the bull market following the financial crisis was doubted by many investors. A graph of steadily increasing market returns was included, with quotes from several highly regarded investors, arguing to sell stocks for cash given the likelihood of a steep market downturn. This wasn't to imply that markets always go up, but served as an instructive reminder of how difficult, or impossible, it is to "time the market", moving in and out of stocks profitably and consistently. This is why RMC has always focused on prudently building portfolios to weather market cycles and suited to one's objectives and risk tolerance. Like that bull market, this first half rally has been questioned by many investors, and deemed unsustainable for several reasons:

- Many pockets of the economy and financial markets are vulnerable to stress as interest rates rise. Although the Federal Reserve may be near the end of its rate hiking cycle, the expectation of higher rates for longer increases the chance of stress. Some commercial real estate assets, for example, may not be able to support higher interest rate debt as lower interest rate debt matures, increasing the probability of defaults. The Fed's rate hikes have also significantly raised short term rates, causing a deeply inverted yield curve, and inversions of this level have always preceded a recession. Extended periods of short-term rates above long-term rates weigh on bank profitability and ability to lend. This issue is exacerbated when combined with anticipation of greater regulation and tighter lending standards due to the bank crisis. While the impact of higher rates has still not stunted economic growth, as evidenced by U.S. GDP growing at a 2.0% annual rate for the first quarter, some argue that stress is still to come.

- Economists have been warning of an impending recession for about a year now, pointing to a breakdown in consumer spending, which comprises nearly 70% of U.S. GDP. With what may be the most anticipated recession in history, many have now pushed this event out to 2024, as credit card balances and interest rates remain high, the student loan moratorium ends soon, and excess savings continue to be spent down. Conversely, many consumers locked in very low long-term rates during the pandemic, which ensures lower interest payments on their largest liabilities like a home mortgage. Additionally, wage inflation remains elevated, and is now actually higher than inflation levels for some goods and services.

- Like many individual investors, large asset managers and hedge funds were under invested in technology stocks to start the year. As to not miss out on the move upwards, significant inflows to technology and growth investments pushed prices even higher, further narrowing market breadth. While the S&P 500 was up nearly 9% through May, the Equal Weighted S&P 500 index was still in negative territory. Market breadth improved in June, but five of eleven sectors remain negative for the year – Consumer Staples, Energy, Financials, Healthcare, and Utilities. Although concentrated market return is not a new phenomenon, narrow leadership can leave the market vulnerable for a quick turn downward. Regarding valuation, the forward P/E of the S&P 500 at the end of 2022 was 16.7x, in line with the 25-year average, and now trades at 19.1x. Removing the top ten largest companies in the index, however, the forward P/E is at 17.8x.

The S&P 500 technically entered a new bull market on June 8 after crossing the 20% threshold above its October 2022 low. A retest of that October price level would suggest tighter monetary policy finally caught up to the economy, however, a smaller pullback is more probable and is typical market behavior. A recession is also typical for the economic cycle, despite the impending doom that has been attached to those predictions. While Animal Spirits are alive and well with some investors in 2023, it is more likely these exuberant forces will be tempered by the “wall of worry” before asset prices become too inflated. This difference in opinion of market bulls and market bears is what drives the short-term volatility in market prices, and what creates opportunities for long-term investment. Capitalizing on these opportunities, with a focus on company fundamentals, portfolio objectives, and individual risk tolerance, instead of fear or greed, keeps investors on track for the long run.