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The Rose-Colored Glasses Market

Economic Perspective

The figurative phrase 'rose-colored glasses' is a metaphor often used when someone may have overly optimistic or unrealistic expectations with respect to an anticipated outcome(s) - while ignoring or overlooking the negative elements of a situation. Throughout history, the stock market (more often than not) views the world from a lens of optimism over pessimism. Over the long run, this has served investors well & enabled the bulls to frequently trounce the bears. However, the proverbial 'wall of worry' that this market has climbed even has us a little bit skittish & wondering how much higher can we go? The April 8th bear market decline (21% intraday drop from previous highs in the S&P 500 Index) decline in stocks seems like forever ago! The market has gone practically parabolic since the initial trade & tariff worries. While the market is hot, our economy is not. Our investment team cautions that the economy is not as rosy as this market suggests. We believe it may be wise for the Fed to act by cutting rates sooner rather than later.

The manufacturing sector continues to struggle. The ISM manufacturing index has contracted for the last four months. As a result, it remains a priority for the new administration to redomicile production and bring jobs back home. In addition, the labor market is producing mixed signals. Microsoft just cut 9,000 employees, and other firms have followed suit. The ADP jobs report recently came in much weaker-than-expected (-33k private jobs vs. +100k expected) whereas the Non-Farm Payrolls (NFP) report came in much better-than-expected (+147k jobs vs. +120k expected). The June NFP report moved the 3-month moving average gains up to 150k per month (from 141k). Good, not great.

On the bright side, JOLTs (job openings) are increasing. However, excluding finance and insurance, most of these openings were in the lower-paying hospitality, leisure and food service industries. This suggests to us that many businesses are cautious and in wait-and-see mode with respect to hiring skilled labor. As we have seen in the past, our large domestic service sector continues to carry the economic growth baton & propel our economy forward. The recent ISM Services report came in at 50.8 (slightly expansionary). It marks 11 out of the last 12 months that the index has experienced growth. The resiliency of the broader service sector is impressive. Importantly, the New Orders component of the report came in at 51.3 – much improved from a very weak reading the month prior at 46.4. We are encouraged that business sentiment will continue to improve as we get more clarity on the tariff situation.

Market Perspective

Significant rallies after a market correction are often met with profit-taking and/or consolidating price action over a period of time. We see this as likely as we enter the seasonally soft, low-liquidity summer period for the market. While some important technical indicators and charts for stocks are bullish (i.e.- a recent 'Golden Cross' experienced by the market where the 50-day moving average crossed the 200-day moving average), several key valuation metrics (i.e.- Forward Price/Earnings ratio at almost 23x) suggest caution & reflect a lot of good news is already priced into stocks! As a result, our investment team will be intensely focused on the upcoming corporate earnings season (primarily mid-July to mid-August) to see whether the fundamental bulls can maintain their advantage over the bears. Key questions remain: Will profit margins continue to improve from the already strong 13.4% level? Will reported earnings continue to beat estimates & remain in the high single digit range? Are consumers still spending, or trading down to private label brands? What is management saying about business investment and capital expenditures during the second half of the year? The answers to these questions will undoubtedly drive market returns during the second half of the year. In our opinion, with valuations rich & margins of safety low, only companies with stellar results will be able to maintain premium valuations. Therefore, stock selection will remain especially important.

Looking Ahead

Following the Federal Open Market Committee's most recent monetary policy meeting (they decided to hold interest rates steady), the Fed released its quarterly SEP (Summary of Economic Projections). It highlighted the committee's median estimates for economic growth, unemployment and inflation. In short, the committee's forecast was less than rosy. They lowered GDP growth estimates (to +1.4% this year and +1.6% next year), raised unemployment expectations (to 4.5% from 4.4% in March) as well as their inflation forecast (Core PCE up to 3.1% from 2.8% in March). So, why won't Jerome Powell and the Fed respond by cutting interest rates if the risk of stagflation is real? The answer is tricky. According to its dual mandate, it is tasked with pursuing two key economic goals: maximum employment and stable prices. We would describe the current employment situation as good and inflation (prices) getting better. While our investment team believes the Fed has room to cut rates, there is also an argument for a wait-and-see approach in an era of tariffs. With the lasting economic impact of tariffs uncertain, the Fed decided a wait-and-see approach was prudent. As of now, the fed funds futures market is pricing in only a 5% chance of a July 30th rate cut and about a 50% chance of a September 18th rate cut. Powell is basically betting his committee will have much more economic clarity in the fall. Thankfully for the economy, substantial fiscal stimulus is on the horizon. The passage of the One Big Beautiful Bill (looking past the long-term implications of the significant increase in the deficit) is likely to stimulate economic growth at just the right time. As a result, we are likely to see accelerating economic growth exiting the year and into 2026. Importantly, this could enable economic and company fundamentals to 'catch up' to current stock levels. If Corporate America can do its part, maybe the stock market's current optimism isn't so far-fetched after all.