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Mixed-up signals

The Dow Jones Transportation Average hardly seemed to notice last week's splashy new high in the Dow Jones Industrial Average. By the rules of Dow Theory, it's no kind of bull market when a new high in the Industrials is not promptly confirmed by a new high in the Transports, and vice versa. So it may bode badly that the Transports remain stalled 11% below their 2021 all-time high. Of course, Charles H. Dow, cofounder of *The Wall Street Journal* and eponym of the theory, never contemplated a peacetime federal deficit equal to 14.7% of GDP or the balance sheet of the yet-unimagined American central bank swelling to $9 trillion.

Confusion is the topic at hand, specifically the babble of once-trusty indices and indicators that can't seem to find common ground. In preview, we fall back on the Old Faithful of equity valuations to venture a guess as to future stock market returns, and we change our mind over a trio of trucking-related equities.

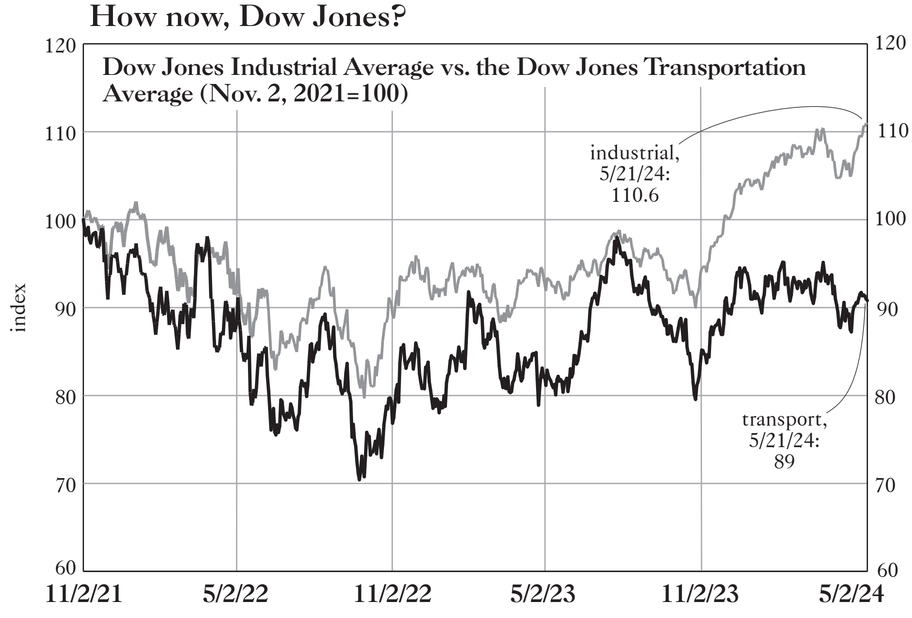
Back to the nonconforming Dow indices. "In determining the trend," the late, great Richard Russell, proprietor of Dow Theory Letters, authoritatively laid it down, "it is a never-to-be-forgotten rule that the movements of both averages must be considered together. The movement of one average must always confirm the other (although not necessarily on the same day), and conclusions drawn from the action of one average unconfirmed by the other are usually deceptive. The confirmation principle is based on logic. If there is to be a valid increase in manufacturing and production, there will also be an accompanying increase in shipping and transportation. Goods produced, if they are not to sit idly in the warehouses, must be distributed to their destinations."

It's an intuitively appealing principle, but what propelled the transport index to its 2021 peak had little to do with the business cycle. Under pandemic house arrest, citizens spent their government-issued stimmie checks on a consumer-electronics buying binge. Compounding that surge in retail demand, Covid-era supply chains became snarled, including the ones through which 20-foot-equivalent shipping containers had once efficiently moved. The dysfunction increased the utilization of America's trucking fleet and precipitated a surge in freight rates.

When the lockdowns ended, consumers decamped from their homes to purchase flights, hotel rooms, cruises—experiences! The collapse in the demand for merchandise relieved supply chains, released trucking capacity and toppled freight rates. And that was the basis for our bearish call on truckers Knight-Swift Transportation Holdings, Inc. and Werner Enterprises, Inc., along with the engine-maker Cummins, Inc., in the issue of *Grant's* dated Nov. 11, 2022.

Profit margins for truckload carriers fell to a 14-year low in the first quarter of this year, according to ACT Research. Consensus estimates for

How now, Dow Jones?



source: The Bloomberg

Knight's 2024 adjusted earnings per share have collapsed to $1.27 from a little over $5 in late 2022 while, over the same span, estimates for Werner have plunged to $1.25 per share from slightly over $4. Since we had our bearish say, Knight's shares have returned negative 12.1% and Werner's negative 10.1% compared with a 36.6% levitation in the S&P 500 (all figures include reinvested dividends).

Would you suppose that a collapse in the profitability of Cummins's customers would lead to a decline in orders for heavy trucks and the Cummins engines inside them? So would—and so did—we. But orders scarcely flagged, and carriers have continued to spend on new equipment, "due to an expensive EPA mandate landing in 2027," as ACT president and senior analyst Kenny Vieth explains. So Cummins's shares have generated a positive 20% return since we said they wouldn't.

The cure for low trucking rates indeed turns out to be low trucking rates. "Data show that capacity is contracting," FreightWaves notes in its second-quarter report on carrier rates. "This trend suggests a market adjustment where demand should soon start to outpace available capacity, potentially signaling an end to the freight recession by as early as late 2024 or spring 2025."

The market is—or is meant to be—forward-looking, and the shares of Knight, Werner and Cummins are likely to rally before the improvement shows up in earnings. We therefore lift our anathema on those stocks.

Utilities are a time-honored investment safe haven, so it's odd to see the utility component of the S&P 500 rally by 14.5% this year, outpacing the blue-chip gauge itself by 3 percentage points. The normally staid electrical power sector is seeing turbocharged growth thanks to the "electrification of everything," in particular of artificial intelligence (see page 3).

The inverted yield curve (of which more below) has long been warning about the recession that evidently hasn't materialized. Spreads on the ICE BofA U.S. High Yield Index, at 307 basis points, are historically tight to Treasurys. Over the past quarter century, they have been this compressed or more in only 4.1% of the minutes out of every investment hour.

Surprises to the downside

source: The Bloomberg

Reasoning from this fact alone, one might assume that credit performance is primo. It is not so. According to Moody's Investors Service, the "issuer-weighted spec-grade default rate stood around 5.8% [in the first quarter] on a 12-month basis, the highest in three years, indicating ongoing challenges for many companies." The source of rising defaults and narrow spreads alike is the intense competition brought on by private credit funds.

Yet "Dr. Copper, the metal with the Ph.D. in economics," to borrow a line from John Mendelson, once of Morgan Stanley, is making new highs. So one might conjecture: no recession.

But wait. The yield curve, as measured by the difference between 10-year Treasury and 3-month bill yields, has been inverted for 572 days. Ergo, there must be a recession.

The Bloomberg U.S. Economic Surprise Index, which measures how new economic data compare with consensus estimates, registers at negative 0.36, indicating a string of disappointing sightings. So, yes, possibly, a cyclical downturn is upon us. But tell that to the Atlanta Fed's GDPNow model, which predicts real, annualized growth of 3.6% in the second quarter.

And tell it to the S&P 500, which is trading at 34.7 times its cyclically adjusted price-to-earnings ratio, a level exceeded only during the everything bubble in 2021 and during the dot-com boom of the 1990s.

Naturally, animal spirits are roaring—respondents to the May BofA Global Fund Manager Survey registered as the most bullish since November 2021. For the record, from Jan. 3, 2022 through Oct. 12, 2022, the S&P 500 logged a 24.5% decline, including reinvested dividends.

Small investors, too, are all in. According to the American Association of Individual Investors, mom-and-pop savers allocated 69.4% of their portfolios to stocks in April, only the 14th time in the past two decades that such commitments have topped 68%. The median, one-year forward return following such a high-water mark in the S&P 500 is a meager 1.7% over the prior 13 instances.

The record is small consolation to the surviving bears. There was one fewer of this species on Sunday when Mike Wilson, chief U.S. equity strategist and CIO at Morgan Stanley, revised his former downbeat call—the S&P 500 would fall by 15% by year end, he had maintained—to a slightly upbeat one: The blue chips will rally by 2% through June 2025, he says now.

"The problem today," colleague Evan Lorenz observes, "is not a looming recession (although one will occur eventually) or a financial crisis, but, with everyone fully invested, who will be the incremental buyer? Note, for example, that last week's meme-stock rally in the shares of retail favorites GameStop Corp. and AMC Entertainment Holdings, Inc. fizzled after a scant two days. The sequel is never as good as the original."

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