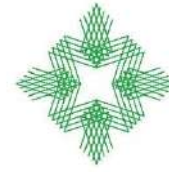


60 Cuttermill Road  
Suite 516  
Great Neck, NY 11021  
(516) 439-5100

112 Westwood Place  
Suite 210  
Brentwood, TN 37027  
(615) 620-3900



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## RECESSION OR SOFT LANDING? OUR OUTLOOK FOR THE MARKET

Chart I



*Source: Strategas Securities, LLC as of 9/30/2023*

The third quarter of the year lived up to its historic reputation of being a difficult three-month period. The S&P 500 declined 3.2% in the quarter and 4.9% on an equal-weighted basis. The trend of favoring mega capitalization growth stocks was also apparent when viewed on a nine-month basis ending September 30<sup>th</sup>.

### **% Change 1/1/2023 – 9/30/2023**

S&P 500 Capitalization Weighted	13.0%
S&P 500 Equaled Weighted	1.7%

*Source: Bloomberg*

The trend is exacerbated by the fact that only about ten mega capitalization stocks account for over 96% of the market returns for the first nine months of the year (Chart II).

**Chart II**

<b>Annual S&amp;P 500 Contribution of 10 Largest Weights During Positive Performance Years</b>		
<u>Year</u>	<u>Top 10 as % of Total</u>	<u>S&amp;P 500 % Perf.</u>
<b>2023 YTD</b>	<b>96.5%</b>	<b>11.7%</b>
2007	78.7%	3.5%
2020	58.9%	16.3%
1999	54.5%	19.5%
2021	45.0%	26.9%
1998	36.8%	26.7%
1996	33.9%	20.3%
2017	33.3%	19.4%
2019	32.8%	28.9%
1991	28.6%	26.3%
2006	27.6%	13.6%
2016	26.6%	9.5%
2003	23.6%	26.4%
1995	22.3%	34.1%
2014	22.2%	11.4%
2004	21.1%	9.0%
2005	20.5%	3.0%
2010	19.6%	12.8%
2012	19.2%	13.4%
1997	19.1%	31.0%
2013	17.6%	29.6%
2009	15.5%	23.5%
1992	14.9%	4.5%
1993	12.2%	7.1%

*Source: Strategas Securities, LLC as of 9/30/2023*

The flattish, equal weighted market returns reflect the overall outlook for corporate profits. Consensus estimates assume no growth in S&P 500 earnings this year. Despite a sharp rise in interest rates, mega cap stocks have enjoyed an expansion in valuation while most other equities reflect p/e compression. This has created the bifurcated market we are currently experiencing. We see little evidence that this current trend is likely to change anytime soon.

Importantly, most companies will report quarterly earnings over the next four weeks. Barring a disappointing earnings season, the market may continue to trade around current levels and stage a modest year-end rally if the outlook for 2024 earnings remains positive.

## INFLATION IS TRENDING LOWER

**Chart III**



*Source: Strategas Securities, LLC as of 07/31/2023*

Most observers would indicate that the rapid rise in inflation was largely caused by a sharp increase in global consumer demand as Covid lockdowns disappeared concurrent with a delayed recovery in the global supply chain. Aggressive financial assistance to consumers by the government added to the sharp jump in consumer demand. This created more pressure on the global supply chain as consumer demand spiked. For the most part, these factors are now returning to a more normal pattern. Indeed, many believe the U.S. consumer has used up much of its excess savings (Chart III). Thus, we should see a slowing in consumer demand in the near future. At the same time, the global supply chain is also returning to normal. In combination, inflation trends have steadily slowed from the prior levels of early 2023.

**Chart IV**



*Source: Strategas Securities, LLC as of 9/30/2023*

Currently, future expectations are assuming a 2.8% inflation rate (Chart IV). While the Federal Reserve is continuing to indicate a 2% inflation target in the longer term, we point out that the historical inflation rate has averaged about 2.6%. Regardless, should inflation rates drop below 3% in 2024, we believe the Fed may well have to cut interest rates next year. Barring a surprise jump in inflation in the future, U.S. interest rates may be at or near a peak. While the Fed may boost short term rates one more time in 2023, the continued slowdown in consumer demand, GDP growth, wage growth, and shelter costs should combine to hold inflation to 2-3% in 2024. This sets the stage for a possible Fed rate cut next year.

Recent jobs data indicate that the strong job market remains powerful. This is giving rise to recent inflation fears. However, wage growth is moderating even with strong employment trends. As consumer demand continues to slow, a soft landing remains a real possibility in 2024.

### **GOVERNMENT REFINANCING SHOULD ALSO BE A HEADWIND TO GROWTH**

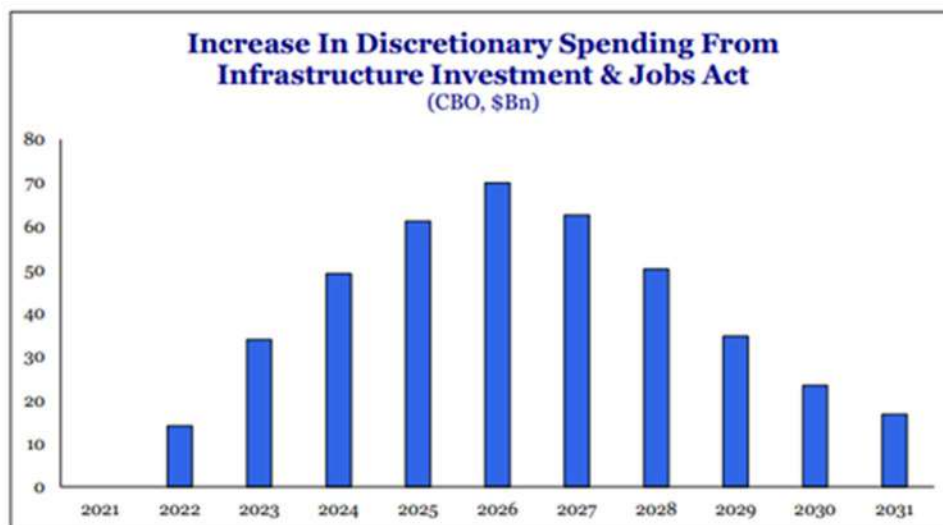
Chart V



*Source: Strategas Securities, LLC as of 10/12/2023*

We also point out that U.S. government debt refinancing is at a peak. Over half of all federal debt needs to be refinanced in the next two years (Chart IV). The debt coming due has an average coupon rate of about 3.0%. Current refinancing is likely to average 4-6%. This should cause a dramatic increase in interest expense over the next few years. The U.S. government may have to cut back on spending and/or seek higher tax revenue to offset the increase in debt servicing. This should act as a headwind to economic growth in the future.

**Chart VI**



*Source: Strategas Securities, LLC as of 9/30/2023*

One area that should not feel this pressure would be government spending on infrastructure. With the passage of the infrastructure and jobs act (Chart VI), significant government spending in this area is poised for acceleration in the next few years. This will largely impact industrial America as programs are put in place to modernize our aging infrastructure.

## **OUTLOOK FOR 2024**

Our base case assumes inflation below 3% and interest rates are stable or likely to decline. This leaves corporate profits as the potential big swing factor in 2024. At this juncture, our assumption is that the consensus view of corporate profit growth of 10-12% is likely to be too high.

- High interest rates should temper profits at many companies as they refinance debt at much higher rates.
- Fiscal policy expansion is likely to be tempered by a sharply higher cost of servicing debt.
- A divided congress suggests little likelihood of a stimulus program if the U.S. economy continues to slow.
- Consumer spending trends should continue to moderate as savings return to normal levels.

On the plus side, we may see a continued slowing in inflation and an ultimate cut in interest rates. Additionally, China seems to be accelerating its growth now that its Covid lockdown is over. If we do slip into a recession, it may be a shallow one. Overall, the equity market should remain bifurcated with mega cap and growth stocks holding up better than cyclical and slow growth industries.

## **PORTFOLIO CHANGES**

We made significant portfolio changes in the third quarter. Taking advantage of the market pullback, we increased our exposure to technology and added one growth-oriented pharmaceutical company. Concurrently, we sold our position in Generac to reduce industrial exposure. The following is a summary analysis of our new additions.

### **Merck:**

Merck is a diversified pharma company with a leading oncology portfolio trading at a below-market multiple. Their top drug, Keytruda, treats several types of cancer and generates over \$20 billion in annual revenue. Merck's broad portfolio includes eight drugs that earn \$1+ billion in annual revenue. These include Gardasil (HPV vaccine), Bridion (muscle recovery after surgery), Januvia (type 2 diabetes), among others. We like the company's diversified revenue base, large portfolio of nascent drugs ("shots on goal"), strong track record of outperformance, and discount valuation.

### **ASML ("Advanced Semiconductor Materials Lithography"):**

ASML is a \$240 billion market cap Dutch semiconductor company with a monopoly position on extreme ultraviolet ("EUV") lithography machines. These \$200+ million machines imprint the designs you see on microchips and are the building blocks for the semiconductor industry. Experts say it could take decades for another company to catch up to ASML's proprietary technology. The company should benefit from the "de-Chinafication" of the semiconductor industry as the U.S., Europe, Japan, and Korea build out their local chipmaking plants.

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