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INVESTMENT MANAGEMENT

SLIMMON'S TAKE > TAKEAWAYS & KEY EXPECTATIONS

# Equity Market Commentary

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

As I have repeated often, the only consistency to investing is human behavior. Economic and macro conditions influencing the market change constantly. How we react to those changes really does not.

Accurately predicting how evolving macro conditions will impact the market is virtually impossible to successfully repeat year-in and year-out.

Yet an understanding of these consistent behavioral patterns creates huge investment opportunities for investors who recognize them and have the emotional quotient to capitalize on them. It's what we on the Applied Equity Team like to call, "the Fat Pitches".

*In my opinion, the consistency of behavior since the October low is about as textbook as it gets.*

I believe we are in the process of traveling the four stages of the simple quote from Sir John Templeton in 1966:

***"Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria."***

Overly simplistic? *"Andrew, it has to be more complicated than this."*

Maybe not. Consider the following:

1. The lead line of the January 4<sup>th</sup> Slimmon's TAKE was "**Pessimism is Rampant**". Historically after a nasty 25% decline in the S&P 500, as we experienced in 2022, the odds of a good year for stocks increases exponentially. But most investors did not see it that way.
2. On our January 17<sup>th</sup> 2023 Market Outlook webcast, we quoted Barton Biggs, as we were convinced, "*investors were still fighting last year's war*". We saw four glaring signals that we believe indicated investors were way too bearish.

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3. To me, marking-to-market these four tell-tale behavioral signs from our webcast will assist in understanding what stage we are in today.

A. **Wall Street's Strategists**

Where they were at the beginning of 2023:

Wall Street's strategists on average expected less than a 5% return for the 2023 year.<sup>1</sup> Consensus of this group is a historically a strong contrarian signal.

Where they are now:

We are just starting to see strategists lift price targets, but only by a select few. Most remain convinced it's a bear market rally and have not budged.

**Still in pessimistic stage.**

B. **Economists**

Where they were at the beginning of 2023:

According to the Philly Fed survey, in late 2022, most economists expected a recession in 2023. As the WSJ pointed out, we have *never* had a recession when a majority of economists expected one.

Where they are now:

As the February Global Fund Manager survey reported this week, expectations of a 2023 recession have fallen from 77% in November 2022 to 24%.<sup>2</sup>

**Exited pessimistic stage.**

C. **Investor sentiment**

Where they were at the beginning of 2023:

Investor sentiment at the outset of 2023 was just horrible. We saw record daily put volume<sup>3</sup> in late December, and never before had the bull-to-bear spread spent so many weeks in the bearish camp. Massive contrarian signals.

Where they are now:

Sentiment is capitulating. Last week, AAll bullish sentiment rose to the highest since late December 2021, the first time in 58 weeks with higher bullish sentiment than average.<sup>4</sup>

**Exited pessimistic stage.**

D. **Global allocators**

Where they were at the beginning of 2023:

Institutional global allocators<sup>5</sup> had gone overweight bonds versus equities at the end of 2022. As we showed, the history of this is a contrarian signal also. The last two times they went overweight bonds were in May 2020 and March 2009, and both times stocks had crushed bond returns by year-end.

Where they are now:

No signs of reallocation yet. They are still net 31% underweight equities.<sup>6</sup>

**Still in pessimistic stage.**

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<sup>1</sup> Fundstrat, Bloomberg.

<sup>2</sup> Bank of America. February 2023.

<sup>3</sup> Bloomberg.

<sup>4</sup> Factset Market Intelligence February 14th, 2023

<sup>5</sup> BofAGlobal Fund Manager Survey.

<sup>6</sup> Factset Market Intelligence. February 15<sup>th</sup>, 2023.

But with the market so strong YTD, now what?

4. My conclusion:

*The first stage of a bull market, the pessimism stage, is largely complete. We are just entering the skepticism stage.*

While the media no longer laughs off any bullish commentary (as mentioned in the January 4<sup>th</sup> Slimmon's TAKE), they still give more credence to the disbelieving bears than they do the bulls.

As Bloomberg reported this past weekend:

*"Investors have pulled \$31 billion from equity mutual funds in the past six weeks, the most to start a year since 2016 as investors are apprehensive and are not buying the 2023 rebound."<sup>7</sup>*

**To me, "apprehensive" sounds a lot like "skepticism".**

5. One final tell-tale sign that we are only modestly into the skeptical stage:

On virtually every presentation I have done over the last six weeks I have received this question: *"Why would I invest in equities with so much uncertainty when I can get 4.5% 'risk-free'?"*

It is only in the early stages of a bull market when the pains of losing money are still so raw that 4.5% looks attractive. In the later stages of a bull market, 4.5% feels underwhelming.

Yes, with the S&P 500 up 7.4% YTD, 4.5% does not look bad. However, if and when the market breaches the double-digit return level, anxiety will likely build quickly.

6. I do not believe *the Presidential cycle* gets enough respect.

Too simplistic? Maybe not.

A. As we discussed on the webcast, Q1 of a pre-election year has historically been the best quarter of the 16 Presidential quarters. **That's this quarter.** And Q2 has been excellent also.

B. Since 1942, the market has ALWAYS been up from the mid-term elections over the next 12 months.

C. The US economy has NEVER had a recession in the 3<sup>rd</sup> year of a Presidential term.<sup>8</sup>

*Why are the statistics so consistent?* Because politicians want the economy humming along heading into an election year. Monetary and fiscal policy loosen up in order to accelerate the economy, and stocks reprice to reflect a change in growth expectations. I think 2023 will be a textbook case of the Presidential cycle.

7. To be bearish, one needs to ignore the underlying messages of the market. During the rallies experienced in 2022, which were the precursors to two nasty spills, defensive stocks were the leaders. Utilities consistently did well.

This is a very different setup than 2023, where defensives, especially those same utilities, are getting walloped, and cyclical stocks are showing leadership, which is a far healthier sign. To be bearish, in my

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<sup>7</sup> Bloomberg, February 11, 2023.

<sup>8</sup> Strategas, February 15<sup>th</sup>, 2023.

opinion, one must believe the market has it wrong. It is always dangerous to think you are smarter than Mr. Market.

Or, as my personal favorite CNBC commentator Rick Santelli (a noted Chicago bias here) said recently, in his typical pugnacious way, to a panel of bearish economists/strategists, *"Who has a better track record? You or the markets?"*<sup>9</sup>

8. To repeat from the webcast, as much as Applied Equity Advisors is confident that the first half of this year is going to be strong, it's too early to understand the ramifications of the Fed tightening. Yes, the yield curve inversion is good at predicting an economic slowdown, but it is not great at predicting when a slowdown will occur. 2024? 2025? Time will tell.
9. Finally, let's get back to those Fat Pitches. For our US Core, Global Core and Global Concentrated strategies, the pessimism stage tends to offer the most Fat Pitches. Many of these opportunities have started to come our way in 2023, as evidenced by our performance. However, just like with the market overall, it's still the early stages.

We'll detail these in the next Slimmon Take, expected early next week.

Andrew

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<sup>9</sup> CNBC, February 14, 2023.

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