Powell Kills the Optimism

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As expected, Powell's comments on Wednesday, June 21st spooked investors who thought rates were done moving up or that cuts were on the horizon. Like we've warned for months now, we're not out of the woods yet. However, we also haven't turned bearish on stocks. Despite a whole lot of bad news, company earnings have been strong for the first quarter of 2023. At the same time, we don't think our monetary problems are behind us. Make no mistake, continually raising rates will cause a liquidity crunch as we've already seen with SVB, First Republic and a handful of other regional banks. Eventually, Powell will have to pivot, or he'll go down as one of the worst Fed chairs we've ever had.

Either Powell is posturing, or he really does intend to abruptly kill growth and send our economy into stagflation. While 5% rates don't equate to a depression, 6 or 7% rates could cause some serious pain. For three years, the Fed has enabled politicians to whipsaw monetary supply, usually only a feature of communist or socialist countries. With M2 money supply on the decline and large banks earning billions risk free, there's little incentive for companies to spend money on capital expenditures, unless they have a reasonable chance of earning 15% or even higher IRRs. Again, it doesn't mean Armageddon is lurking around the corner, but stagflation can slow down market growth for years on end. In our opinion, many companies are priced for total perfection…one slip up with earnings and we could see some significant volatility within the S&P 500 Index.

Big Tech – We've been long run buy and hold investors in Apple, Microsoft, Amazon, Facebook (Meta), Google and Netflix. They're excellent companies and have generated outsized returns the past 10 years. We don't recommend panicking out of these stocks, however it could be a good idea to lock in some profits from the past 12 months. While a few of these companies are less of a bargain than they were at the end of 2022, high octane growth companies are trading for astronomical, COVID level prices. While we've given up some of the upside by not owning ultra-aggressive growth in 2023, we've earned great returns on Big Tech with far less risk. Remember, the market is mostly weighted towards Big Tech companies and the S&P 500 Index's return will largely be determined by only a handful of stocks.

Flight to Safety – so called "safe" sectors like consumer staples, utilities and energy stocks have performed extremely poorly this year. Like we wrote at the end of last year, so many Wall Street analysts were overly bearish, driving billions of dollars into these cyclical industries. While many of these stocks are great long-term holdings, we cautioned clients not to overweight towards them. The market is always a forward-looking indicator of what's to come, so by the time most people react and rebalance, the easy money has already been made. Overpaying for utilities and consumer staples is almost as bad as buying a bond for the wrong price…it's nearly impossible to recover losses.

Quality Dividend Growth – the capital allocation balancing act is to buy quality companies for a reasonable price. Buying high quality companies with a consistent history of increasing dividend and stock buybacks has been a winning strategy for our team the past 42 years. While many S&P 500 Index companies are overvalued and not worth owning, there's dozens of great names that are still undervalued and represent an attractive buying opportunity. Through our math driven portfolio management process, we look for companies with above market growth rates, low leverage and strong balance sheets where expected capital appreciation is 6-10% annually the next 5 years. Many of these companies also issue 2-3% in dividends, so our target return is 8-13%, more than compensating us for taking equity risk. It's no guarantee, but the process has driven consistency over time.

Yes, we've sounded more bearish the past few weeks, but our philosophy is still the same - buy and hold good companies for the long run, taking some profits along the way. Don't be alarmed though if we re-enter some choppy waters later this summer, we still have some bad monetary policy to burn off.

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