Pacific Coast
INVESTMENT ADVISORS

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5285 SW Meadows Rd. Ste. 315
Lake Oswego, Oregon 97035
P: 503.968.2500 | F: 503.968.2100
www.PacificCoastIA.com

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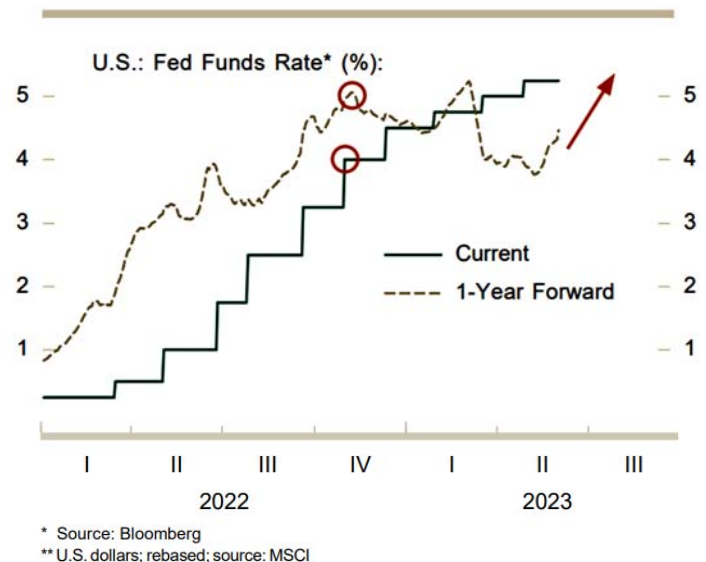
Federal Reserve Policy: The "Hawkish Pause"

The Federal Reserve, following a series of ten consecutive rate increases, has opted for a strategic pause to assess the delayed impact of its previous rate hikes. Despite the pause, Chairman Powell clearly communicated the FOMC's continued hawkish stance towards monetary policy, indicating that this pause was likely not an end to the current tightening cycle but rather a slowdown. Though the current policy rate remains steady at 5-5.25%, the Fed reiterated that decisions regarding future policy rates remain actively under consideration. Projections hint at the likelihood of two additional hikes for the remainder of 2023.

Rate Expectations "Peaked" Too Early, More Upside Potentially Ahead

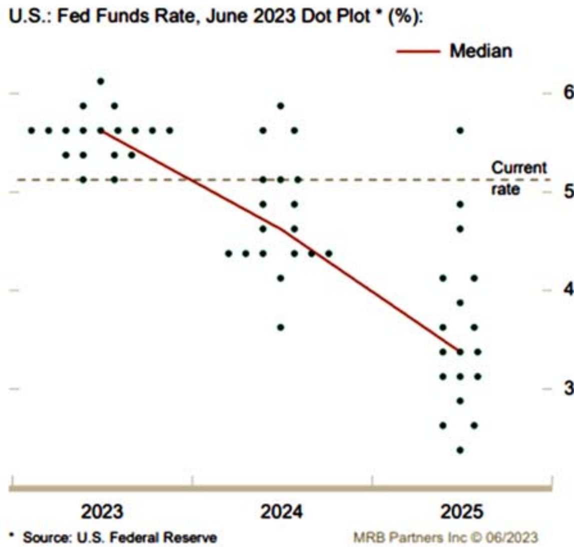


The Underestimated Resilience: US Economy and Persistent Inflation

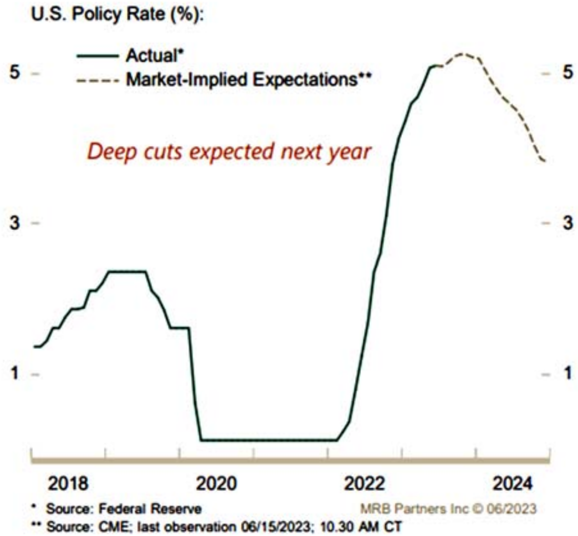
As we discussed last month, expectations for rate cuts in 2023 were misplaced as the US economy continued showing signs of resilience despite the stress in the banking sector during the first quarter of the year. The Fed recently updated its economic forecasts, further validating this narrative. The projection for 2023's real GDP saw an upward adjustment to 1.0% from 0.4% and the unemployment rate estimate was revised down to 4.1% from 4.5%. Inflation has also continued to remain sticky with the Core PCE inflation projection for this year seeing an increase from 3.6% to 3.9%, still well above the Fed's preferred 2% target.

The narrative that the U.S. economy is heading towards recession has been challenged by economic data that points to more resilience than previously assumed. This resilience, paired with a stubborn inflation that refuses to wane, is causing the Fed to reevaluate its terminal policy rate. A higher policy rate might become necessary if the Fed aims to guide inflation towards its 2% target in the medium term.

FOMC PARTICIPANTS EXPECT A HIGHER TERMINAL RATE



MARKETS ARE PRICING IN DEEP CUTS IN 2024



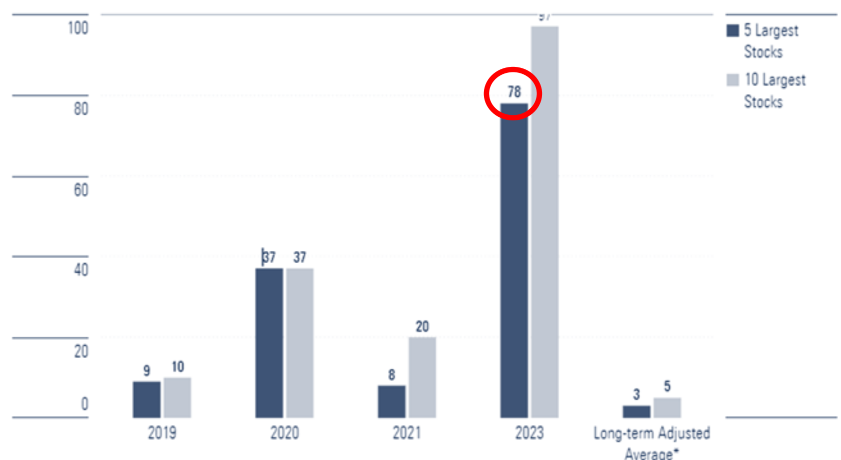
Despite adjustments in economic forecasts, there are no signs of an impending recession or inflation moving towards the 2% mark on its own. Consequently, the possibility of 2024 rate cuts appears to be receding, despite current market expectations. The Federal Reserve remains committed to data-dependent decision-making, indicating a still ongoing tightening cycle and potential downside risk for bonds.

A Closer Look at Market Concentration

This year, an unusual trend is unfolding in the U.S. stock market. A small number of stocks heavily influence the market's gains, suggesting a high level of concentration that surpasses recent records.

Within the S&P 500, the top ten stocks have exerted a remarkable influence, more than double their share compared to the previous year. Five tech titans—Apple, Microsoft, Alphabet, Amazon.com, and Nvidia—are responsible for a whopping 78% of the total gain. This trend, wherein a select few stocks dominate the returns, is reaching a significant peak in 2023.

Delving into the numbers reveals even more. When analyzing the Morningstar US Large-Mid Index, which includes the 716 largest U.S. stocks, we find that a significant 97% of the 9.6% total gain through May 2023 comes from the top ten stocks. In more striking terms, Apple, the largest stock in the U.S. market, is singlehandedly accountable for 17% of the market's returns. The three largest stocks collectively have contributed nearly half of the stock market's rise this year.



Cumulative Market Impact of the Largest US Stocks

	2019	2020	2021	2023	Long-term Average
Largest Stock	3%	13%	6%	17%	3%
2 Largest Stocks	9%	18%	4%	35%	3%
3 Largest Stocks	8%	27%	2%	47%	3%
4 Largest Stocks	10%	28%	5%	57%	3%
5 Largest Stocks	9%	37%	8%	78%	3%
6 Largest Stocks	9%	38%	11%	78%	4%
7 Largest Stocks	9%	39%	17%	90%	4%
8 Largest Stocks	9%	39%	17%	98%	4%
9 Largest Stocks	9%	38%	18%	99%	4%
10 Largest Stocks	9%	37%	20%	97%	5%

This concentration of performance has significant implications for investor portfolios. Investors in index funds tracking the overall market might see double-digit returns, but it's essential to note that high returns from a few stocks can quickly turn into significant losses if these companies falter. This vulnerability leaves the market potentially unstable.

A similar pattern is seen when analyzing market performance by industry. In May, gains from the Technology, Communication Services, and Consumer Discretionary sectors significantly offset losses in the remaining eight. This allowed the S&P 500 to eke out a 0.3% return. Although the S&P 500 has risen by about 9% since mid-March, the percentage of stocks trading above their 200-day averages has not shown significant improvement. This limited leadership and lack of broad market participation have become major concerns for markets.

There are deeper concerns as well. The ongoing increase in the valuation of already expensive U.S. stocks is leading to unsettling valuation differences. U.S. stocks are now trading at a 12-month forward P/E ratio of 19, a level only surpassed during the 1990s stock market bubble and in 2020-2021 (see chart right).

With U.S. profit margins still high and revenue growth slowing, the earnings risks for 2024 are cause for concern, despite the otherwise (relatively) positive economic growth outlook.

US Equity Valuations Looking Stretched

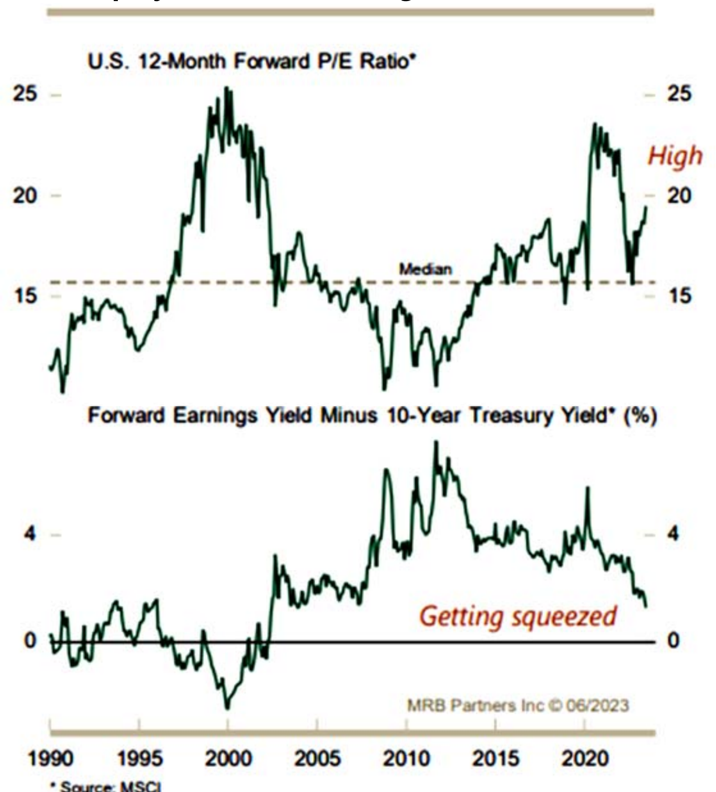
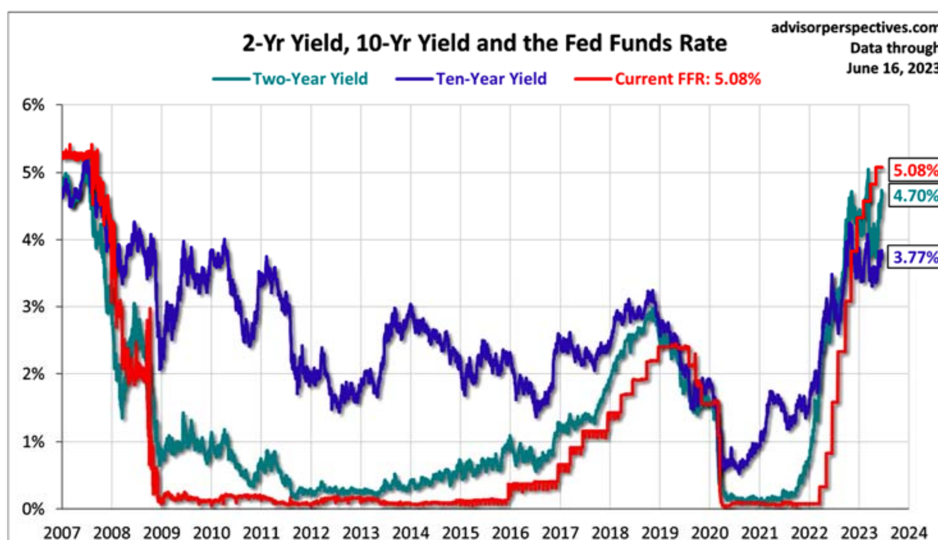


Chart of the Month - Cash Offers Attractive Yields

With equity valuations appearing stretched and lackluster earnings forecasts, holding cash and cash equivalents, such as treasury bills and government money market funds, allows us to earn attractive yields while mitigating risk in the portfolios. Below is a chart of the current yields 2-yr, and 10-yr Treasury Notes, as well as the federal funds rate.

When the Federal Reserve increases or decreases the federal funds rate, yields on Treasury bills and other short-term interest rates tend to move in the same direction because the Fed's actions influence the general level of short-term interest rates in the economy.



Final Thoughts:

In our current economic landscape, it's vital to carefully monitor the trajectory of inflation and the Federal Reserve's corresponding adjustments in monetary policy. Similarly, trends in market concentration and the performance of key stocks significantly affect investors.

With equity valuations trending higher amid potential signs of slowing revenue growth and weaker earnings forecasts, risk management is paramount. Hence, maintaining cash and equivalents can yield attractive returns while helping to mitigate portfolio risk.

We're committed to guiding you through these challenges, and we deeply appreciate your trust and confidence.

Enjoy Your Summer!

This newsletter and previous months are available on our website at
www.PacificCoastiA.com

Ryan J. Murphy, MSFP, CFP®, AIF®
ryanm@pacificcoastia.com

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