

Discount the Happy Talk

The stock market finished Friday on a high note, with the S&P 500 index just north of 4,200 for the first time since August 2022 and up 17.6% versus the market bottom in October.

Part of recent gains are related to optimism about the effect of Artificial Intelligence on some high-tech stocks. Another part might be due to signs that Congress and the White House are closing in on a budget agreement that might limit spending growth for the next couple of years while averting a debt default.

But the recent rally also seems related to a general sense of increasing optimism about the broader economy, with investors getting more confident the economy will avoid a recession this year and next.

For the long-term, we remain optimistic about the US economy and the stock market. But we don't share the stock market's optimism about the next year or so and think recent data support the case that the US is still headed for a recession.

Economy-wide corporate profits declined 5.1% in the first quarter of 2023, the fastest drop for any quarter since 2020 during the early days of COVID. As some analysts have pointed out, the drop appears to be driven by large and unprecedented losses at the Federal Reserve, a result of the Fed paying banks higher interest rates for them to hold reserves, combined with the Fed's massive balance sheet.

But appearances can be deceiving. Yes, the Fed is losing more money than ever before, but those losses are due to payments to banks that should lift those banks' profits. And despite that boost to banks' profits, economy-wide profits *excluding the Fed's losses* were still down 2.7% in Q1.

These profits are important because that's what we use in our Capitalized Profits Model to assess the stock market. That

model takes these profits and discounts them by the 10-year US Treasury yield. These data go back seventy years to the early 1950s. Using a 10-year Treasury yield of 3.8% (the Friday close) to discount profits suggests the S&P 500 index is fairly valued at about 3,500, well below the Friday close of 4,205.

Meanwhile, there was trouble lurking beneath the surface of Thursday's GDP report, which included our initial look at first quarter Gross Domestic Income, an alternative way to count economy-wide production (as opposed to GDP) that is just as accurate. Real GDI declined at a 2.3% annual rate in first quarter, not the 1.3% annualized gain counted for Real GDP. In addition, Real GDI is now down 0.9% versus a year ago, compared to a 1.6% gain for Real GDP during the same timeframe.

One last problem: The Fed delivered its monthly report on the money supply last Tuesday and it showed that M2 declined another 0.8% in April, the ninth consecutive monthly drop. We have gone from the Mount Everest of M2 increases in 2020-21 to the Death Valley of declines in 2022-23, with the largest drop since the Great Depression. It's hard to see the economy not eventually feeling the pain caused by that drop.

We're not trying to say the economy is already in a recession. Recent figures show the job market is still holding up and consumer spending is still expanding. What we are trying to do is show that we are not out of the woods regarding recession risk, not by a long shot.

We are not often pessimistic about equities and think the long-term is still bright. However, we think there are still problems ahead in the near term and investors need to be prepared.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|-----------------|--------------------------------|-----------|-----------------|--------|----------|
| 5-31 / 8:45 am | Chicago PMI – May | 47.1 | 47.8 | | 48.6 |
| 6-1 / 7:30 am | Initial Claims – May 27 | 235K | 231K | | 229K |
| 7:30 am | Q1 Non-Farm Productivity | -2.5% | -2.2% | | -2.7% |
| 7:30 am | Q1 Unit Labor Costs | +6.1% | +4.5% | | +6.3% |
| 9:00 am | ISM Index – May | 47.0 | 47.1 | | 47.1 |
| 9:00 am | Construction Spending – Apr | +0.2% | +0.1% | | +0.3% |
| afternoon | Total Car/Truck Sales – May | 15.3 Mil | 14.9 Mil | | 15.9 Mil |
| afternoon | Domestic Car/Truck Sales – May | 12.2 Mil | 11.8 Mil | | 12.7 Mil |
| 6-2 / 7:30 am | Non-Farm Payrolls – May | 195K | 190K | | 253K |
| 7:30 am | Private Payrolls – May | 164K | 160K | | 230K |
| 7:30 am | Manufacturing Payrolls – May | 5K | 10K | | 11K |
| 7:30 am | Unemployment Rate – May | 3.5% | 3.4% | | 3.4% |
| 7:30 am | Average Hourly Earnings – May | +0.3% | +0.3% | | +0.5% |
| 7:30 am | Average Weekly Hours – May | 34.4 | 34.3 | | 34.4 |