

McMurtry Investment Commentary March 2023

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Can equity markets climb the current wall of worry and go higher?

We all know the current wall of worry issues that are providing headwinds for the equity market. Some of us feel that these worries are much worse than we have all experienced in the past and that the equity market has nowhere to go but down materially from here.

The war in Ukraine, the possibility of Communist China invading Taiwan, the very hawkish Federal Reserve Bank, stubbornly high inflation, declining corporate profits, a weakening global economy accompanied by a possible global recession, China's lockdowns negatively affecting global demand and high equity market valuations are some of the worries that the equity market is currently dealing with.

Recently I have noticed how frequently many equity strategists and economists are copying each other's opinions, thinking that there is safety in the numbers of people thinking about the same outcome. In my opinion, this is extremely dangerous as it discourages independent thinking. These strategists frequently repeat exactly what the Chairman of the Federal Reserve is saying regarding fighting inflation by keeping rates high. Once again this totally amazes me as the Federal Reserve was totally wrong keeping interest rates artificially low during Covid when they kept saying that inflation was transitory. Now the Central Bank is more hawkish than they have been in over twenty years and we are supposed to trust their judgement. I think not. It is important to keep in mind that the Federal Reserve has a dual mandate – to keep US domestic inflation low and employment growth stable. Currently, they are being remiss by only focusing on one mandate – controlling inflation. I am quite surprised that no one has actually questioned them in this regard. Secondly, the Central Bank is blaming labour as one of their main causes of the current inflation that the US is experiencing. Once again this is absolutely absurd to blame labour as their incomes have only recently kept pace with inflation. We should all be aware that labour is a lagging and not a leading indicator.

Now I would like to point out some specific points to refute these bearish strategists and economists that markets will get much worse than they are now.

Sam Stovall of CFRS correctly has pointed out on several occasions that only once in fifty years has the US equity market gone down in consecutive years. Unless we think that a possible recession will end up being the same or worse than the last major one in 2008, equity markets will most likely not retest their recent 52-week lows. The 2008 recession was a major banking crisis of confidence. Today banks are much stronger and better capitalized than they were in 2008 and their book of loans is not based on collateral that was faulty at best.

The technical pattern of the equity market is not indicating that a major equity market collapse is about to happen. The overall market breadth is improving and many stocks are now trading above their moving averages. Secondly many stocks have already declined much more than the benchmark indices. This may indicate that the predicted collapse in the benchmark indices may not come to pass with the average stock having already gone down considerably.

Ned Davis, the highly regarded US money manager recently published a graph showing how the equity markets rebounded in 2006 at exactly the same time that the Federal Reserve stopped increasing interest rates. While 2023 is not 2006, I doubt very much that it is 2008 either.

Historically there has always been a long lead time from when the Central Bank starts increasing rates sharply before there is a negative reaction to the economy and the rate of inflation. It has been only one year since the Federal Reserve began their tightening cycle. It is quite likely that it will take up to another six to eight months before there is a material effect on the rate of inflation and on employment and economic growth. It should also be pointed out that the decline in the US money supply over the last year has been one of the largest declines in the last fifty years, according to Jeremy Siegel, the Wharton Business School professor.

The domestic US economy is very resilient despite the sharp increase in interest rates. The unemployment level is extremely low and there has been a sharp pickup recently in retail sales. The unusually strong January employment growth, that made the Federal Reserve turn more hawkish, is unlikely to repeat itself to the heights seen last month. Credit spreads are not rising to the levels experienced during the recession of

2008 and this implies that any recession we may end up having will be a very mild one.

US corporate earnings per share estimates for the S&P 500 index have already come down from a high of 243 in April, 2022 to the current level of 215, a drop of 12%. Aggregate earnings per share ex energy are already down by 14% since last April. Once again the most bearish top down analysts and strategists think that this year's earnings per share will go much lower than 215-220, and this is causing them to think that equity markets remain expensive. Taking into account the resiliency of the US economy, the earnings may very well hold up at the current levels of 215-220. Excluding the very high interest rates of 18% plus that we experienced in the late 1970's and early 1980's when inflation was high, the stock market average PE over the last fifty years has been around 18 times, the level that it is today. During the late 1970's domestic inflation was rampant and much more pervasive in the overall economy than it is today.

Historically the stock market bottoms at least six months before the end of the recession. Equity markets have been in a bear market for the last 12 months.

One major headwind, the Chinese economy may be gradually turning up once again. Covid lockdowns are ending and Chinese factory orders have rebounded sharply recently. Some strategists feel that a Chinese resurgence may lead to even more inflation. However, commodity prices remain weak overall and a modest pickup in the Chinese economy is not going to dramatically increase inflation at this time. But a reviving Chinese economy may help the world avoid a hard economic landing.

Overall US domestic inflation has been gradually trending down from 9% to the current level of 6.5%. While the direction is favourable, the Federal Reserve wants the rate of inflation to go back down to the 2% level. At this point this may be quite difficult to achieve without causing the US to go into a deep recession. No matter what the Federal Reserve's rhetoric is to the public, a more likely scenario is to get inflation back down to 4-5% and then pause to see what happens to the economy. Under that scenario value stocks should continue outperforming growth stocks and that implies that Canadian equities should outperform US ones.

Recommendation

This upcoming week we will see the non farm payroll employment number for February. We all know how strong employment growth was in January, so this number will be closely monitored by the strategists. Later this month we will get another read on the US domestic CPI. For the last few months, the CPI growth trend has inched up once again, a worry for the Central Bank. Should both the employment and CPI continue trending up, this will lead to more equity market volatility.

Differing from government stats that indicate the opposite, private sector readings show US job postings slowing somewhat this year. This is confirmed by both ZipRecruiters and Recruit Holdings that indicate the number of job postings listed on their sites has declined so far this year compared to 2022. While it is too early to confirm, this trend may indicate that employment growth is slowing and this is exactly what the Federal Reserve wants.

However, a stable US economy with solid employment growth coupled with an improving Chinese economy clearly postpones the probability of a major hard landing for the economy.

The current wall of worry is no different than the ones experienced in the past. I think there are just as many positive factors to say about the outlook for equity prices as there are negative ones. I would continue to ease back gradually into equities. There will be many opportunities to take advantage of market and specific stock weakness to add to positions. An example of this is Baytex that saw its share price decline almost 10% earlier this week after announcing a highly accretive acquisition in the US.

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