Don't Miss the Data

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There are a million things to worry about on any given day. A potential hot war with Russia, looming economic problems in China, record high interest rate hikes and countless other doom and gloom stories are hitting the news as reasons why stocks will get pummeled in 2024. Like we wrote about last week, there are clearly short-term risks if the U.S. engages in a hot war with Russia. Financial Times reported this week that Nato is launching its biggest military exercise since the cold war in Germany, Poland, and the Baltics to practice guarding against future Russian attacks.

For now, it appears as if China is laying off on a Taiwanese invasion after watching Russia's invasion of Ukraine. While President Xi still has a strong grip on China, it seems like he is facing some backlash amidst significant economic problems that arose after throwing the country's top billionaires in prison. In many cases, political leaders will launch offensive attacks abroad to distract from problems at home. Regardless, China is a risk to keep an eye on. We've made it a point to avoid owning international equities, namely Chinese companies. Another risk to be aware of however, is U.S. based companies with significant Chinese exposure. Most recently, Apple's iPhone 15 launch is facing serious issues with a Chinese government ban for state backed agencies and companies. China represented 20% of Apple's sales in 2022. In our opinion, this signals serious weaknesses in China's economy. Every time President Xi threatens businesses, China gets weaker. Apple isn't the only company exposed to China risk. Starbucks, who has plans to reach 10,000 Chinese stores by the end of 2025 is also exposed to potential risk. Each time an American company expands in China, the threat of a shutdown always lurks around the corner. We aren't bearish on these stocks, but these examples should serve as a warning that companies should consider geographic diversification to friendlier economies like India.

Despite the usual doom and gloom, stock prices will trade on expected earnings. Large company profits are projected to rise 26% by 2025, possibly placing the S&P 500 Index around 5,300-5,500 points by the end of 2024. While we could be wrong on the timing, we think we're right about the market's trajectory. Critics of our view will point to 5% risk free rates and argue for the ownership of Treasuries. While short-term high-quality U.S. debt plays a role in the portfolio for families in or nearing retirement, overweighting to them can seriously reduce long run returns. The looming question is how long the Fed will keep rates high or process a few cuts. We continue to believe rates could stay higher for longer, which could reduce the value of stocks in the short run. However, the doom and gloomers that say profits will plummet simply aren't looking at the data.

One of the main reasons we don't expect profits on large companies to plummet is because of future layoffs. While we obviously don't root for this, the easiest lever companies can pull during a slowdown is wages. The over-hiring trend that took place during 2020 and 2021 could easily reverse and stabilize margins for the rest of 2023 and 2024. Numerous reports show companies using return-to-work policies to force quitting. While some of these trends should help high quality large businesses, we've continued to issue caution around lower quality parts of the market including small cap, high flying tech, and over-leveraged midcaps. The more leverage a company has, the more susceptible it is to major losses after minor decreases in revenue.

JP Morgan CEO Jamie Dimon recently said the economy is on the brink of collapse thanks to proposed banking regulations that would increase U.S. bank capital requirements higher than European banks. While he's right that these proposed regulations would hurt U.S. banks, we disagree with his doom and gloom sentiment. Dimon called for an "economic hurricane" in June of 2022 and said the S&P 500 Index would drop 20% in 2023. He's been wrong so far, but his predictions aren't unlike many other CEOs who have no incentive to overpromise and underdeliver. Rather, companies and CEOs would rather say things are bad and outperform low expectations. While Dimon might be right in the short term, we think he'll be wrong in the long run. As investors we want to be aware of possible downturns, but, adjusting portfolios because something negative might happen in 6 or 12 months is almost always a bad idea.

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