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The Stealth Correction

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The S&P 500 Index is up around 11% year-to-date. Comparatively, mid-cap stocks are up 8%, and small-caps are up a measly 1.6%. Growth oriented companies have led the charge in 2024, coming off a strong 2023 and blood bath in 2022. Since the Fed started raising rates, large growth companies like Microsoft, Amazon, Meta, Google and Nvidia are up 5% while dividend-oriented value stocks are up 23%. None of this should really be all that surprising. Rising interest rates crush valuations and decreasing rates increase earnings multiples. But what's important to note, is stocks ultimately trade on earnings.

Stocks can go up when rates go down, even if profits stagnate. Similarly, stocks can go down when rates rise, even if profits are rising. The signal of stock prices is profits, the noise is the Federal Reserve. Interestingly, small-cap growth stocks have performed the worst out of any category the past 5 years. These companies typically finance their growth with a lot of debt, and with rising interest rates are facing a credit crunch. On the other hand, large-cap growth stocks the past 5 years have absolutely ripped. The difference is earnings quality and balance sheet stability. As we've pointed out, the Mag-7 deserve their massive market capitalizations because of the amount of money they earn and cash on hand. For example, NVIDIA is now worth $2.98 trillion, 55% more than Amazon, almost 5x more than J.P. Morgan, and a shocking 5.5x more than ExxonMobil. Even after returning more than 3,000% for investors the past 5 years, NVIDIA is only trading at 44 times forward earnings.

So, what could go wrong for companies like NVIDIA? First, competition could kill growth and earnings could fall. This is a possibility but seems less likely than a second scenario where investors place a different multiple on NVIDIA's future profits. A stock trading at a 44 P/E multiple could easily correct in the short term to 30x earnings, sending the stock down 30% or more. None of this is meant to say buy or don't buy, but rather to point out owning stocks requires fortitude…and lots of it. While companies like Nvidia are having a positive impact on S&P 500 returns in 2024, there are a lot of companies that are currently in a stealth recession.

Of the mega-caps, year-to-date, Tesla is down 30%, Salesforce is down 10%, Johnson & Johnson and UnitedHealth Group are down 6%. Similarly, in the large-cap bucket, Intel is down 40%, Walgreens is down 39%, Boeing is down 30%, Adobe is down 26%, Gilead is down 21%, and Humana is down 20%. While many of these names may not ever return to their all-time highs, they certainly represent a portion of the market that's not doing well despite double-digit headline returns. The question for the rest of 2024 is whether high performing growth stocks mean revert to where the rest of the market is or if value & dividend-oriented companies catch up with the highfliers. We think a lot of the answer depends on rate expectations.

Remember, the market prices in these moves 6 to 12 months in advance. At the beginning of 2024, almost everyone on Wall Street said rates would be cut by March and it didn't happen. Looking to April of 2025, 97% of Wall Street says rates will be lower. But the problem is, lower rates mean lower than 5.25%, not post-2008 rock bottom levels of 3.5% or less. In the end, someone is in for a big surprise. Either the economy weakens, the Fed cuts rates for political reasons later this summer, or the Fed stays higher for a lot longer than everyone currently believes. Staying higher for longer won't matter long term because good companies will still make money. As long as we don't pay too much for their earnings, we should continue earning consistent returns. The Fed cutting rates sooner than people think won't matter in the short term but could matter in the long term if inflation comes roaring back like it did in the 70's under Arthur Burns.

In the end, we think the same Stenger playbook will work in either environment. 1) Own quality companies; 2) Invest in U.S. entrepreneurs; 3) Hold large-cap blue-chips with real business models; 4) Avoid long term bonds; 5) Don't try and time the market. Fast forward a few years through the jungle and we think earnings on the S&P 500 will be close to $315, forward P/E will be around 20, and Index will trade around 6,300 points. It's possible the dispersion between the best and the rest of the market will widen and big companies will continue winning at an even faster pace. In our view, you can't go wrong owning the biggest and best, especially at this point in the cycle.

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