Zacks
INVESTMENT MANAGEMENT

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Mitch on the Markets

Portfolio Manager Investing Insights

As Stocks Surge, Are Investors Becoming Afraid of Heights?

Despite some market volatility experienced over the past week, U.S. stocks – as measured by the S&P 500 – are hovering around all-time highs. As I write, the S&P 500 is up over 5% to start the year, and the index has recorded 10 all-time highs so far in 2024.

That makes investors worried.

It's understandable why investors would get jittery here. Stocks' powerful rally, going on four months now, gives the impression that share prices are getting too frothy—especially considering that interest rates are still high, inflation is still above target, many Americans don't feel great about the economy, and the geopolitical outlook is one of uncertainty and instability. And yet stocks are surging?[1]

There's another point to make, which I think influences investor sentiment, sometimes indirectly. And that is: bear markets and/or market crashes almost always start with 'all-time highs.'

This setup can sometimes lead to two responses: 1) investors get out of stocks because of the 'fear of heights'; or, 2) investors attempt to time the market top, often with the strategy to "buy the dip" later. I would strongly urge against both approaches.[2]

The first reason, in my view, is that the predominant factor driving the sustained rally is better-than-expected economic and earnings growth, especially what we saw in Q4 2023 and in January data. With 67% of S&P 500 companies reporting Q4 earnings as of February 9, the blended earnings growth rate was 2.9%, with 75% of companies surprising to the upside. Positive earnings and upside surprises are happening despite the ongoing drag from the Energy and Materials sectors, and the stock market's enthusiastic response mirrors what we saw in 2023.

The second reason is that historically, all-time highs tend to be followed by more all-time highs. And certainly, more new highs than we've seen so far in 2024.

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During the 1990s, the S&P 500 recorded a new all-time high on 12% of all trading days. More recently, there have been two bear markets since 2020, and yet the stock market still reached a new all-time high on 11% of all trading days. It happens more often than many investors appreciate.

There's also some data on one-, three-, and five-year returns following all-time highs that may surprise readers. A recent study compared one-, three-, and five-year S&P 500 returns when an investor bought the index on any day, versus buying at all-time highs. Here are the findings:

Invest in the S&P 500 on any day between 1988 and August 2020, and your average cumulative forward returns would have been:

- 1-year: +11.7%
- 3-year: +39.1%
- 5-year: +71.4%

Invest in the S&P 500 on days when the index reaches an all-time high, also between 1988 and August 2020, and your average cumulative forward returns would have been:

- 1-year: +14.6%
- 3-year: +50.4%
- 5-year: +78.9%

The data may be surprising but it's also clear – average forward returns were better when an investor bought the S&P 500 at an all-time high. There's a reason the data looks this way. It's because bull markets generally do not reach all-time highs and then abruptly end. By definition, they continue to reach new all-time highs as a reflection of growth trendlines we see in the economy and within corporate earnings. There are exceptions when a bull market only achieves a handful of new all-time highs, like in 2007, but these are fairly rare.

Bottom Line for Investors

My long-term goal is to capture as much upside as the broad equity markets have to offer, and the most effective way to accomplish this goal is to invest alongside growing earnings and an expanding economy. In 2024, I believe we will get both – economic growth has outpaced expectations on the back of strong consumers and a strong labor market, and Zacks is forecasting a sturdy year for earnings growth, likely over 10% for the full year, in our view.

In the current environment, I can see how all-time highs might seem like a warning signal, particularly with growing optimism and high valuations in some key areas. But I would caution against seeing all-time highs as a rationale for trying to time a market top. After all, the stock market could very well rally +30% before experiencing a meaningful correction, deeming the strategy ineffective.

If you want to capture the economic and earnings growth 2024 is poised to deliver, then my advice would be to own stocks – not to buy and sell them based on predictions about market tops and potential corrections.

[1] A Wealth of Common Sense. February 8, 2024. https://awealthofcommonsense.com/2024/02/all-time-highs-usually-lead-to-more-all-time-highs-in-the-stock-market/

[2] Wall Street Journal. February 11, 2024. https://www.wsj.com/finance/stocks/stock-prices-valuations-financial-advisers-35ced497?&mod=djemMoneyBeat_us

STEADY INVESTOR WEEK

- **Rate cuts might be delayed**
- **U.S. shoppers cut back in January**
- **Geopolitics creates uncertainty in oil markets**

CPI Surprises to the Upside

Last week, the U.S. Labor Department released a key measure of inflation for January, the consumer price index (CPI). Inflation ran hotter-than-expected. The consensus among economists was for a 2.9% year-over-year increase, but headline CPI came in at 3.1%. Equity markets experienced downside volatility on the day of the release, likely as investors recalibrated expectations for the timing and magnitude of interest rate cuts in 2024. At the beginning of the year, expectations were that the Fed would cut rates for the first time in March, but comments made by the Fed—coupled with this latest CPI data—have pushed that date back to June. Investors may assume this inflation report and the market's reaction register as negatives for 2024, but some additional context is needed. First, January's CPI print was still an improvement from December's, which came in at 3.4%. The downtrend remains in place, even if inflation did not fall quite as much as economists hoped. Second, there are components of the CPI reading that obscure what is happening with prices in the U.S. economy. The main culprit is sheltering costs, notably the owner's equivalent rent (OER) component. Shelter costs accelerated 0.6% in January from December, compared to December's 0.4% increase. This reading seems to contradict what we've been seeing with rents tied to newly signed leases, which have been declining or remaining relatively flat. It's also true that if we strip out the shelter component, the year-over-year change in the CPI would have been 1.6%, well below the Fed's target. The upshot here is two-fold: first, we expect the shelter component and OER to decline in the coming months, anchoring CPI data as the year progresses; and, second, the Fed's preferred inflation gauge, the PCE price index, places a smaller weight on housing costs, so the hotter-than-expected reading should not factor too much in policy decision-making.[1]

After a Strong Holiday Shopping Season, Consumers Retreat in January

As expected, U.S. retail sales fell month-over-month in January, following a stronger-than-expected holiday shopping season. The Commerce Department reported that retail sales fell 0.8% in January, which marks a sharp departure from the 0.4% increase reported from November to December. Retail sales are generally expected to fall in January compared to December, given that consumers are taking a break from the big spending that accompanies the holidays. But there was also cold weather that gripped the U.S. in January, which almost certainly impacted consumers' desire and ability to spend. Even still, there were some bright spots in the report, notably that sales at food services and drinking establishments went up 0.7%, highlighting the ongoing shift in spending from goods to services.[2]

Geopolitics Creates Uncertainty in Oil Markets, But May Not Impact Price

With two ongoing wars and disruptions in a critical Red Sea shipping route, one would think that oil markets should be experiencing price volatility related to supply concerns. But that hasn't happened yet. Supply and demand dynamics explain why. On the demand side, the International Energy Agency (IEA) forecast that the world would consume an average of 103 million barrels a day in 2024, which is up just 1.2 million barrels a day from 2023 levels. The IEA is essentially predicting that modest global economic growth in 2024 will keep oil demand steady – not trigger an acceleration. On the other side of the ledger, the IEA expects that rising production from non-OPEC+ countries will boost global oil supply by 1.7 million barrels a day in 2024, led by the U.S., Brazil, Canada, and Guyana. Plentiful supply should more than outstrip increases in demand, according to the IEA, which should in theory result in low price volatility this year.[3]

[1] Wall Street Journal. February 13, 2024. https://www.wsj.com/finance/stocks/rate-cuts-might-be-delayed-thats-no-reason-to-panic-fca2c141?mod=djemMoneyBeat_us

[2] Wall Street Journal. February 15, 2024. https://www.wsj.com/economy/consumers/why-wall-street-expects-an-underwhelming-retail-sales-report-c8f01bbe?mod=economy_lead_story

[3] Wall Street Journal. February 15, 2024. https://www.wsj.com/business/energy-oil/higher-global-oil-supply-set-to-satisfy-demand-increase-iea-says-46852c85?mod=djemMoneyBeat_us

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