Ridgetop Wealth Management
Second Half Outlook

Can the Good Times Continue?

We have been bullish on U.S. equities all year. This has paid off as the S&P 500 is on pace for the second best-first half of an election year on record. Going into the second half of the year, the positive cyclical story remains intact. Inflation appears to be moderating enough for the Federal Reserve to lower rates, a corporate earnings acceleration is continuing, and the market tends to enjoy a year-end rally during presidential election years. Overall, equity performance in the year's second half shouldn't be much different from the performance in the first half.

Choppiness

In our business that word is overused almost as much as "volatility." We think the stock market is likely to advance in the second half of the year, but the "choppiness" shoe is likely to be a good fit. Heading into 2023, and even 2024, many economists expected a recession to materialize. Low expectations meant the economic data had a low bar to clear. With the second quarter earnings season all but complete, the beat rate (the percentage of companies reporting earnings that beat analysists expectations) is a high 80%. Now after a great first half in the S&P 500 optimism has emerged. The longer investor optimism remains high, the bigger the risk that it turns into complacency and leaves the market vulnerable to a few pieces of bad news.

The eighteen month rally we have had has left valuations stretched and the market a bit overbought. With these vulnerabilities at hand its far more likely that we see choppiness this summer than smooth sailing. Our base case is to maintain an overweight to equities for now, and that any pullbacks would be seasonal in nature and not the start of a cyclical bear market.

The Technical Data

You have heard us repeat the old adage, "don't fight the Fed and don't fight the tape" ad nauseum. This mantra still very much stands as the Fed is a lot closer to easing than tightening, and the market continues to hit fresh highs. That said we are mindful of one meaningful negative technical divergence: in mid-June both the S&P 500 and Nasdaq hit new all-time highs. On the exact day the indices were hitting a new high, the number of declining stocks outnumbered advancing stocks and the number of stocks hitting new 12-month lows outnumbered the number of stocks hitting new 12-month highs.

In Q1 of this year we saw a broadening of the market. Four hundred of the five hundred stocks in the S&P 500 were going up in unison for example. Over recent months stock market participation is becoming narrower and narrower. It's just a handful of stocks that are advancing and moving the entire market. This is not a healthy sign for the market and the rare negative divergence I mentioned above has most often occurred prior to a major market move to the downside (think Tech Bubble and the final months leading up to the 2022 bear market).

The Weight of the Evidence

Now that we have sufficiently scared you, we will reiterate that the vast majority of the weight of the evidence is with the bulls.

- The broad US economy remains resoundingly positive. Jobless claims have risen to roughly 230,000 but is still significantly below the 500,000 threshold associated with a recession.

- We are moving closer to net global easing by central banks. The percentage of global central banks in an easing cycle has climbed to 41%. When 50% or more are easing it has been historically bullish for global equities.
- Surveys show that there is excessive optimism by the top 10% of people in this country who own a lot of stocks, yet there is ample skepticism by a lot of other folks. The data illustrates that the overall social mood about the economy is negative. Typically before market peaks the vast majority of the American public feels great – throwing everything they have into risk assets, speculating, taking on debt because life/the economy feels unstoppable. This is not currently the case.
- Most technical divergences resolve themselves. The market advance has been extremely narrow as of late, but short-term breadth has not yet bled into long-term breadth. Over 62% of stocks are above their 200 moving averages. The implication is that the market has some time to heal before the overall trends turn from positive to negative.

In Summary
This is not a low risk environment. A short term market correction very well could lie ahead, but a bear market remains unlikely at this time. We maintain an overall optimistic outlook on equities. This outlook is warranted as our models and indicators are pointing us in that direction. For now the overwhelming evidence in bullish. Despite a great first half it looks like this market is likely to finish the year even higher.