

Getting Defensive

Executive Summary

1. The US stock market, as measured by the S&P 500 index, is beginning to appear overvalued. Corporate earnings may not be able to keep pace to sustain current valuations.
2. The US economy is showing signs of slowing. The job market is beginning to weaken and there are indications that consumer spending may slow.
3. There are substantial geopolitical risks that do not appear to be factored into the current stock market pricing. Should a significant global event occur, the stock market may decline precipitously.
4. Investors should strongly consider boosting their liquid reserve (checking, high yield savings and money market funds) and potentially allocate investments to a more defensive allocation.

The US Stock Market is Overvalued and Heavily Concentrated

At least for a little while, it appeared that the stock market was beginning to come back down to earth. The S&P 500 index lost 5% in a matter of weeks during April; however, stocks have since rebounded and restored their record highs.

The chart below compares stock prices to earnings over the past 30 years by using the Price-to-Earnings (PE) ratio. **The last times PE ratios were this high were the end of 2021 post-covid**

this high were the end of 2021 post-covid bull market and the tech bubble crash of 2000. In both cases, the S&P index lost over 18% of its value.





S&P 500 valuation measures

GTM U.S. 5

Equities

S&P 500 Index: Forward P/E ratio

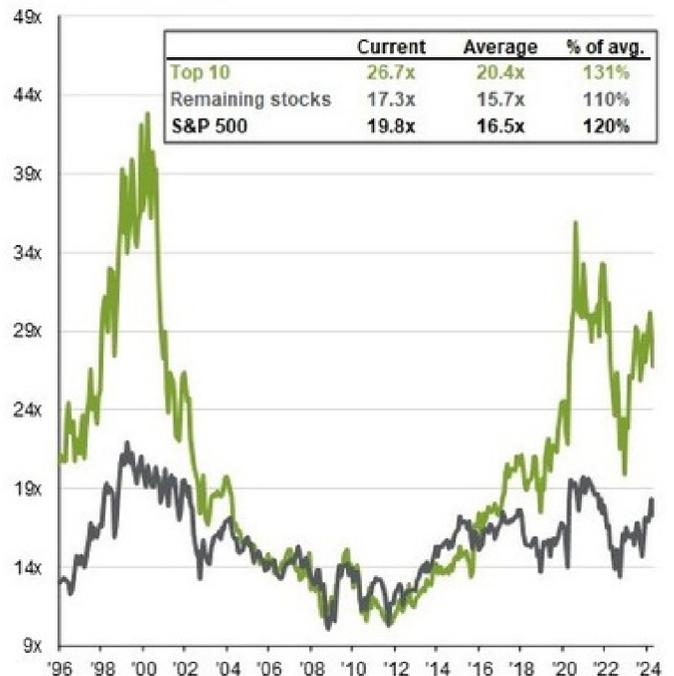


SOURCE: JPM Morgan Guide to the Market/Past performance is not indicative of future results

In addition to appearing broadly overvalued, the dominance of a few large technology companies has led to a significant concentration within the US stock market. The tech giants known as the Magnificent 7 which include Apple, Amazon, Facebook (Meta Platforms), Google (Alphabet), Microsoft, Nvidia and Tesla, significantly influence market indices like the S&P 500 as well as the Nasdaq. These companies command sizable market capitalizations and have enjoyed remarkable growth over the past decade, driven by innovations in areas like cloud computing, e-commerce, digital advertising, and social media.

Per the chart on the right, the earnings and PE ratios of these companies vastly exceeds the rest of the stock market. While the long-term outlook for these tech companies remains very strong, prudent investors may question their current stock price valuations.

P/E ratio of the top 10 and remaining stocks in the S&P 500 Next 12 months, 1996 - present

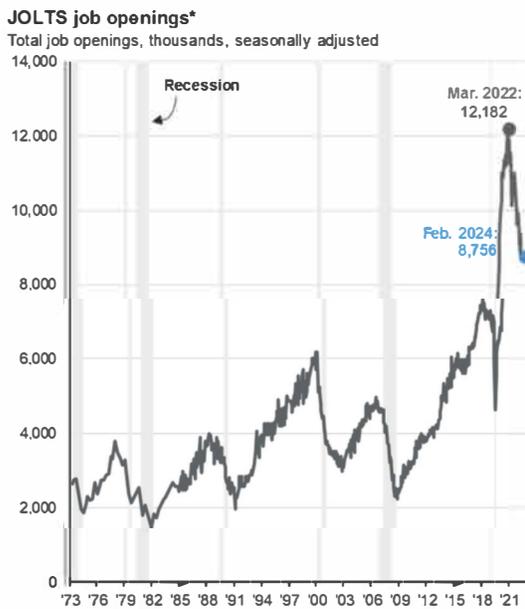


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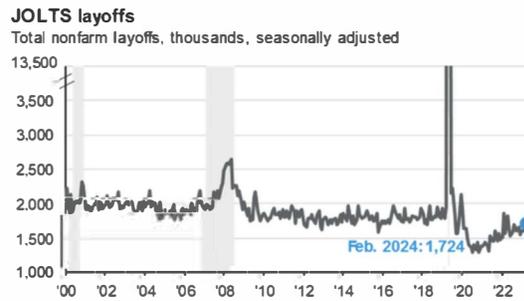


Economic Growth is Slowing

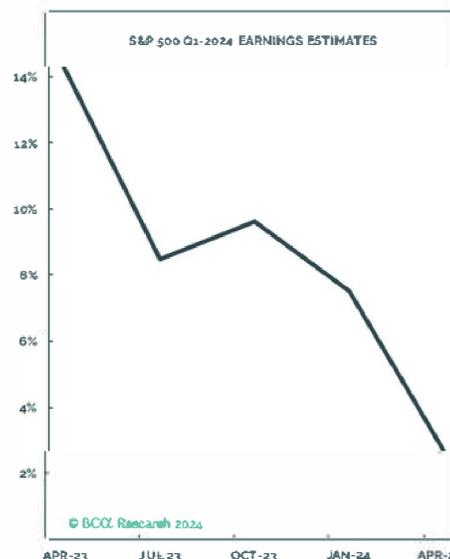
We are now seeing hard evidence that the US economy is beginning to slow. First and foremost is the ongoing decline of new jobs and increases in jobless claims. Below are charts showing a variety of JOLTS (job openings and labor turnover survey) data. As reflected, job openings are showing a steady decline and job layoffs are accelerating. Much of the reduced demand for labor stems from each company's struggle to continue showing positive earnings.



SOURCE: JPM Morgan Guide to the Market

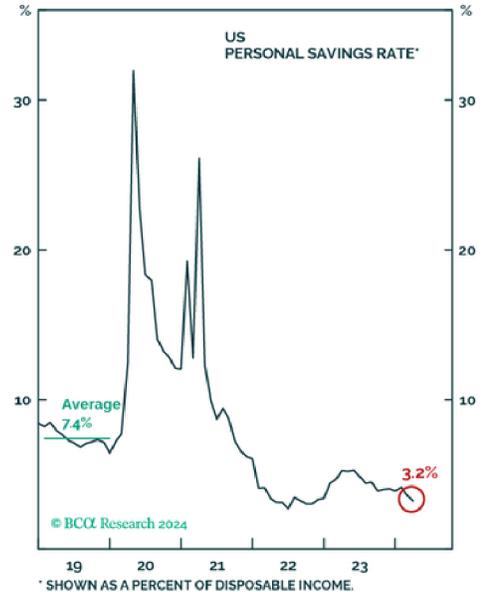


Corporate earnings projections are on a downward spiral. Many companies that have met earnings expectations are doing so with a combination of workforce reductions and share buybacks which inflate their PE ratio. Those companies that have not met earnings expectations have watched their stocks prices pummeled by investors. Going forward, it may be far more difficult for companies to exceed inflated expectations, as reflected in the chart on the right.

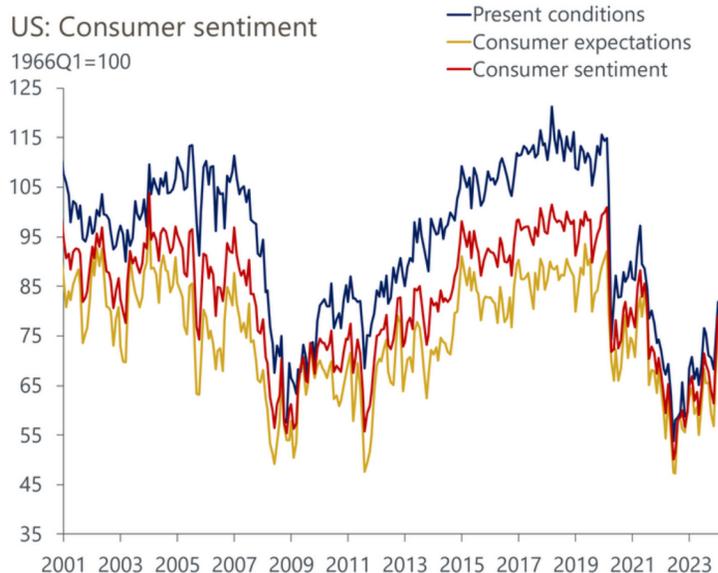


SOURCE: REFINITIV 1886

One of the reasons companies could find it difficult to boost earnings is that many economists are forecasting far less consumer spending activity. Consumers must rely on income and savings to procure products and services. The chart below demonstrates that the US personal savings rate is at its lowest level in years. While savings vaulted to their highest levels during COVID thanks to government transfers, this surplus has largely been spent.



Lower consumer savings and diminished job demand will likely contribute to a reduction in consumer spending in the US. With a significant portion of the population experiencing financial strain, consumer confidence may wane, further dampening spending habits. In fact, the consumer sentiment survey released on May 10th showed a sharp drop due to higher gas prices, broader inflation concerns and fears about future income. In addition, reduced savings diminish consumers' ability to weather unexpected expenses or income shocks, prompting them to adopt more conservative spending patterns.

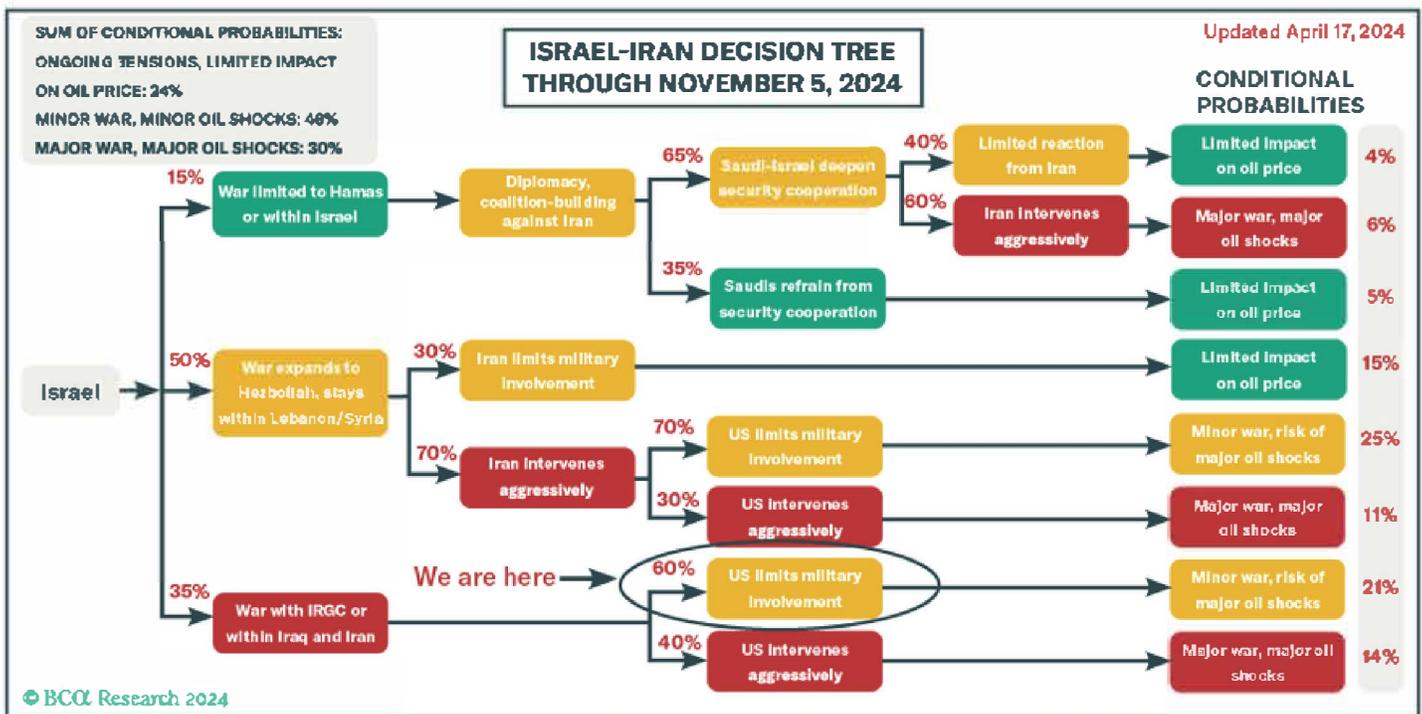


SOURCE: Oxford Economics

Geopolitical Risks Abound

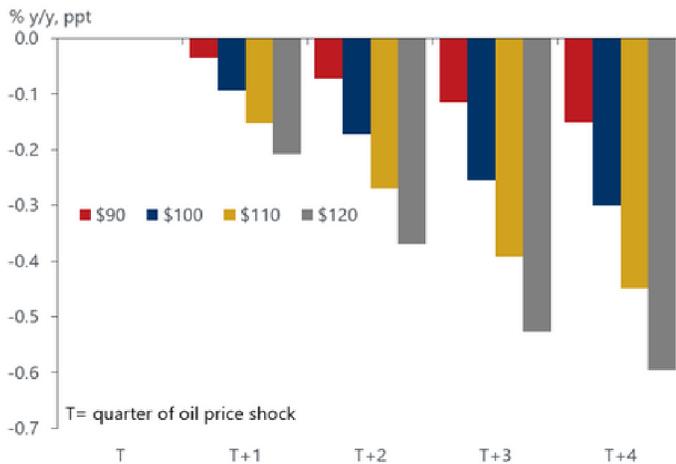
The ongoing conflicts in Israel and Ukraine pose significant dangers to the global economy, amplifying geopolitical tensions and disrupting regional stability. The situation in Israel threatens to destabilize the Middle East, a crucial hub for energy production and transit. Any disruption to oil supplies from the region could lead to sharp increases in energy prices, exerting inflationary pressures on global markets and hampering economic growth. Moreover, the conflict has the potential to spill over into neighboring countries, exacerbating regional instability and undermining investor confidence in the broader Middle East.

BCA Research, a highly reputable independent research firm, created the flow chart below to illustrate the potential risks of an oil shock in connection with the Middle East conflict. Where we stand presently is circled but the risk of a major shock remains.



For example, the WTI Crude oil index was selling near \$70/barrel at the beginning of the year. Near the time Iran launched its missile attack on Israel, the price soared to over \$85. In the event of a future minor oil shock, the price could be in the range of \$80 - \$120. However, a major shock could result in prices well above \$120. The following chart demonstrates that oil prices of \$120/barrel would have a severe negative impact and could prompt a global recession.

US: GDP deviation from baseline under various oil prices

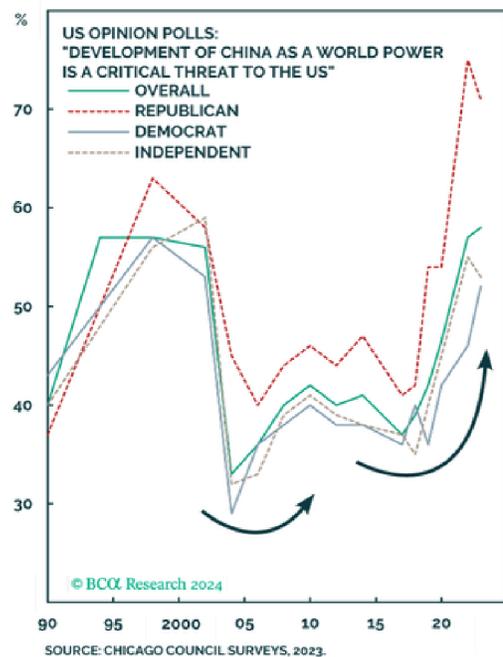


SOURCE: Oxford Economics

Similarly, the conflict in Ukraine poses significant risks to the global economy. The geopolitical standoff between Russia and Western powers has led to heightened tensions, economic sanctions, and uncertainties about energy supplies, given Ukraine's strategic location as a transit route for Russian natural gas to Europe. Any escalation in the conflict could disrupt critical supply chains, increase geopolitical risks, and dampen investor sentiment, leading to market volatility and capital flight from the region. Furthermore, the conflict underscores broader concerns about the erosion of international norms and the challenges of resolving disputes through diplomatic channels, raising

questions about the stability of the global order and its implications for economic cooperation and trade.

The United States and China continue to have a rocky relationship. The chart below illustrates voter feelings towards China which has emboldened both major presidential candidates to propose a variety of bare-knuckled trade policies designed to protect the US economy. Unfortunately, these policies could spark a trade war that might inflict significant economic damage on both countries and reverberate across the global economy.



SOURCE: CHICAGO COUNCIL SURVEYS, 2023.

Psychologically, there is a tendency for investors to dismiss the likelihood of unpleasant risks. Perhaps this explains how the stock market continues to reach record highs in spite of the global threats illustrated above. Should a serious geopolitical event occur, investors should anticipate the significant possibility of a sharp decline in the US stock market.

Investment and Planning Implications

With the job market loosening, the broader economy slowing and substantial risks looming over the stock market, we strongly advise that clients consider sustaining a large cash reserve, particularly families that primarily have one income. This reserve will help to cushion against any potential reductions in bonuses and other compensation, especially while inflation remains stubborn.

In late cycle stock markets, we tend to favor a variety of different defensive industry sectors. For many clients, we have adjusted our models to include sectors such as utilities/energy, consumer staples, and healthcare, which are often less susceptible to economic downturns. These industries often demonstrate lower correlations with broader market indices, making them less susceptible to systemic risks and offering a degree of portfolio insulation during periods of market stress, in our opinion.

Additionally, income-focused investments are often preferred during volatile periods due to their ability to provide a reliable income stream and stability amidst market fluctuations. Assets such as dividend-paying stocks, bonds, and alternative investments can offer consistent cash flows regardless of short-term market movements. We believe this dependable income stream serves as a buffer against market volatility, helping investors maintain a steady source of income even during turbulent times.

It is important to emphasize that the timing of any stock market downturn is nearly impossible to predict with any accuracy. **BCA Research has indicated they expect a market downturn within the next 6-12 months.** From our perspective, we believe it is prudent to plan for eventualities now. If you would like to discuss your personal financial situation, please do not hesitate to contact us.

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