MARKET MINUTE
WITH McGAREL

Dave McGarel, CFA, CPA
Chief Investment Officer

April 2023

The stock market displayed resilience in the first quarter of 2023 even as earnings forecasts for this year modestly declined. For the quarter, the S&P 500 Index was up 7.5%. At the beginning of 2023, earnings were expected to grow by low single digits by the end of the year. Today, 2023 earnings are expected to be down slightly from 2022. Yet, the growth sectors of the economy are dominating like it's 1999! Year-to-date through 3/31/23, Information Technology is up 22%, Communication Services 21%, and Consumer Discretionary 16%. Megacap growth companies are heavily weighted in these sectors and have led the way with outperformance in the first quarter. Even a speculative basket First Trust tracks, the 100 stocks with high price-to-sales ratios, modestly outperformed the S&P 500 Index.[1] Defensives and cyclicals are slightly up or modestly lower. Financials is the worst sector down 6% reflecting the current banking tumult.

It appears investors have been solely focused on interest rates as the dominant factor in equity positioning. Expectations are high for an end to the hiking cycle in the next quarter. Since the Silicon Valley Bank failure led to a banking crisis in early March, expectations have risen for rate CUTS toward the end of the year. Let's forget for a moment that EVERYONE has gotten the rate hike cycle wrong so far. Going into 2022, the Federal Reserve (Fed) was expected to move the fed funds rate higher by 75 basis points from zero starting in July through December. Instead, the Fed started increasing rates in March, sooner than expected, and ultimately raised interest rates 425 basis points. So far in 2023, the Fed has increased rates by another 50 basis points to 4.75%. Shock and Awe. ALL forecasts from early 2022 were significantly wrong.

Why would we think everyone (or anyone?) is right about forecasting future interest rates with any precision this time? Just like last year, it may well play out differently from the consensus forecast.

Our concern is that some market participants may be missing the forest for the trees. Let's say the Fed does cut rates later this year as inflation subsides and the economy softens. If investors expect that we are back in a 2019 environment where the Fed cuts rates and the market soars, we would disagree and note the differences today. The Fed cut interest rates in 2019 from 2.25% to 1.50% and stocks returned 31.5%, the second best return since 1997. However, valuations were much lower than today and earnings growth was finally accelerating after the listless growth in the mid 2010's.

If the Fed doesn't raise again and then lowers rates 75 basis points in the second half of this year, the fed funds rate would be at 4.00%, not 1.50%. The market trades at 19 times this year's estimated earnings. In January 2019, it was closer to 15 times. Earnings growth is slowing, not accelerating. Revenue growth may prove more challenging in an environment where price increases are tougher to pass on. Margins have already been getting hit based on higher wages and other increased costs. We believe none of this has to be disastrous to the stock market but neither does the data speak to a rip higher in earnings expectations or increased multiples any time soon.

In our view, investors need to focus on the windshield and not the rearview mirror. We believe a world of "higher for longer" rates and slower growth than the last four years is much more likely than a return to the abnormally low interest rate environment where long duration growth stocks dominate and high valuations are accepted. We continue to believe that the valuation spread between growth and value stocks will tighten as investors realize overall earnings growth will be very modest in a higher for longer rate environment. We advocate to use this opportunity to rebalance portfolios away from the highfliers and into areas of the market with better valuations.

Sector	Year-to-Date Total Return	2023 Estimated Price-to-Earnings
Information Technology	21.8%	27.0x
Communication Services	20.5%	17.3x
Consumer Discretionary	16.1%	26.4x
Materials	4.3%	17.1x
Industrials	3.5%	19.4x
Consumer Staples	0.8%	21.1x
Real Estate	1.9%	35.5x
Utilities	-3.2%	18.2x
Energy	-4.7%	10.0x
Health Care	-4.3%	17.5x
Financials	-5.6%	13.1x
S&P 500 Index	**7.5%**	**19.0x**

Source: Bloomberg. Data as of 3/31/23.

Past performance is no guarantee of future results.

The information presented is not intended to constitute an investment recommendation for, or advice to, any specific person. By providing this information, First Trust is not undertaking to give advice in any fiduciary capacity within the meaning of ERISA, the Internal Revenue Code or any other regulatory framework. Financial professionals are responsible for evaluating investment risks independently and for exercising independent judgment in determining whether investments are appropriate for their clients.

[1]The 100 stocks with the highest Price/Sales from the universe of the 1,000 largest US firms with at least $1 million in average daily volume over the last 3 months and 12 months of trading history.

The **S&P 500 Index** is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. For illustrative purposes only and not indicative of any investment. **Price-to-Earnings** is calculated by taking the price divided by next twelve months earnings per share. **Earnings per share** is calculated as a company's profit divided by the outstanding shares of its common stock. The resulting number serves as an indicator of a company's profitability. There is no assurance any forecasts will be achieved.