Market Commentary
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English Version

Cutting Through the Noise and Riding Out the Storm

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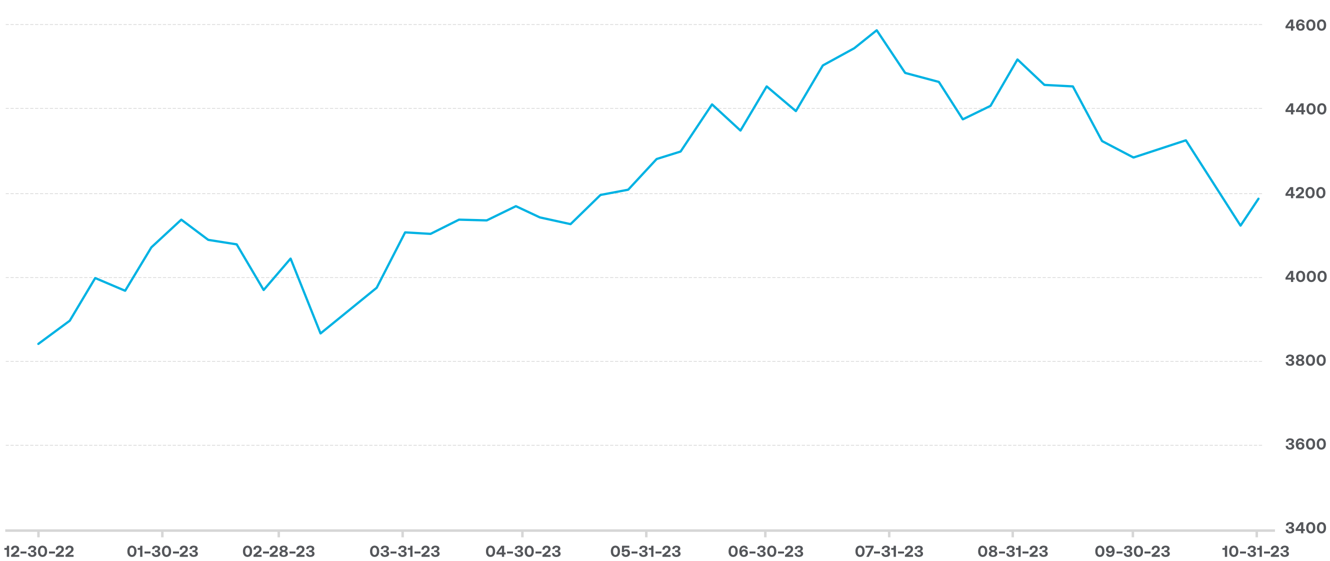
Cutting Through the Noise and Riding Out the Storm

Some say that being an equity market strategist is like being a meteorologist. There is truth in that both roles involve some level of forecasting; however, the timeframes for these forecasts can be vastly different. When a meteorologist tells us that a storm is coming, we ready our umbrellas, as we know that we will likely encounter rain the next time we go out. We might even look out the window ourselves to see a cloudy sky above. Weather tends to change relatively quickly within the context of the seasons, and a meteorologist can use the data at hand to make predictions for the week ahead. An advantage for this science is that the weather is not subject to the influence of emotions. The data shows what the data shows, and it is up to the meteorologist to interpret it. Markets are a little different though. Equity markets in particular tend to be very fickle, where the data could be saying one thing, and the market could be doing something very different to what the data would suggest. Most of the time, that fickleness is driven by emotions. Imagine if the meteorologist tells you that rain is coming, but you look out the window and see a sunny day, not a cloud in the sky...would you take the umbrella or leave it behind?

This is what happens in the formulation of market strategy, when the data says rain is coming, even though the skies appear to be completely clear. To be honest, this is how we felt this past summer. For the better part of the summer, we had been calling for a pullback in the stock market. In recent reports titled "**Our Views on the US Equity Markets and How to Approach Them**" and "**The Importance of Maintaining a Long-Term Perspective**" published respectively on July 7th and August 18th, we specifically advocated for the need to take a more defensive position in light of a potential market pullback. By that time, the S&P 500 had been moving higher on the

S&P 500 (Year to Date through 10/31/23)

Source: Bloomberg, Insigneo, as of 10/31/23



back of the Artificial Intelligence wave, well into our 4100-4300 year-end target range. Many Wall Street strategists raised their year-end targets to adjust for the rally. We are firm believers in the premise that adhering to a disciplined investment process rooted on data, not emotions, is the best way to navigate any market. As a result, we did not change our year-end target range, stuck to our process, and followed the data, which indicated an impending pullback. We wrote of the need to protect equity market positions, by opting to invest in quality-oriented holdings, using hedging strategies, or tactically reducing overweight exposures. We were seeing the storm and advising of the need to close the windows and bring in the dog, calling for umbrellas when there didn't appear to be a cloud in the sky. Believe me, being one of the few teams on the Street calling for a pullback in the middle of a seemingly unstoppable market rally was a lonely place to be. In fact, the S&P 500 kept moving higher from our report in early July, reaching its peak later that month. However, as of the time of this writing, the market had pulled back approximately 6% off its high. Keeping those umbrellas close paid off.

So, the rain is here; now what? We would still keep those proverbial windows shut, as we do not believe that the pullback has run its course. True, the market has rallied the past few days after the Federal Reserve announced it was leaving rates unchanged at the current level between 5.25%-5.5%, a 22-year high. We believe that although the market could bounce from a short-term oversold level, this bounce is likely to be short-lived. We could settle in the 4100-4200 level for some time, but we would not be surprised if the market retreated to the 3800-4000 range through the first half of next year.

To understand where we are coming from, let us first look at what the Fed said. Chairman Jerome Powell did appear to take a more dovish tone on the future path for interest rates. However, he also appeared to leave the optionality to raise rates further on the table, if needed. He said that the Fed would "proceed carefully" as they are not confident yet that financial conditions are restrictive enough to "finish the fight". He also said that monetary policy would remain restrictive until inflation was back on a path to reach 2%, and although it has been trending downwards, it was still above their desired target. The labor market also remains an important variable and Powell alluded that although the labor market has been "rebalancing", it remains tight. He went on further to say that the change in financial conditions has to be "persistent" in order for the Fed to consider changing its stance on monetary policy, and that it remained committed to reducing inflation below its 2% target over the long term, which would likely lead to lower economic growth. To be fair, it does appear that the Fed is done raising rates. The market is currently pricing in only a 10% chance of a rate increase at the next meeting in December and we agree that there is a very low probability of this happening. However, nothing that chairman Powell said jumps out at us as an indication that the Fed will be cutting rates anytime soon. There is a big difference between not raising rates and cutting rates. We have been proponents of the idea that rates would remain higher for longer and we continue to believe this. In fact, the Fed has been saying this. When asked about the possibility of cutting rates, Powell himself said that they were not even considering it yet. We recently attended a conference where Vincent Reinhart, ex-economist at the Federal Reserve and Chief Economist at BNY Mellon's Standish Asset Management, commented that the Fed is unlikely to make the same policy mistake twice in the same direction, meaning that it was more likely to keep rates higher for longer than needed, rather than risk cutting too early only to have to tighten again. We share the same view as Mr. Reinhart.

But if we look at the market's reaction at the end of last week, it was acting almost as if the Fed had said it was going to start cutting rates soon. Why this discrepancy? We have seen this behavior throughout the year, where investors driven by emotion have jumped the gun many times, trying to get ahead of the Fed pivot. If we think about it, for the last 15 years or so, the market has been used to the Fed reacting relatively quickly in response to changing market conditions. Over the same period, investors have become accustomed to historically low interest rates in the financial system. What is sometimes forgotten is that a relatively large number of market participants have not been operating in the market for more than 15 years, so naturally, many are reacting to the environment they know. We choose to follow the data, and what the data tells us is that although inflation and the job market are trending in the direction the Fed wants them to, rate cuts are not imminent, as some in the market might think.

Coupled with our view that the Fed is going to hold rates higher for longer, the current earnings season further corroborates our thesis that there could be more downside ahead for the US equity markets. Many companies have reported reasonably good quarterly numbers, some even beating market expectations. However, most guidance and management team outlooks have proved cautious. A trend that we are seeing is that revenues have come in higher than expected, but much of this has been a result of higher prices, not higher demand. Many companies are beginning to indicate that demand is in fact starting to trend downwards. At the same time, let us remember that inflation not only increases sales prices but also costs, so many companies are also beginning to experience rising costs while facing the prospect of slowing demand. In theory, this dynamic should lead to a decrease in profit margins. Some industrial companies like Caterpillar reported weaker than expected backlogs this quarter, meaning that end customers are expecting lighter demand growth. This was reinforced by the ISM Manufacturing Index data published recently, showing that the New Orders component of this index is weakening. Factory orders are also mirroring this trend. Some companies stated that orders this quarter are down due to post-Pandemic destocking, as during that period people wanted goods rather than services, so companies ramped up production to meet this demand. This is true, but we have been hearing about the post-Pandemic destocking trend for a while now, so this dynamic should be at or nearing completion. Pandemic-destocking or not, we believe that the current resilience in sales growth that has been observed in previous quarters is likely to break down as volume demand slows, especially given higher unit costs. Further exacerbating this trend is a consumer that is becoming more conservative given the prospects of a recession and the possibility of job loss, which is likely to happen if the Fed cools the labor market, as it is trying to do. Excess savings accumulated during the Pandemic continue to dry up, while credit card and auto loan delinquencies continue to march higher.

Taking things down to the individual stock level, we see that companies that posted strong beats to earnings expectations this quarter saw reasonable moves higher in their stock price in reaction to these beats, yet companies that beat expectations, but perhaps in a less meaningful way, saw their stocks move disproportionately lower. This was the case among four of the stocks that have been leading the market higher for most of the year: Amazon, Microsoft, Alphabet, and Meta. Driven by their cloud and AI businesses, Amazon and Microsoft posted great numbers, seeing their stocks rise by an average of 4.95% higher on the day of their reports. On the other hand, Alphabet and Meta posted decent numbers but did not necessarily crush expectations. As a result, their stocks dropped an average of 6.6% on the day of their reports. This discrepancy in stock reactions could be an indication that market expectations might still be too high. Granted, the comparison between these four stocks is only a small subset of the market, but this trend is becoming visible in other sectors as well, which could be an indication that investors need to reset expectations lower. An expansion in the market's valuation multiple, rather than earnings growth, has been in large part responsible for the market's previous move higher. This is a normal occurrence in market cycles; however, earnings need to converge with higher expectations at some point in order to sustain higher price levels. Given that there are signs that earnings growth could be turning weaker than expected, current earnings expectations may not be able to provide the support implied by current market multiples, a dynamic that is resolved by a reduction in equity prices.

Taking a step back to look at the big picture, companies are warning of a cautious outlook ahead and the Fed is telling us that it is not even thinking about cutting rates any time soon, yet investor expectations remain relatively high. The market appears to be myopically focused on the possibility of lower rates and almost banking on the fact that the Fed will achieve a soft landing in the economy, without considering that if rates need to come down sooner than when the Fed would like them to, it is likely because the economy is doing worse than expected, not the other way around. This scenario does not paint a rosy picture for US equity markets in the short-term. This is not to say that all we see for the market ahead is gloom and doom. In fact, we believe that once market expectations and economic reality converge and the Fed signals that it is ready to start cutting rates in due time, the equity markets could have a meaningful move higher. We believe that although the end of 2023 and the beginning of 2024 could see equities move lower, the back half of next year could see equities move meaningfully higher. All we are saying is that we are not there yet. For now, continue to keep the windows closed, the dog inside, and umbrellas close by. However, let us also keep things in perspective and remember that we invest for the long term. When it storms, we do not panic, sell the house, and move to a different neighborhood. We just take the proper precautions to ride out the storm until the sun shines again. ■

House Views Matrix

	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
US Equities[1]	NEUTRAL	OVERWEIGHT
European Equities	NEUTRAL	NEUTRAL
Japanese Equities	NEUTRAL	OVERWEIGHT
Emerging Market Equities	NEUTRAL	UNDERWEIGHT
Chinese Equities	NEUTRAL	UNDERWEIGHT
US Treasuries[2]	NEUTRAL	OVERWEIGHT
Investment Grade Fixed Income	NEUTRAL	UNDERWEIGHT
High Yield Fixed Income	NEUTRAL	UNDERWEIGHT
Emerging Market Sovereign	OVERWEIGHT	NEUTRAL
US Dollar	NEUTRAL	OVERWEIGHT
Energy[3]	NEUTRAL	OVERWEIGHT
Precious Metals	UNDERWEIGHT	UNDERWEIGHT
Cash	OVERWEIGHT	OVERWEIGHT

[1] Relative to global equities in USD
[2] Relative to aggregate fixed income markets in USD
[3] Relative to an overall commodity allocation

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