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Equity Market Commentary

SOLUTIONS & MULTI-ASSET | APPLIED EQUITY ADVISORS TEAM | SLIMMON'S TAKE | JUNE 2022

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I think there is a greater than 50% chance that the S&P 500 intra-day low of May 20th (S&P 500 = 3810) was **the market low for the year**.

There are plenty of reasons why that may not be the case, but I am increasingly of the opinion that, while it's not necessarily clear sailing from here, that low might hold.

Let's begin with a discussion of the three supporting reasons for my conclusion before moving to the arguments against.

Technical

1. On May 20th, the market dropped to, and ultimately rejected, a 20% correction. A substantial close below that level would have moved the market into a true bear market.
2. The market stopped dropping at the important 38.2% Fibonacci retracement of the 2020-2022 rally.
3. The following week, the NYSE had 3 days in a row where over 80% of the total volume was on the upside. That's a very bullish sign.
   The last three times the market had that kind of positive breadth (2011, 2016 and 2020), every time stopped a decline and led to dramatic upside in stocks over the following three and six months.
4. On June 2nd, Fed Vice Chair Brainard sounded surprisingly hawkish, and the largest software company in the world lowered guidance. While seemingly two big negatives, the market rallied despite the news. As Leon Cooperman says, a good time to buy stocks is when they stop going down on bad news.

Macro

1. Could 2022 be a repeat of 1998, 2011 and 2018? In each of those years, the market declined and stopped just short of -20%, followed by a dramatic recovery leading to new all-time highs within 6 months.
2. In each of those years, the macro issues causing the selloff were very different, as they are in 2022. However, the commonality was in each of those years there was no recession. In effect, the market rejected the macro issues that had caused the anxious selloff.

So, will we have a recession this year?

That question leads to my final reason of why May 20th could have been the low for the year:

Fundamental

Clearly, corporate America does not see the same level of weakness that the stock market is projecting.

1. Insider buying is off the charts—1 standard deviation above trend.

   Except for the energy area, insider selling has dried up.

2. Corporate buybacks are accelerating.

   The original estimate of $750 billion in buybacks for the year has already reached $600 billion *just for the first half of 2022*.[1]

   Anecdotally, I hear corporate buyback desks are quite busy.

3. Not to mention, earnings guidance has moved HIGHER. Yes, that's right, *higher*, NOT lower.

   The bottom-up S&P 500 consensus earnings (which is what companies use to guide the sell side) has moved higher every week, not lower.

   <u>Clearly the economy is slowing. I do not expect revisions to continue higher forever, but my base case all year has been that the economy will prove far more resilient than what the bears predict. So far, this has certainly proven to be the case</u>.

All in all, the arguments are compelling for May 20th being the equity market low for the year, so why wouldn't I indicate more confidence than a "greater than 50% chance"?

Because there are plenty of issues to cause worry:

1. Quantitative tightening (QT): We have never experienced a similar magnitude of QT before. Therefore, there is no way to know the ramifications of the Fed not buying as much as $30 – $60+ billion of Treasuries and as much as $35 billion of mortgage-backed securities per month.
2. Jamie Dimon's statement: "A hurricane is coming." What does that mean? What does he see?
3. *Don't Fight the Fed*. They still have plenty of tightening to go.
4. Sky-high gasoline prices. How much will this dent other consumption?
5. While some inflationary inputs seem to be peaking, the actual inflation rate is still running at a level that historically does not provide good equity returns.

Therefore, the recession call becomes key.

But if there is no recession, stocks could be substantially higher by the time that is apparent.

I am not in the 'recession is coming' camp. I agree with corporate America, but clearly, we cannot rule out the possibility.

So what's an investor to do?

1. The S&P 500 has had a relatively rapid bounce off that 3810 low. I would not be surprised to see some short-term weakness.
2. But I maintain the 6-12 month returns off these levels will be very attractive, and therefore expecting further substantial weakness may be either too greedy or overly pessimistic.

Finally, two quick points on AEA's portfolio positioning.

1. We have had a value over growth bias in our U.S. exposure. <u>That is moderating</u>. We believe the magnitude of underperformance of quality growth stocks (particularly in the consumer sector) leads us to increase our growth allocation. Clearly there are negative headlines, but the real money is never made when "the coast is clear". Our stock selection bias is to favor companies that have generated high levels of profitability relative to their peers and have produced outsized shareholder returns over time, adding them to the portfolios when they are out of favor and depressed. Increasingly, quality growth stocks are meeting these criteria.

[1] JPMorgan. May 27, 2022

2. Our Global strategies have steadfastly maintained a significant allocation to Asia ex-Japan, while remaining underweight in Europe and Japan. While the Asia ex-Japan overweight hurt performance in 2021 and into 2022, the tide is beginning to turn as China reopens from the COVID lockdown, growth-supportive initiatives continue, and regulatory risks appear to be receding. As the clouds begin to clear, these stocks are attracting more investor interest.

Andrew

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