Investment Strategy
July 2024

The S&P 500 Index suffered a shallow correction in April before rallying back to new all-time highs. However, the internal market behavior has been poor during the past quarter as the average stock has not participated in this rebound. The largest 8 stocks[1] increased in value by $2.7 trillion in the second quarter while the other 492 members of the index declined by $523 billion. This has left the top 8 stocks representing 35.2% of the entire S&P 500 Index. For the year, the S&P 500 has gained 14.5% whereas the average stock is only up 4.1%, the largest underperformance since at least 1990[2]. In contrast, the Dow Jones Transportation Average[3] is down 3% this year and the Russell 2000 index of small and mid-sized companies is little changed. While the performance in the stock market is very concentrated, the warnings coming from consumer-facing companies are broadening. Over the past few months, a diverse group of companies have reduced earnings guidance based on a weakening economy. This is leading to further job cuts and business closures. At the same time, the housing market remains frozen and new building permits for industrial and multi-family projects are contracting quickly. These dynamics reflect a slowing economy and a large segment of society that is struggling after several years of high inflation. A few stocks are beginning to reflect these realities, but the overall index continues to be pulled up by the trillion-dollar tech companies.

Major U.S. corporations have better data on the U.S. consumer than any government agency, providing them with a greater understanding of the underlying trends going on within the economy. To track the health of everyday Americans, no company has better insight than Walmart and their thousands of stores spread across North American neighborhoods. Walmart initially pointed out a slowdown last October following the end of the employee retention credit (ERC) tax benefit the month before. The government program was shut down due to overwhelming fraud. Interestingly, we heard anecdotes that sales of Mercedez "G Wagons" slowed abruptly last October as well. Walmart noticed another stepdown in activity during March. They also mentioned that over the past few quarters shoppers have bought less general merchandise, such as home goods and electronics (discretionary spending), as they prioritize food and healthcare related items (non-discretionary spending). The company's CFO went on to say that "wallets are still stretched", but Walmart is benefiting because they have "customers that are coming to us more frequently than they have before and newer customers that we haven't traditionally had […] coming into a Walmart.

According to Walmart's experience, the typical American is feeling the pressure from years of accumulated price increases and is being forced to prioritize spending on necessities. More affluent shoppers are being impacted as well and are searching for ways to save money. As we

[1] Based on total value end of 2Q: MSFT, AAPL. NVDA, AMZN, META, GOOG, AVGO, LLY
[2] According to Dow Jones Market Data
[3] This index tracks 20 companies in transportation, like trucking and railroads, that benefit from a strong economy

review commentary from other companies, we find a bifurcated economy. Low-income households and most of the middle class are struggling to pay for basic needs and falling behind on credit card bills and car payments. The upper class is not impacted by inflation and continues to positively respond to record high stock prices and home values. For instance, the CEO of Kimberly-Clark (maker of Kleenex, Scott, Huggies) pointed out the premium tier of products "continues to grow very very robustly. That all said, […] middle-to-lower income households look like they are becoming more stretched." We also see confirmation that weakness has surprised companies within the past few months, resulting in profit warnings. Here's a selection of commentary from across the spectrum of companies:

- **Wallgreens CEO Tim Wentworth** - "We assumed….in the second half that the consumer would get somewhat stronger" but "that is not the case." He added that "the consumer is absolutely stunned by the absolute prices of things, and the fact that some of them may not be inflating doesn't actually change their resistance to the current pricing. So we've had to get really keen, particularly in discretionary things."
- **McDonald's:** "Consumers continue to be even more discriminating with every dollar that they spend as they faced elevated prices in their day-to-day spending, which is putting pressure on the [quick-service restaurant] industry,"
- **Nike:** "We now expect fiscal 2025 reported revenue to be down mid-single-digits, with the first half down high single-digits."
- **General Mills:** "We expect ongoing macroeconomic uncertainty to result in continued value-seeking behaviors by consumers, affecting both the products they buy and the channels they shop."
- **Pool Corp:** Preliminary data indicates a downturn in demand for new pool construction and remodeling of 15% to 20% for the year.
- **Southwest Airlines:** "The reduction in the Company's RASM [revenue per available seat mile] expectations was driven primarily by complexities in adapting its revenue management to current booking patterns in this dynamic environment".

The U.S. consumer is showing obvious signs of stress and fatigue, but the economy continues to report modest headline growth on the back of massive government spending. The U.S. budget deficit was roughly $1 trillion through the end of May, helping to support business activity and overall employment. In contrast, housing activity is dismal. The sector has traditionally been the biggest driver of U.S. economic growth as new homes are built or existing structures are repaired or upgraded. Home purchases also trigger the buying of furniture and other home goods. The number of real estate transactions has been slow for 18 months. Existing home sales this year are on pace to match 1978 when there were roughly half as many adults in the US. We don't expect a pickup in housing activity because affordability is at the worst level in decades. As such, the biggest private driver of the U.S. economy will continue to be a drag for the foreseeable future.

The construction of industrial facilities and multi-family (apartment) buildings have also been a major tailwind for the economy over the past few years. Activity in both jumped following COVID as e-commerce quickly expanded and higher rents (and cheap new capital) encouraged the highest number of new apartments since the 1970s. Unfortunately, it looks like builders overproduced as future building permits for both types of construction are falling quickly and are now below pre-COVID levels. The drop in commercial construction[4] has been particularly pronounced with new projects down roughly 75% to levels last seen in 2012. This likely foreshadows job losses for construction workers in the months ahead.

The typical engines of the economy have become much weaker over the past 18 months. Full-time employment is estimated to be down 1.2% over the past year, or down 1.6 million jobs[5]. These job losses have largely been white collar as business services and technology companies shed workers. Blue collar work in construction, manufacturing, and the transportation industries have thus far been largely unaffected. Regardless, corporate America is reporting weaking sales and warning of a deteriorating consumer while the U.S. is at historically low unemployment. We believe the U.S. economy is losing momentum which could result in higher unemployment, putting greater stress on many consumers. At the same time, investment losses are piling up in commercial real estate, apartment buildings, hotels, and many private equity and venture capital funds. Most investors are still in denial about these losses as they see the S&P 500 reach new highs and homes trade at prices well above pre-COVID levels. As these losses crystallize, it is likely even the wealthy consumer will begin to taper their spending as well. Taken together, the economy is wobbly despite staggering levels of government spending and a record-high S&P 500. We believe the major U.S. stock index is incredibly dangerous as it trades at one of the highest valuations in stock market history against a backdrop of enormous structural challenges that will not be friendly to corporate profitability. We continue to be conservative in our portfolios because we are simply not being compensated for the growing risks that abound the investing landscape.

Sincerely,

Keating Investment Counselors, Inc

[4] Construction of office, retail, and industrial properties based on total square feet
[5] Based on US household survey. Haver Analytics, BLS, Rosenberg Research

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