



Insigneo Weekly Dispatch

Don't Get Sucked In

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I remember, as a young analyst starting out in the industry, I thought I had the market all figured out. I thought beating the market was easy: you do some due diligence, pay attention to the media, and buy internet-related stocks. After all, that had been the trend for a while and many fortunes had been made that way, so why not follow the trend? That was 1999, the market turned steeply downwards the following year, and I quickly learned the consequences of getting blindly sucked into a trending market. Almost 25 years later, I have a completely different view on chasing trends. Granted, I am not saying that trend-investing does not have its merits. Approached the right way, trend-investing can yield positive results. What I am saying is that blindly getting sucked into a trending market for fear of missing out is not a winning strategy.

The S&P 500 has been trending upward this year, rising close to 8% in 2023. In early February, after having risen close to 9%, we expressed our doubts about the strong rally. In our monthly update published February 9th of this year, we stated: "Given these strong rallies to start the year, we think that caution is warranted ahead, as a near-term pullback in equities would not be unusual." The S&P 500 retreated approximately 5.5% from that point, touching the 3800 level on March 13th. However, from mid-March to now, it has bounced back, finding itself again close to where it was in early February. A question that has been top of mind for many investors revolves around the sustainability of this recent rally, and whether to participate in it or not. Our view this year has remained neutral on U.S. equities, tactically repositioning within specific sectors as opportunities present themselves, but not

committing new funds into the market. In other words, not getting sucked into the current trend.

To better understand our logic, let's examine where the current leadership for this recent trend has been stemming from. Sustainable rallies tend to be broad based, driven by many stocks across many industries. Market breadth measures how broad based a move in the market is. Looking at the market breadth for the current rally, we find that it has actually been quite narrow, primarily led by a small number of Large Cap Technology companies. In fact, on average, "Big Cap Tech" names are up over 20% for the year, while the average stock in the market is up about 3%. If we drill down into some of the specific stocks behind this move, we find that Alphabet is up 22%, Microsoft 27%, Meta 98%, Amazon 30%, Apple 30%, and NVIDIA up 86%. Keep in mind that these 6 stocks alone comprise almost one fourth of the S&P 500. Given the outsized weight in the index of names such as these, it should come as no surprise that a significant move in these stocks has propelled the market higher. As we can imagine, this move has also led to extended valuations for sectors such as Information Technology. As of the time of this writing, on a P/E basis, the S&P 500 was trading at 18.5X current earnings. However, the Information Technology sector was trading at 25X earnings, representing a 35% premium over the index. To give you a frame of reference, the 10-year average valuation for the S&P 500 stands close to 19X, whereas the Information Technology sector 10-year average valuation stands near 21.4X, representing a 13% premium. Although narrow market breadth is an indicator of an unsustainable rally, it is not the only data point that we are seeing that gives us pause.

When markets rally sustainably off a bottom, small cap stocks generally tend to lead the way. However, this is not currently the case in the U.S. equity markets. As we mentioned above, the S&P 500 has risen close to 8% in 2023. However, the

S&P 600, which is comprised mostly of small cap stocks, is down almost 2% over the same period. There could also be other dynamics at play pointing to an unsustainable rally. J.P. Morgan makes the argument that volatility management by institutional investors, along with increased share buybacks by the companies themselves could be artificially propping up equities. Something else to keep in mind is that the market has never bottomed before a recession. It is true that this market cycle has been unlike most others, so a different outcome this time would not be out of the question. However, the probability that many data points pointing to the unsustainability of the current rally would all be wrong at the same time is low.

An important dynamic that will shed more light on the rally is the current earnings season. As of this writing, approximately 50% of the companies in the S&P 500 have reported earnings. So far, earnings have surprised to the upside, coming in stronger than expected for every sector. To be clear, earnings growth has decelerated on a quarter over quarter basis; however, this deceleration has been lower than expected.

The strongest earnings have come from the Information Technology and Communication sectors. Microsoft posted strong results and stated that it is committed to be the leader in the "AI platform wave". The company also emphasized the resilience of its cloud unit, Azure. Alphabet also saw revenues recover, stating that its cloud unit finally achieved profitability. However, management did say they foresee "headwinds" going forwards. Meta stole the show, coming in with stronger than expected earnings driven by a rebound in ad spending. Despite the strength in software-related names, we are seeing a different dynamic in the semiconductor industry. Many of these companies are seeing slower demand for chips, which are used for a wide range of consumer end products, which could foreshadow a slowdown in economic growth. The Financials sector has been a bit of a mixed bag, where large, established companies like

J.P. Morgan posted strong numbers and saw deposits increase, yet smaller banks appeared more cautious. Some of this caution is being reflected as decreased share buybacks, to preserve capital until the outlook for the industry clears. In the Consumer Discretionary sector, Amazon posted strong earnings last night, beating expectations and seeing sustained growth in its AWS cloud platform. Tesla was buffeted by the prospect of lower profit margins as the company lowered auto prices, creating concerns of a brewing price war. However, Visa, traditionally a good barometer for consumer demand, saw volumes rise over the quarter. Interestingly though, much of this rise was due to stronger than expected demand for air travel, and much of it was outside the United States. Earnings in the Consumer Staples sector have been strong, with Coca Cola, Procter and Gamble, and Kimberly Clark indicating that demand has remained relatively steady despite increased prices. This has been driven by the relative inelasticity of demand for products in the sector, where consumers are less likely to reduce consumption, regardless of price or economic backdrop. Two sectors that tend to be good indicators of economic growth are Industrials and Materials. Curiously, companies in both sectors are starting to show some signs of weakness. In Materials, packaging companies such as Silgan and Packaging Corp reported weaker numbers and outlooks on lower consumer demand, as well as demand shifts away from goods and more towards services. This trend is also being reflected in the Industrials sector, as United and American Airlines reported increased demand for air travel, yet logistics and trucking companies like UPS and Old Dominion are seeing lower shipments of goods. These dynamics could portend an upcoming

reduction in retail sales, particularly if credit becomes restrictive and unemployment grows.

Looking at the big picture, earnings for the first quarter are coming in stronger than expected, but some cracks in the economy are becoming evident. As we sit once again with the S&P 500 closing in on the 4150 level, near the highs from early February, we are once again of the opinion that another near-term pullback in equities would not be unusual. To be clear, we are not calling for a bear market. However, we do think that a pullback to the 3800-3600 level is possible, and a retesting of the October 2022 lows near 3500 is not out of the question. We do believe that a pullback would create a good entry point for investors with a long-term horizon. However, in our opinion, staying neutral or taking some profits off the table for the time being would be a better strategy than getting sucked into the current rally that could prove unsustainable in the near-term. Prudence is sometimes the better part of valor.



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