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Investor Sentiment Positive, But Consumer Concerns Emerge

Major Equity Indices (Price Returns)	Value	2023 YTD (through 8/31)	August 2023	2022 Low	% from Low
NASDAQ Composite	14,034.97	34.1%	-2.2%	10,213.29	37.4%
S&P 500	4,507.66	17.4%	-1.8%	3,577.03	26.0%
Russell 2000	1,899.68	7.9%	-5.1%	1,649.84	15.1%
S&P 500 Equal-Weight	6,074.36	5.8%	-3.4%	5,167.33	17.6%
Dow Jones Industrial Average	34,721.91	4.8%	-2.4%	28,725.51	20.9%

Data Source: FactSet as of 8/31/23

The State of the Market. The widely followed, large-company S&P 500 equity index declined 1.8% (price return, not including dividends) in August, the first monthly decrease since February this year (a period of six months) as equity markets took a breather from relatively strong year-to-date (YTD) gains. Despite the August decrease, a rebound to close the month (the S&P 500 gained 3.2% from 8/18/23 to 8/31/23) helped to limit the damage. However, those late-month gains were skewed toward a limited number of large-capitalization, technology-centric growth stocks (which have led the market for most of the year) and not due to a broad-based turnaround, which would be a healthier indicator of continued near-term gains. On a YTD basis, through 8/31/23, U.S. equities produced solid gains for investors, but much like the last two weeks of August, gains were concentrated. While the large-company S&P 500 delivered a gain of 17.4% (and 18.7% total return including dividends) through August, the large-company, but more technology- and growth-centric, Nasdaq Composite index produced a price return of 34.1%. But other indices, while still solidly positive, delivered less impressive relative returns over the year's first eight months. This included a 7.9% YTD gain for the Russell 2000 (the most widely followed index of small company shares) and 5.8% for the Dow Jones Industrial Average. 2023 returns have been paced by large gains in a handful of large companies, driving the Nasdaq Composite and S&P 500 to lead the market as those indices are weighted by market capitalization (larger companies comprise a larger proportionate share of the index). We have calculated that, through August, the S&P 500's ten largest companies (by market capitalization) contributed 75% of the index YTD total return. This means that the index's other 490 companies contributed just a quarter of the total return. From 2001 through 2022 (22 years), the ten largest companies contributed an average of 38% of the total return annually. Earlier this year, we discussed how the average stock performance had lagged that of the large capitalization leaders in 2023, and that discrepancy continued YTD through August. The Equal-Weight S&P 500 index (calculates the return of all S&P 500 companies on an equal-weighted basis) delivered a YTD price return of 5.8%.

Key August Drivers. We attributed August equity market weakness to a rise in interest rates as the yield on the U.S. 2-year Treasury note (we consider a proxy for short-term interest rates) moved to 5.06% on 8/25/23 from 4.61% on 7/13/23, and the U.S. 10-year Treasury (a proxy for long-term U.S. rates) moved to 4.25% from 3.75% over the same period. In addition, on 7/26/23, the U.S. Federal Reserve Bank (Fed) implemented a 0.25% increase to its overnight bank lending fed funds interest rate target range to 5.25% to 5.50%. While using interest rate levels to predict near-term equity market moves is unreliable at best, in theory, higher interest rates should lead to lower equity valuations because the present value of future earnings and cash flow is lower as interest rates rise. While we believe that the Fed is very close to ending its interest rate hiking cycle (designed to tighten credit conditions to relieve inflation pressure), investors are increasingly convinced that interest rates are likely to remain higher for longer, which can create new and ongoing challenges. In late July, the U.S Treasury announced plans to borrow (by issuing Treasury securities) $1.0 trillion (T) in the third quarter (3Q23), which was $274 billion (B) higher than the 3Q23 financing estimate given in May. The increase in financing needs was attributed to lower-than-expected tax receipts as well as ongoing federal budget deficits (in May, the Congressional Budget Office estimated a fiscal 2023, ending September, federal deficit of $1.5T). This led ratings agency Fitch, on 8/1/23, to reduce the U.S. federal debt rating to AA+ from AAA as Fitch cited concerns about ongoing deficit spending and weakened governance. Following the third quarter debt issuance, the Treasury expects to issue at least an additional $850B in 4Q23. Bond issuance in the current higher interest rate environment increases federal interest expense, adding to budget negotiation challenges. By late August, investor sentiment improved as interest rates dipped (the 10-year Treasury yield was 4.09% on 8/31) as consensus S&P 500 earnings estimates for 2023 and 2024 trended higher, July economic data largely exceeded expectations as reported, and Fed Chair Jerome Powell's comments at the Fed's annual economic summit at Jackson Hole, WY suggested that while the Fed expects interest rates to remain elevated, the probability of another fed funds rate hike in September had diminished. In addition, investor sentiment regarding sustainable technology investment to support artificial intelligence (AI) opportunities remained high. This contributed to the equity market gains to close the month, although with some trepidation given the relatively narrow gains discussed above, as well as typical lower trading volumes in late August leading up to the Labor Day holiday.

September Considerations. The S&P 500 declined modestly early in September, down 1.1% through 9/8/23, but the index remained well above the mid-August closing low. Several factors remain in place that could drive positive investor sentiment and higher equity prices, but consumer headwinds are building, creating potential challenges for markets. Positive drivers include better-than-expected economic growth as real gross domestic product (GDP) increased 2.1% annualized in 2Q23, with both consumer spending and business investment surprising to the upside. Consumer spending (personal consumption expenditures as reported by the Bureau of Economic Analysis) was again solid in July, leading to upward revisions in 3Q23 GDP estimates. Supporting positive consumer conditions has been a robust labor market with positive monthly gains in nonfarm payrolls (jobs) for 32 consecutive months (January 2021 through August 2023) and an unemployment rate in August of 3.8%. In addition, investors have reacted positively to declining inflation trends, with the headline consumer price index (CPI) coming in at 3.2% in July 2023 (year-over-year, Y/Y) and 3.0% in June 2023, after peaking at 9.1% in June 2022 Y/Y, and remaining above 4.0% for 26 consecutive months (April 2021 to May 2023). Continued lower inflation data, combined with solid economic growth, has boosted expectations for an economic soft landing, where the economy slows, but avoids slipping into a recession despite substantially higher interest rates since early 2022. Adding to the soft-landing sentiment has been a recent increase in FactSet consensus (compiled from Wall Street) earnings estimates for the S&P 500. Estimates for 2023 earnings had moved lower for every month in 2023 through July but increased modestly at the end of August for the first time this year. Consensus estimates for 2023 and 2024 reflect growth expectations of 2% and 12%, respectively, which would be a welcome recovery from Y/Y quarterly earnings that have decreased for each of the past three quarters. The bulk of 3Q23 earnings reports will begin in mid-October.

We believe the positive data is balanced by signs that consumer spending has peaked, suggesting that GDP growth could slow in the quarters ahead. Despite the positive labor data we discussed above, monthly jobs growth over the past three months (ending August) was 150 thousand (K), significantly below the three-month monthly average of 312K back in March. In addition, the BLS calculated a benchmark revision, which lowered previously reported jobs increases over the first half of 2023 by 306K. In recent months, BLS data shows that consumer spending has outpaced income, taking the savings rate (savings as a percentage of disposable income) to 3.5% in July, the lowest monthly number since November 2022. While consumers have relied on savings that were bolstered by pandemic-driven stimulus payments to support current spending, there is some evidence that excess savings has dwindled. A paper from the Federal Reserve Bank of San Francisco on 8/16/23 estimated that U.S. households accumulated $2.1 trillion in excess savings during the pandemic, but that excess had dropped to $190B in June of this year and would be depleted during the third quarter. In addition, an 8/8/23 release from the New York Federal Reserve Bank showed that U.S. consumer credit card balances increased 4.6% from 1Q23 to 2Q23, exceeding $1.0T for the first time, and the percentage of credit card and automobile loans that became delinquent (at least 30 days late) exceeded 7% for the first time since 2019/2020 prior to the pandemic. In addition, an emerging expense for many consumers begins in October, when student loan payments to the federal government resume after a 3-year hiatus. According to the Education Data Initiative, outstanding federal student loan balances were $1.6T in mid-August, with the average monthly payment an estimated $503. While continued labor market and wage growth could provide funds and confidence for slow and steady spending increases, we must acknowledge the potential constraints that are building. A slowdown in spending does not necessarily translate into a recession scenario, but that remains a possibility and at least, we expect slowing GDP growth at some point (perhaps 4Q23), below the level in the first half of 2023 (1Q23 2.0%, 2Q23 2.1%).

Takeaways. Despite a pullback in equities in August and early September, investor sentiment remains positive. Equities could move higher over the near-term due to expectations for an economic soft landing (led by consumer spending and technology investment to support AI), a view that Y/Y earnings growth will resume in 3Q23, and improving inflation data that ease pressure on the Fed and interest rates. At the same time, we see data to support weakening finances for many households that could translate into slower consumer spending growth before the end of the year (the most recent data for July remained strong). Since early July, the S&P 500 has remained consistently above our estimated index trading range of 3,800 to 4,400 (with a fair value of 4,100), trading as a high as 4,589 (closing price) on 7/31/23. As of 9/8/23, the index traded at 19.2x the consensus S&P 500 earnings estimate over the next four quarters (3Q23 to 2Q24). This represents a 15% premium to the average forward P/E of 16.3x over the past 23 years (since 2000). We do not expect P/E expansion given the relatively high interest rates across the economy today, but equities could move higher if earnings growth resumes as expected and continues in 2024 and beyond. But a lot must go right for that to happen and we continue to maintain a conservative approach. We recommend investors stay invested in equities but remain diversified across sectors including exposure to some of the traditional “defensive“ sectors (such as Consumer Staples, Utilities and Health Care). At the same time, elevated technology spending is expected to continue, driving revenue for suppliers, while companies making investments need time to show positive return on investment (ROI). We continue to look for companies with strong free cash flow (to support growth) and manageable debt levels that provide some insulation from high interest rates as higher interest payments in future periods will be a drag on earnings growth.

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Market Indices: The information on indices is presented for illustrative purposes only and is not intended to imply the potential performance of any fund or investment. Indices provide a general source of information on how various market segments and types of investments have performed in the past. Index performance assumes the reinvestment of all distributions, but does not assume any transaction costs, taxes, management fees, or other expenses. You may not invest directly in an index. Past performance is not an indicator of future results. The Russell 2000® Index is a market cap weighted index that measures the performance of the 2,000 smallest companies in the Russell 3000® Index. The S&P 500 Index is a market capitalization weighted index that is designed to measure the US large-cap equity performance. The index is composed of the 500 leading publicly traded US companies based on size, liquidity, industry, and profitability criteria. The Dow Jones Industrial Average is a price weighted index that tracks 30 large, publicly-owned companies trading on the New York Stock Exchange (NYSE) and the NASDAQ Composite Index measures all NASDAQ domestic and international based common type stocks listed on The NASDAQ Stock Market. Today the NASDAQ Composite includes over 3,000 companies

According to S&P Global, the S&P 500 index, which is weighted by market capitalization covers approximately 80% of total market capitalization available to investors. We view the S&P 500 as the best available index to measure the performance of large-cap U.S. equities. The S&P 500 Equal Weight Index is compiled by S&P Dow Jones. It is an equal-weight version of the widely used S&P 500. The index includes the same constituents as the capitalization-weighted S&P 500, but each company is allocated a fixed weight, or 0.2%, of the index total, and is rebalanced quarterly.

Fair value refers to a valuation method based on our view of the intrinsic value of an asset or index, determined by macroeconomic factors and earnings expectations rather than current market prices. This is our view of intrinsic value as of the date of this report.

The Federal Reserve Bank's Open Market Committee (FOMC) consists of twelve members--the seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining eleven Reserve Bank presidents, who serve one-year terms on a rotating basis. The FOMC holds eight regularly scheduled meetings per year. At these meetings, the Committee reviews economic and financial conditions, determines the appropriate stance of monetary policy, and assesses the risks to its long-run goals of price stability and sustainable economic growth.
The term "monetary policy" refers to the actions undertaken by a central bank, such as the Federal Reserve, to influence the availability and cost of money and credit to help promote national economic goals. The Board of Governors of the Federal Reserve System is responsible for the discount rate and reserve requirements, and the Federal Open Market Committee is responsible for open market operations. The Federal Reserve influences the demand for, and supply of, balances that depository institutions hold at Federal Reserve Banks and in this way alters the federal funds rate. The federal funds rate is the interest rate at which depository institutions lend balances at the Federal Reserve to other depository institutions overnight.

The National Bureau of Economic Research (NBER) is a private non-profit research organization. The NBER is widely used as an organization that analyzes U.S. economic data and the business cycle and determines the start dates and end dates of economic recessions.

The forward S&P 500 price-to-earnings ratio (P/E) is a valuation measure, calculated by dividing the price of the S&P 500 index over the weighted average earnings per share (EPS) estimate of each company in the index. Earnings are based on "forward" consensus estimates expected over the next 12 months (NTM), using quarterly analyst estimates as provided by FactSet.

Gross domestic product (GDP) refers to the monetary measure of the market value of all final goods and services produced within a country's borders within a specific time period. The U.S. Bureau of Economic Analysis reports inflation adjusted (real) GDP as annualized percentage growth from the previous quarter.

FactSet is a data aggregation software utilized by D.A. Davidson's Wealth Management Research. The FactSet Consensus refers to the aggregate of all analysts' estimates from firms that submit estimates to FactSet for a given financial metric.

U.S. Personal Consumption Expenditures (PCE) is an indicator of the growth in consumer spending and measures the value of goods and services purchased by persons who reside in the U.S. It is reported monthly by the Bureau of Economic Analysis. Retail Sales, reported monthly by the U.S. Census Bureau, reflects a monthly survey of sales by retail and food service firms in the U.S.

The consumer price index (CPI) is a measure of average change over time in the prices paid by urban consumers for a market basket of goods and services. It is reported monthly by the U.S. Bureau of Labor Statistics.

The Global Industry Classification Standard (GICS) is a four-tiered, hierarchical industry classification system. Companies are classified quantitatively and qualitatively. Each company is assigned a single GICS classification at the Sub-Industry level according to its principal business activity. MSCI and S&P Dow Jones Indices use revenues as a key factor in determining a firm's principal business activity. The 11 sectors are: Communication Services, Consumer Discretionary, Consumer Staples, Energy, Financials, Health Care, Industrials, Information Technology, Materials, Real Estate, and Utilities.

The Bureau of Labor Statistics (BLS) compiles U.S. labor statistics from two monthly surveys. The household survey measures labor force status by demographics; the establishment survey measures nonfarm employment and data by industry. The nonfarm payrolls component of the establishment survey are drawn from private businesses and government entities. The nonfarm payrolls number is among the most widely used data points to assess U.S. employment trends. The unemployment rate is the percentage of the labor force that is jobless and actively willing and available to work.

The Treasury yield curve displays the market interest rate across different contract lengths for U.S. Treasury bonds, indicating the relationship between the interest rate and the time ("term") to maturity. The yields of the 2-year and 10-year U.S. Treasury bonds are widely followed barometers of the current U.S. interest rate environment. Treasury bond data used in calculating interest rate spreads is obtained directly from the U.S. Treasury Department, through FactSet.

The Bureau of Economic Analysis reports monthly data on personal income (income received by all persons from all sources) and outlays (the sum of personal consumption expenditures, personal interest payments and transfer payments). It gives a comprehensive look at the income and spending patterns of U.S. consumers.

The U.S. Treasury regularly issues press releases to provide updates on its borrowing needs in the months ahead. The 7/31/23 release is linked. https://home.treasury.gov/news/press-releases/jy1662.

Congressional Budget Office. Since 1975, CBO has produced independent analyses of budgetary and economic issues to support the Congressional budget process. Each year, the agency's economists and budget analysts produce dozens of reports and hundreds of cost estimates for proposed legislation. The May 2023 update to 10-year budget projections: https://www.cbo.gov/data/budget-economic-data#3.

Fitch Ratings is a global credit agency that investors use to asses an entity's credit worthiness and estimated ability to pay back its debts. It is one of three widely-used global ratings agencies. Investment grade ratings are AAA, AA, A, and BBB. On 8/1/23 Fitch moved its ratings on U.S. Government debt to AA+ from AAA. https://www.fitchratings.com/research/sovereigns/fitch-downgrades-united-states-long-term-ratings-to-aa-from-aaa-outlook-stable-01-08-2023.

On August 24-26, 2023, the Kansas City Federal Reserve Bank held its annual Economic Symposium in Jackson Hole, WY. The 2023 conference was titled "Structural Shifts in the Global Economy." Federal Reserve Chair Jerome Powell made opening comments on 8/25/23. Thos comments are linked here: https://www.federalreserve.gov/newsevents/speech/powell20230825a.htms

The Federal Reserve Bank of Atlanta produces a widely-followed GDPNow estimate of the current quarter GDP trends. It is not a forecast but rather an estimate of current GDP trends using only economic data that has already been reported (most data is reported on a monthly basis). The most recent estimate is here: https://www.atlantafed.org/cqer/research/gdpnow.

New York Federal Reserve Bank data on household debt and credit balances can be found here:
https://www.newyorkfed.org/microeconomics/hhdc.html,
https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2023Q2

San Francisco Federal Reserve Bank data on consumer excess savings can be found here: https://www.frbsf.org/our-district/about/sf-fed-blog/excess-no-more-dwindling-pandemic-savings/

The Education Data Initiative is an independent research firm that compiles data on the U.S. education system from publicly available data. Their work on student loan balances and payments can be found here: Hanson, Melanie. "Average Student Loan Payment" EducationData.org, May 30, 2023,https://educationdata.org/average-student-loan-payment

Hanson, Melanie. "Student Loan Debt Statistics" EducationData.org, August 20, 2023,https://educationdata.org/student-loan-debt-statistics