Are We Due for a Correction?

Article by: Nick Stenger, *Chief Executive Officer, Financial Advisor*
Phone: (630) 912-8295 | Email: nick.stenger@stengerfamilyoffice.com

Despite all the abysmal 2022 year-end predictions, the S&P 500 Index is up nearly 17% for 2023. The average Wall Street S&P 500 forecast for the year was only 4,009. To analysts' surprise, Q1 and Q2 earnings haven't been nearly as bad as initially thought. Overall earnings for Q2 are down 9% year-over-year. Driving most of the decline though are energy stocks. Excluding energy, earnings are relatively strong for 2023 and projections into 2024 and 2025 look even better. That's why we've remained cautiously optimistic. While earnings are strong, valuations are the metric to watch. Valuations are primarily influenced by interest rates, which is why we've closely monitored the Fed the past 3 years. As of July 21st, the S&P 500 is now trading at a forward price-to-earnings (P/E) ratio of 19.5 with many investors hoping rates drop back to the 3.5% range in 2025. We believe some sectors of the economy have become overvalued because of these rate projections while others have become undervalued and still represent a significant buying opportunity.

Banks/Financials – after the SVB and First Republic fallout in March this year, many investors panicked out of all bank stocks thinking we'd end up in another 08/09 style collapse. While there still may be some pain ahead with regional banks, we think many high-quality large banks have become unreasonably undervalued. Many large banks are now trading for 7-10 times earnings, significantly lower than their 12-15 historical averages. If rates remain around 3-4% for the next few years, large banks that pay nearly 0% on deposits should continue raking in profit.

Healthcare – with over 10,000 baby boomers retiring every day, healthcare can be a good long-term investment. However, post-COVID many vaccine makers have traded off as sales have dropped. While we're not overloading on all healthcare stocks, there are a few select names that have billions in cash reserves and significant innovation in the pipeline. Overall, healthcare is fairly valued from a P/E standpoint, so we're somewhat neutral on our exposure.

Communication Services – companies like Meta, Google and Netflix dominate this sector and our economy, which is why we think they are good long-term investments. At the end of 2022 we added to communication services in our Resilient America and Strategic Value portfolios because they had become significantly undervalued and oversold. While they're not quite as undervalued today, they still represent substantial monopolies in our modern economy. Facebook and Instagram have nearly 4 billion active users, 50% of the world's population. Google's stats are similar with 4.3 billion users. Very few companies in history have commanded market share of this magnitude. At some point these companies may be broken up by regulators which we expect to unlock even more long run shareholder value.

Energy – oil and gas earnings are expected to be 50% lower for the second quarter of 2023. As we warned late last year, energy stocks were priced for perfection and represented a time for investors to take profits. While we don't think energy stocks will drop dramatically from current levels, we see them as a potential value trap for the next few years.

Technology – we've long broken tech stocks into two major categories; 1) Established Tech and 2) High Octane Tech. Established technology related companies like Apple, Microsoft and Amazon have fared well in 2023 and the past decade. We've long advocated owning these stocks into perpetuity because of their dominance and massive market share. On the other hand, many fairy-tale high-octane tech stocks have rallied 100% or more in 2023 with hopes of rate cuts in early 2024. While they may continue to perform and we'll wind up wrong, we aren't willing to take the risk of owning high octane growth when we can meet return objectives with tech companies that are already well established. Technology is most susceptible to market corrections and could be an area to exercise caution around for the rest of 2023.

In summary, we continue advocating for a cautiously optimistic approach to portfolio management, especially for retired clients. When rates were near 0% in 2020, it was hard to own fixed income when stocks were making new highs every day. With rates now hovering around 5.5%, we're compensated for managing risk and can still target 8-10% annualized returns for the next few years. A correction will happen at some point, but doomsday prepping in advance is not a good investment strategy. Rather, investors should be a goals based financial plan that allocates capital according to long term objectives. We do expect the Matthew principle to continue compounding for the next few years like it has the past 10 years – i.e. the big get bigger. That's why we've taken security selection seriously, owning the biggest and best names with the strongest balance sheets.

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NICK STENGER
CHIEF EXECUTIVE OFFICER
FINANCIAL ADVISOR

Stenger Family Office LLC. 400 E. Diehl Road, Suite 550, Naperville, IL 60563