Grab Your Machete

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A few weeks ago we called the current stock market environment the "Jungle." In contrast to what we once called the "Wilderness" years, the jungle is full of risk but not without upward movement in stocks. In our opinion, the key differentiator is that high quality stocks could continue outperforming for a while. The past 5 years, the S&P Top 50 Index has outperformed the S&P 500 Index by nearly 3% per year and by 3.5% the past 3 years. The Top 50, heavily dominated by Microsoft, Apple, Meta, Nvidia, Google, and Amazon, have helped take markets to brand-new all-time highs. There's risk owning these stocks, but there's a reason why these companies are so dominant – in some ways, they've become quasi-utilities, critical to our day to day lives and business. For example, few companies could operate without Microsoft Office, smartphones, or Google's advertising data. During the jungle years, we could continue to see outperformance in the best names as bottom tier companies head to zero.

Sifting through the garbage to find diamonds starts with a universe of roughly 8,300 United States based companies. Out of the 8,300 only 1,933 are profitable and projected to be profitable the next 12 months. Of the 1,933 that are profitable, only 1,093 have grown profits and revenues the past 5 years. Of those 1,093, 297 pass our balance sheet tests and have a strong cash position. Of those 297, only 96 meet our large capitalization criteria. When it's all said and done, our Stenger quality screen reduces potential portfolio companies by 99%. This isn't a new phenomenon, but its impact on investor portfolios is more critical during high inflation, high interest rate environments. Similarly, mid-cap companies have seriously underperformed large-caps and small-caps have underperformed mid-caps the past 5 years. The rising cost of capital is having a major impact on companies that took out tons of cheap debt during 2020 and are now facing resetting interest rates in 2025.

There are some other risks to markets and the economy right now. First, inflation is stubborn, and the Fed is most likely going to make a mistake with interest rates. While crude oil is down 35% since their peak 2022 levels, *prices are still 42% higher than they were in 2019*. Home prices are down 5% since all time highs, but still 32% higher than 5 years ago. A bright spot for inflation is used car prices which are down 17% since peak levels, but again, 28% higher than they were in 2019. In either direction, it's likely the Fed will screw something up. Either inflation is moderating faster than they think, the consumer is weakening, we're about to enter recession and the Fed will stay too high for too long, or the Fed will cut rates too soon for political reasons and we'll wind up in the 1970's all over again. In the short run, both types of mistakes will trigger a short-term correction, not a reason for investors to panic.

Investors shouldn't be overly focused on politics as a major investment risk. Markets favor gridlock in Washington which is likely to occur this election season. Gridlock slows down the rate of policy change, providing a stable and predictable environment for businesses to operate. Statistically, the first year in a presidential election cycle is very positive and returns are usually in the low double digits. Markets love predictability which is why year 1 is typically positive and year 2 leading into the midterms can be volatile.

For all the reasons to be nervous, there's plenty of good news going on under the surface. First quarter earnings on the S&P 500 were incredibly strong, up 5.4%. Excluding Bristol Myers, earnings growth would have been 8% for Q1 (FactSet). Excluding Bristol Myers, Gilead, and Pfizer, earnings growth would have been north of 10%, an incredible surprise to Wall Street analysts.

Technology is moving at the speed of light and technology drives earnings growth over time. Companies have a propensity to produce record beating earnings because they can leverage tech to reduce costs and improve productivity. During the jungle years, we could continue to see strong stock market performance for the best companies while at the same time seeing doom and gloom news for the rest of the economy.

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