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SLIMMON'S TAKE > TAKEAWAYS & KEY EXPECTATIONS

# Equity Market Commentary

SOLUTIONS & MULTI-ASSET | APPLIED EQUITY ADVISORS TEAM | SLIMMON'S TAKE | AUGUST 2023

AUTHOR

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**We listen to you!**

One of the many aspects of this business I love is the relationship between corporate fundamentals and behavioral finance and its net impact on stock prices. Anyone who follows us is likely aware of that.

As it pertains to corporate fundamentals, my team and I spend a huge portion of our day listening to calls, reading reports, and analysing companies.

On the behavioral side, I am enormously fortunate to have such a great group of readers who are on the front lines working with clients directly. I greatly value their feedback.

What does that have to do with this Slimmon's TAKE?

1. Last month, I released a Market Alert warning of the dangers of August/September seasonality. The equity market was up significantly year-to-date; sentiment and complacency (lack of volatility) had soared; and the riskiest stocks had performed the best. This is never a good sign, particularly as we enter the slowest corporate news flow period of the year.

2. However, as I said then, "talk is cheap." Watch what people do, not what they say. As much as retail investors say they are more bullish; ***they are not acting upon it***. Easy to see, simply by going to the Investment Company Institute website and looking at ETF and mutual fund flows.[1]

3. Anecdotally, the #1 most frequently asked question I have received this year is: "When is the correction coming? I have cash to invest."

[1] https://www.ici.org/research/stats/weekly-combined.

4. Therefore, I have questioned how much of a correction the market will provide when so many want a good entry point. Won't pullbacks offer an opportunity for that cash on the sidelines to be invested, *thereby cushioning the downside*?

5. Yet, while institutions have increased their equity allocations (hence why the market has rallied), retail is traditionally last to the party. The data tells us they have not shown up yet.

When Leslie or I receive consistent feedback from those of you on the front lines, we listen:

1. Here is a portion of an email response to July's Market Alert I received:

   *Andrew, FOMO (Fear of Missing Out) amongst my clients is **not** in equities, it's in bonds.*

2. Here's the summary of a conversation Leslie had:

   *He disagreed with Andrew on one point from the Market Alert. He thinks clients are happy with a 5% savings return, and until the Fed eases, they won't move cash into equities.*

Those are just two of *many comments*.

Let's rewind back to February 2021 when, after 11 months of selling equities off the covid-lows and a 66% rally in the S&P 500, retail fund flows turned positive. Investors decided to show up to the party.

Now, fast forward to last year's bear market. Flows turned consistently negative in September 2022 and have remained so *despite a 26% rally off the October 12th, 2022, low*.[2]

Therefore, I assumed that given we are nearing the one-year anniversary of "selling **after** a bear market", it was time for investors to flip, as they did in 2021.

However, I neglected to factor in one key difference *that many of you have pointed out*:

- In February 2021, 3-month Treasury bills were yielding only 0.05%. Today they yield 5.36%.[3]

The pain of missing out on the equity rally and sitting with cash was far more acute in 2021 than it is today.

In my opinion, there are two implications:

1. Short-term drawdowns may **not** be supported by an influx of cash buying into the correction. In fact, seasonality is historically *more volatile* than normal when the S&P 500 is more richly priced and the 10-year Treasury yield is at its highest level in a year, as both are **now**.[4]

[2] Bloomberg as of August 8th, 2023.
[3] Bloomberg as of August 8th, 2023.
[4] Sentiment Trader. August 9th, 2023.

2. Ultimately, stocks need to go even **higher** for the pain threshold to become unbearable and FOMO to kick in.

Could #2 possibly be wrong and retail investors will simply miss out on this rally altogether?

As I often say, the *only* consistency to the investing business is the *fear-to-greed-to-fear cycle*. To say the greed part of the cycle will *not* emerge at some point is to say, "this time is different". It simply must happen.

However, maybe we are not yet at that February 2021 juncture?

The only question in my mind is, *how much does the equity market need to move up before a 5.25% in Treasury yield starts to look less attractive in comparison*, thereby unleashing that cash? *(Feel free to weigh in with an opinion!)*

My thesis that equities will be higher into year-end is also predicated on the ***positive inflection in quarterly year-over-year earnings growth***.

As I pointed out in our January webcast, stocks rally in down earnings years, most of the time. But why? Two reasons:

1. They sell off the year prior in anticipation of a down earnings year. (Check the box on 2022).

2. They rally in the second half of the year in anticipation that *the next year will be better*.

I think it's quite likely #2 is yet to come. The bottom-up 2023 consensus estimates went up after the Q2 earnings season, not down as the bears had predicted. [5]

That's important because consensus is *estimating a 12% earnings recovery next year from $220 to $246.* And given Q2 came in strong, there were no cuts to that $246 estimate.

As it appears today, the S&P 500 will inflect from -6% year-over-year negative earnings growth in Q2 to +8% year-over-year positive earnings growth in Q4.

***Negative to positive inflections tend to be greeted warmly by investors.***

But that is not the only potential catalyst for equities later this year.

The other big one is *old Joe* in the White House, who will be running for re-election next year. Remember that our President has been in DC for *50 years*. He knows it's all about "the economy, stupid" *in the year of the election*.

Old Joe understands he needs to pump the economy *next year*. As Dan Clifton, Washington strategist at Strategas writes:

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[5] Factset as of August 4th.

*Biden's big spending initiatives: Infrastructure, Clean Energy and Chips* ***do not Kick in until 2024.****"* [6]

We hear this from our infrastructure plays. They are all awaiting the billions of earmarked infrastructure money, expecting to see flows really turn on early next year.

Meanwhile, when asked about the $52.7 billion Chips Act, Secretary of Commerce Raimondo said just recently:

*We will start to give out the money later (Q4) this year.* [7]

These public works programs should be big kickers for industrials, materials, semi-equipment, and other sectors. Not to mention, despite the debt ceiling etc., I expect the President, will find *further* ways to ingratiate himself to voters. $$$

In conclusion:

1. Retail has not capitulated and invested what they previously pulled……. yet.

2. Earnings growth is inflecting positively.

3. Another wave of *already approved* fiscal spending is around the corner.

Hence, we remain confident on the rest of the year, although I concede, we are wary from now until Q4. The market could be more volatile than I had previously anticipated. The bears have been put through the ringer and are perhaps due for a respite.

Finally, I want to address a comment I hear often, with which I take issue: "*Stocks are Expensive*."

As you can see from the following chart, yes, the S&P 500 is more expensive than its average.

However, that's only because a few big names are pulling up the numbers.

*Most* stocks in the S&P 500 are cheaper than average, as evidenced by the S&P 500 equal-weight index. The same is the case for both mid-caps and small-caps.

Obviously, P/E is just one metric to use. Yet there are plenty of fertile equity opportunities out there. Do not let blanket statements by the bear crowd scare you.

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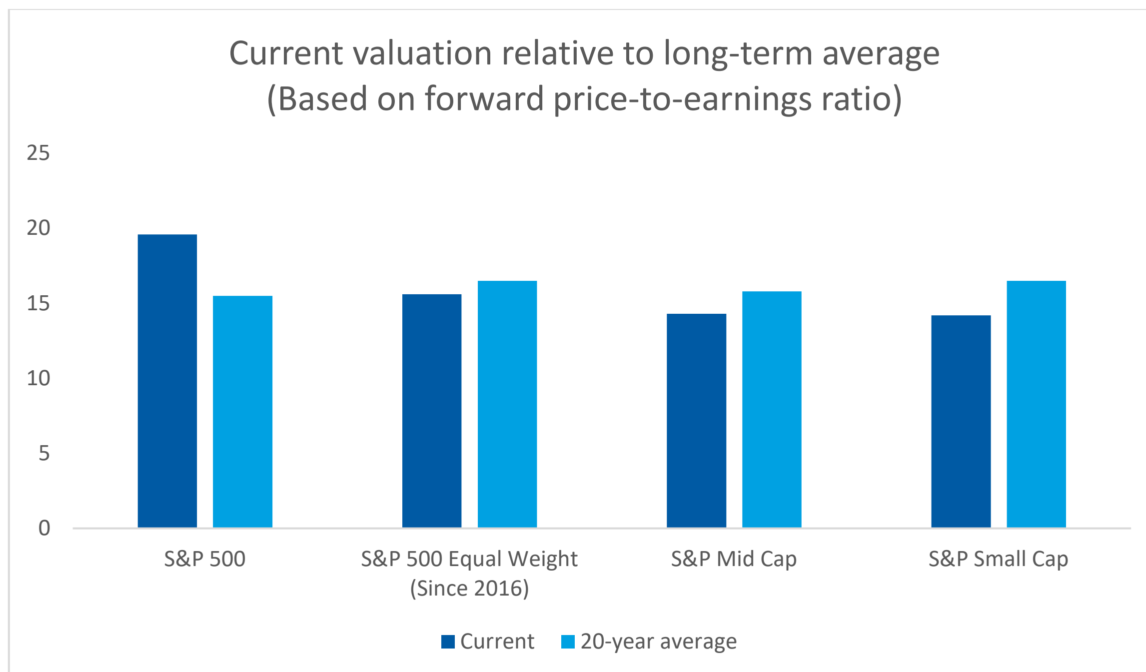
[6] Strategas, August 8th, 2024.
[7] CNBC, August 9th, 2023




Source: Trust Advisory Services

As hard as it might be to believe, given the run in the mega-caps, the S&P 500 equal-weight has outperformed the S&P 500 over time.[8]

That is why our US Core, and the US portion of our global products not only have exposure to the mega-caps but also to the mid-caps within the S&P 500.

No doubt, having more S&P 500 equal-weight exposure has been painful YTD, given the tremendous outperformance of the mega-caps.

However, we believe the combination of cheaper valuations and some reversion to the mean (time for the rest of the market to catch up) does give us confidence looking forward.

*Andrew*

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

[8] Since 1989, the SPX equal-weighed total return index has compounded at 11.03% annualized versus 10.11% for the SPX. Bloomberg, August 8th, 2023.

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