CHARTWELL INVESTMENT PARTNERS

Chartwell Strategies Current Outlook

"Never confuse a single failure with a final defeat."
-F. Scott Fitzgerald (1896 – 1940)
(novelist, essayist, and short story writer)

Summary

- *In the third quarter, stock indices moved slightly lower as stock prices continued to retrace and consolidate from the all-time highs registered in the November 2021 to January 2022 period. This November, after a difficult October, stock prices began to move higher as interest rates showed signs of peaking.*

- *The nearly two-year retracement and consolidation process may be ending as stocks and bond prices rallied at the beginning of November. Although caution is warranted, if there is significant follow-through in the weeks ahead, it may signal the beginning of the bull market's second leg that began in April 2020.*

- *Third quarter corporate earnings reports were generally favorable as inflation raised corporate revenues and earnings.*

Background

For the past four years, investors have been faced with a tumultuous environment. In January 2020, it became apparent that a deadly virus was spreading from Wuhan, China that U.S. Government health officials accurately predicted, would cause a worldwide pandemic. In an effort to limit the spread of the virus, the federal government closed the U.S. economy, except for the continuance of essential services. Fear and uncertainty caused the stock market to plunge, resulting in a cataclysmic bottom on March 27th.

From the March 2020 low of 18,213 on the Dow Jones Industrial Average (DJIA), as the economy gradually reopened and began to recover, the stock market began an erratic, but powerful move that peaked at 36,952 in January 2022. This was an all-time high for the DJIA. Unfortunately, other forces were also at work that began to negatively affect the U.S. economy. Excessive spending by the government created inflationary pressures that eventually raised the cost of living for most Americans by about twenty percent over the past three years. Interest rates also rose as the Federal Reserve Board (FRB), attempting to slow economic growth, tightened its monetary policies. The combination of higher inflation and interest rates reduced consumer purchasing power, raised corporate overhead and slowed the economy as the cost of financing large items such as homes and automobiles became unaffordable to a large segment of the population.

Predictably, higher interest rates and inflation caused stock prices to pull back from highs reached in late 2021 and early 2022. While a pause in a bull market advance is normal as investors take profits and the marketplace reassesses the unfolding environment, unfortunately, this period of consolidation has been complicated by the effects of the war in Ukraine upon the U.S. and global economies. Now, with the outbreak of war in the Mideast between Hamas and Israel, another major source of uncertainty has emerged.

There have been other aspects to this story that have been frustrating and confusing to the marketplace. For one, energy prices have been a significant factor in raising the inflation rate. However, government "climate change" policies have discouraged the domestic production of oil, coal and natural gas. Although natural gas prices have remained quiescent, coal and oil prices have been volatile and generally higher. Excessive federal government expenditures are also a continuing concern. A politically divided Congress has been instrumental in slowing spending in recent months, but now, with pressure to support two wars and increased concern regarding the country's porous border with Mexico, government expenditures seem likely to resurge. Finally, the Nation has been beset with numerous labor strikes including the United Auto Workers union, the truckers' union, airline pilots and health care workers at Kaiser Permanente; the impact of inflation on the average workers' spending power suggests more labor unrest in the near future.

Past performance is no guarantee of future performance. All investing involves risk of loss. An investor cannot invest directly in an index. The Index returns provided throughout are an example of alternate return potential during the relevant time periods; however, indices may possess different investment attributes that may make comparisons difficult such as volatility, liquidity, market capitalization, and security types. This commentary is for informational purposes only. It is not an offer to buy or sell any security and should not be construed as investment advice. The views in this report were those of the Adviser at the time of writing this report and may not reflect our views on the date this report is first published or anytime thereafter.

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Therefore, in response to these problems the stock market has been undergoing a correction for the past two years. Table 1 below, shows the dates and prices of the major indices that reached their all-time highs in the November 2021 to the January 2022 period and the dates and prices when these indices reached their reaction lows. As shown in the table, the DJIA, S&P 500 and NASDAQ made their lows last year and the small-cap indices made their lows just weeks ago. The overall declines have been substantial, ranging between 19.3 and 37.8 percent from their all-time highs. This long period of "recession discounting" begs the question of when will prices stabilize and the bull market, that began in April 2020, resume. The indices listed in Table 1 cannot be described as overvalued at this time when the effect of 7 popular stocks are considered (See next paragraph). In fact, after two years of consolidation, many stocks are selling at low price-to-earnings ratios, discounts to book value, low multiples of free cash flow and some offer high dividend percentage returns. Furthermore, after the end of the third quarter, it has most probably been tax related selling, not investment fundamentals, that drove the Russell 2000 and Russell Value indices to new reaction lows in October.

Performance of Major Indices During Current Market Pullback

INDEX	ALL TIME HIGH		REACTION LOW FROM ALL TIME HIGH		
	DATE	PRICE	DATE	PRICE	PERCENT DECLINE
DJIA	1/7/2022	$ 36,952	9/30/2022	$ 29,811	19.3%
S&P 500	1/7/2022	$ 4,818	10/14/2022	$ 3,491	27.5%
NASDAQ	11/26/2021	$ 16,212	10/14/2022	$ 10,088	37.8%
RUSSELL 2000	11/12/2021	$ 2,458	10/27/2023	$ 1,633	33.0%
RUSSELL 2000 VALUE	11/12/2021	$ 2,661	10/27/2023	$ 1,877	28.7%

Table 1. All of the major indices have been discounting a recession for nearly two years.
Source: Bloomberg News

One notable exception to the scenario described above is seven popular stocks that investors believe will continue to grow rapidly: Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla. However, even these "darlings" have been struggling as four of the seven have been unable to eclipse the highs that they set in prior years. Of the seven stocks only Apple, Microsoft and Nvidia have scaled to new highs this year.

Historically, stock investments have been good hedges against inflation. As a corporation's expenses increase they raise their product prices, revenues increase and if profit margins remain the same, earnings increase. This seems to be what is happening as third quarter earnings are being released; in fact, over seventy percent of companies reporting have exceeded analysts' expectations. Indeed, most stocks in our universe traded at their reaction lows last October and have been trending higher since that time.

Lastly, the FRB may be close to ending or has completed its program to increase short-term interest rates. Although they have not achieved their goal of reducing the rate of inflation to two percent annually, the inflation rate has been declining and now, patience may be a more appropriate tactic for the FRB to take. Figure 1 on the next page, which illustrates the interest rate on the two-year U. S. Treasury bill over the past twenty years, lends credibility to this point of view. In 2006, the FRB raised short-term rates to the five percent level as it attempted to slow the boom in housing. This maneuver worked, but unfortunately resulted in a serious recession due to the widespread fraud which had occurred in the mortgage industry.

Today's environment does not compare with that of 2006, however, the point is that a five percent interest rate on the two-year Treasury bill was enough to slow the economy in the past. Now, for the first time since 2006, the two-year Treasury bill is again trading at the five percent level, and this may be enough to slow the economy and allow interest rates to recede. Since most valuations of many stocks may have already discounted a recession, the nearly two-year pullback in stock prices could end soon and the resumption of a bull market begin. Admittedly, this is a "Goldilocks" scenario, but, not at all impossible.

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Yield on the 2 Year U.S. Treasury Bill over the past 20 years

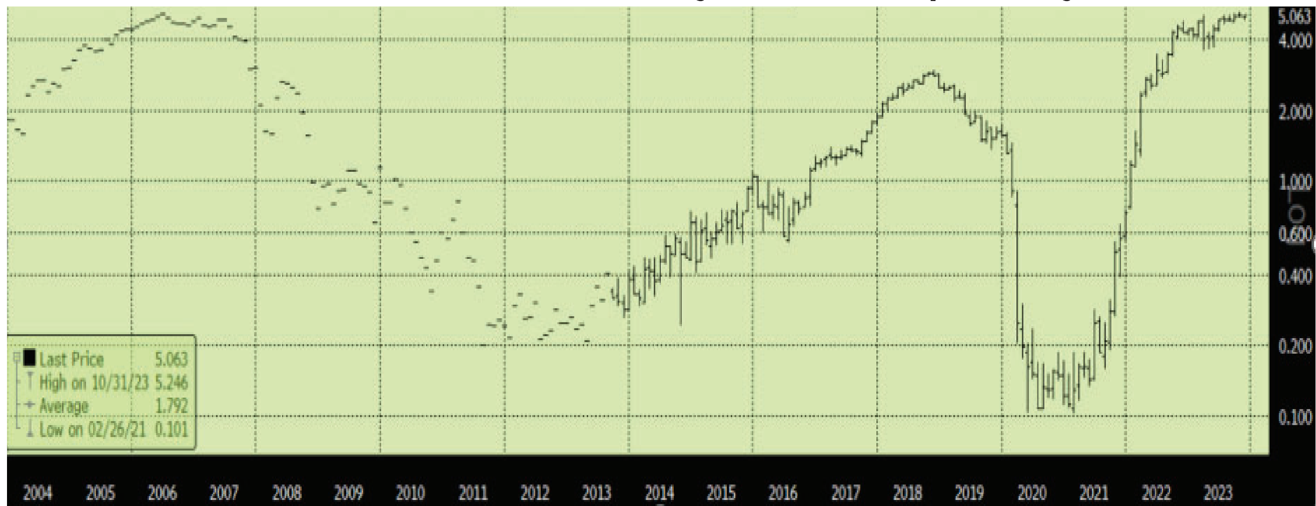

Figure 1. This year the yield on the 2 year Treasury Bill has reached a level not seen since 2007
Source: Bloomberg

We remain cautious on the market, as geopolitical risk has increased (Israel/Hamas) and the lagged effect of 500 basis points of Fed rate increases may yet to be felt. Additionally, we are soon to enter the next Presidential election cycle, which by all accounts will be "heated" and divisive. Recent economic strength surprised the Fed, and this would normally be good, but it let them to telegraph higher rates for longer in their September meeting (some interpreted the tone in the recent November meeting as more "dovish"). Stock market gains earlier in the year were somewhat anticpatory of Fed cuts sometime in '24, but that is now looking much less likely. In the third quarter, all sub-groups of the equity market were down (S&P500 -3.3%), even the previously high-flyer, large-cap Tech cohort (Russell 1000 Growth Tech sector -5.9%). We are focused on downside protection in our portfolios, while still achieving reasonable upside particiption in any market rallies.

As mentioned earlier in the letter, valuations of most stocks beyond the mmega-cap growth group are attractive and some may have already discounted a recession, so we could see upside if a "soft-landing" in the economy is achieved in 2024

If you wish to receive additional information about the IMAP program please contact Chartwell at (610) 296- 1400 or info@chartwellip.com.

Definitions:

Dow Jones Industrial Average: The DJIA or “The Dow” is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The Nasdaq Composite Index is the market capitalization-weighted index of more than 2,500 common equities listed on the Nasdaq stock exchange.

Russell 2000 Index: London Stock Exchange Group plc and its group undertakings (collectively, the “LSE Group”). ©LSE Group 2023. FTSE Russell is a trading name of certain of the LSE Group companies. Russell® is a trade mark of the relevant LSE Group companies and is used by any other LSE Group company under license. All rights in the FTSE Russell indexes or data vest in the relevant LSE Group company which owns the index or the data. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from the LSE Group is permitted without the relevant LSE Group company’s express written consent. The LSE Group does not promote, sponsor or endorse the content of this communication.

S&P 500® Index: (registered trademark of The McGraw-Hill Companies, Inc.) is an unmanaged index of 500 common stocks primarily traded on the New York Stock Exchange, weighted by market capitalization. Index performance includes the reinvestment of dividends and capital gains.

Investors cannot invest directly in an Index.

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