2023 Mid-Year Outlook

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As we approach the mid-point of 2023, the S&P 500 Index is up over 14% for the year, defying bearish Wall Street expectations of major profit declines. Rather, earnings have been strong, with even Bank of America upgrading its year end S&P 500 price target at the end of the first quarter. For the rest of the year, the question remains, where do we go from here? Does Powell push us into an abyss or do entrepreneurs continue growing earnings through this challenging market environment? We've been bullish for the past 15 years and make no mistake, aren't turning bearish anytime soon. In the long run, earnings are expected to rise 9.5% per year through 2025, stronger than average. If interest rates weren't a factor, this would be an extremely bullish sign for stocks. However, with rates hovering around 5%, future profit growth is discounted against high risk-free returns that disincentivize investment in longer term assets like stocks.

Long term we think stocks and profits will rise, but in the short run, getting back to the S&P 500's all time high of 4,750 could take some time until rates stabilize or decrease. Far out 2025 profit estimates are now projected to be $270. At an average forward price-to-earnings ratio of 18, the S&P 500 would trade around 4,860 by year end 2024. If rates adjust back to their usual 3% range, stocks could trade at 20 times earnings, valuing the S&P 500 at 5,400 by year end 2024. Again, the Federal Reserve will be the deciding factor in where markets end up the next 18 months. Valuing the S&P 500 at 18 times earnings requires rates to stop going up and drop into the 3.4% zone by end of 2025. That's why we are still taking a balanced approach to portfolio management, managing risk in the context of rates that could potentially go higher. We want to own stocks that have the potential to rise 8-12% per year the next few years and still maintain a weight for our retired clients in high-quality short-term Treasuries. We may give up some upside if rates are aggressively cut lower in the next year, but downside is protected even if the Fed continues raising for longer.

Housing/Real Estate – we don't expect a major 2008 style residential real estate crash. Even with existing inventory rising slightly the past few months, outstanding availability is still 17% lower than last summer. We will most likely see some price cuts and the number of days on the market extend, but remember, housing prices are still up 40% since February, 2020. Since 1987, housing has gone up 4.4% per year. Even if current prices decrease upwards of 18%, price growth would still be in line with the long run averages. Commercial real estate could be more challenging, especially in the office and warehouse space. We still like the net lease sector, however business inventories are rising, a potential headwind for industrial.

Energy – the oil and gas sector is up 220% since the bottom of 2020, a great trade if you had impeccable timing. The past 5 years though, energy is only up 4% per year including dividends. These abysmal returns have made stock picking in the O&G space more important than ever. For example, the total return on ExxonMobil, Chevron, ConocoPhillips, BP, and Shell the past 5 years has been 38%, 25%, 40%, 20%, and 26%, respectively. Other energy companies like Schlumberger, EOG Resources and Occidental haven't been nearly as good investments, producing largely flat or negative returns the past 5 years. We expect energy prices to remain elevated for awhile, although would recommend caution piling into too many energy stocks. While P/E ratios at the majors are low, it could signal a potential value trap.

International (China/Europe/Japan) - Wall Street has been trying for a decade to convince American investors to dump U.S. blue chips in favor of Chinese, European, and Japanese stocks due to their relatively low valuation metrics. We've argued against this idea the past 5 years and continue to urge caution owning international stocks. While there are some good companies abroad, the CCP has made investing in Chinese stocks nearly impossible. Similarly, bad monetary policy has caused broad Europe and Japan to run massive deficits with very little growth. For 15 years, international has significantly underperformed the U.S., a trend we think will continue.

Bonds – if you've followed the weekly article and show since 2019, we've urged you to stay as far away from bonds, especially long-term bonds, as possible. While we do need a position in secure short-term Treasuries for our retired clients, core bonds have produced a 4.4% total return the past 5 years, an absolute disaster especially when factoring in inflation.

For the rest of 2023, we expect somewhat muted upside, continued volatility, but the rest of the market outside of Big Tech to catch up. We're remaining cautiously optimistic, certainly not bearish, but not overly bullish.

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