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Look Forward, Not Back

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-Gray Howard, Senior Portfolio Manager

Don't look now but the S&P 500 is up about 7.5% for the year and 18% since last October.[1] I mentioned in my December note, I felt the consensus narrative was way too negative heading into 2023 and that seems to be playing out. While it's still early in the year, I continue to believe the stock market bottomed in June of last year, followed by a classic retest in October, and now we are seeing the typical signs of an early bull market advance.

Hardly a coincidence that interest rates and the US dollar peaked around the same time after being the strongest headwinds last year.[1] It's always fascinating how trends tend to reverse at points of extreme yet so many on Wall Street fail to recognize the statistical power of mean regression and its predictability.[2] Many pundits will attempt to assign a reason for a trend reversal, but it all comes down to investor expectations and positioning.

For example, coming into 2023 investors were expecting the worst and were likely already positioned very defensively.[3] In fact, this defensive positioning is the very reason why markets tend to have limited downside as there is essentially no one left to sell.[3] Conversely, heading into 2022 investors were overweight the most aggressive parts of the market and once the Fed started to raise interest rates, it was the very act of these investors bringing down their risk exposure that caused the market to adjust lower.[4] Again, it all comes down to positioning and if everyone is saying the same thing, there's often very little fire power to keep the trend intact.

It's also important to understand what actually moves markets. It's not retail investors watching CNBC or reading the *Wall Street Journal*, but the collection of large institutional interest such as hedge funds, pension plans, and mutual funds.[5] Considering their size or the amount of money they manage, it can often take weeks if not months to complete a buying or selling campaign.[6]

Therefore, the last thing, in my view, they would want to do is advertise their research before they have bought or sold a sizable position. This is often called buy side research as the analytical work is not intended for the public, but only used to increase shareholder value for the particular fund.[7] Conversely, sell side research is what the public receives through major brokerage firms and is designed to sell products and services which is why market strategists and analysts are so often a day late and a dollar short.[7] Precisely why it's so important to listen to what the market is saying as opposed to a bunch of opinions as these large institutions will often leave a very revealing wake behind as they complete their campaigns.

So what is the market saying?

Again, I think we are seeing the typical signs of a bull market advance. For example, the economically sensitive areas of the market like technology and consumer discretionary are by far the strongest sectors year to date. [1] Furthermore, the defensive areas like healthcare, consumer staples, and utilities are all down for the year. [1] Of course the rumblings among most trading desks are that this has just been short covering, but the breadth and momentum of this move would certainly suggest otherwise. [8]

In fact, *Sentiment Trader* had this to say last week…. "As we've seen with other metrics in recent weeks, the types of readings we're seeing now in momentum and breadth are rarely, if ever, seen during protracted bear markets. When investors shift from near-depression, like last fall, to overwhelming optimism, it can precede choppy trading for weeks or even months. But with rare exceptions, it has resolved in higher prices for most equity indexes over the medium- to long-term."[8]

Of course, there is still a long list of things to worry about - recession, WWIII, inflation, unemployment and the list goes on. [9] But keep in mind that markets like to climb a wall of worry and once we have more clarity around these issues, the market will have likely already made a sizable move.

Many continue to believe that the only way to get inflation down is to increase unemployment and decrease wages - ironically, often the same folks that preached about increasing the minimum wage over the past 15 years. [9] Inflation is a byproduct of the amount of money slashing around in the system, otherwise known as M2.[10] After the unprecedented increase in M2 through Covid, we have since seen a rapid decline. See chart https://www.longtermtrends.net/m2-money-supply-vs-inflation/.

Also, when it comes to fighting inflation, unemployment is often a side effect, but not the actual cure. [11] The 1970s were a prime example as we had high inflation and high unemployment. [11] Perhaps the gig economy, work from home, Covid lockdowns, artificial intelligence, are just some of the reasons why the employment numbers remain strong in the face of Fed tightening.

After the market's recent ramp, we are now in overbought territory, and it would be healthy to see a pullback or some sideways consolidation from here. [1] But given the defensive positioning, I would expect pullbacks to be somewhat short and shallow, in my view, as there are still a lot of investors likely on the wrong side of the football.

A great mentor of mine, Andrew Slimmon with Applied Equity Advisors, told me years ago that the key to this business is to buy fear and sell greed. And yes, it really is that simple but in reality, extremely difficult to do! It's human nature to invest in the present while markets are looking forward into the future. But, if we take the time to listen, the market is sending a powerful message that the future is not as dire as most predict.

All the best,
Gray

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