Market Commentary
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English Version

Insigneo Weekly Dispatch

Our Views on the US Equity Markets and How to Approach Them

Barring any meaningful changes in the data, we continue to remain cautious on the US equity markets. As a result, we believe that prudency could prove to be the right strategy in the end.

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Last week I had the pleasure of meeting with many great individuals across our partner offices in Uruguay, Argentina, and Chile. We had great conversations that gave rise to great questions. Two points that we discussed often were our current views on the US equity markets, as well as how to approach them going forward. I thought it might be beneficial to address these two topics in more detail.

Like most on Wall Street, we did not expect the current rally to be as strong as it has been of late. As the S&P 500 index sat between 4150 and 4200, we wrote that even though the index could conceivably move higher, we would stick to our investment process, exercise prudency, and would look to take some risk off the table. As the index hit our target of 4300, we repositioned many of our portfolios, giving them a quality-factor bias, to be better positioned in the face of a looming market pullback. As we know, although most stocks tend to go down in a general drop in the market, those that exhibit quality factors such as sustainable earnings and low debt levels tend to hold up better.

As of this writing the market now sits slightly above the 4400 level. Many strategists on the Street who were once bearish have thrown in the towel and raised their year-end targets for the index. Others have stuck to their guns and remained firmly in bearish territory. An investment process must be flexible in order to be able to adapt to ever-changing market conditions. However, discipline is key, and the balance between flexibility and discipline is one that often proves difficult to strike. Many times, over the past week I was asked "Where do you stand on the market? With the bulls or the bears?" Answers to this question sometimes tend to waver. Personally, I don't like wavering opinions, especially when it comes to investing. Our job as market strategists is to provide a sense of direction. We are not right 100% of the time, and this is where flexibility and humility are key, but we have to base our decisions on a solid investment process rooted on the data at hand. After studying equity markets for many years, I have come to learn that sometimes one can be wrong for the right reasons or right for the wrong reasons. If we are wrong for the right reasons, we can always go back and reevaluate what we could have done better to improve our process. If we are right for the wrong reasons, this is what is called luck. As we know, hope and luck are not an investment strategy. So, my answer to the "bulls and bears" question would put us in bearish territory, as we continue to be cautious and would not be surprised by a pullback in US equity markets in the short to medium term. This is not to say that we do not like these markets over the long term, we do. What we are saying is that despite the market's march higher, the underlying data continues to say that caution is warranted ahead. We choose to follow our process and continue to base our decisions on data, not emotions.

In the first half of this year, on a total return basis, the S&P 500 rose by nearly 17%. As a result of its "market cap-weighted" construction, the S&P 500 is dominated by its largest constituents, mostly large and mega-cap technology stocks. Looking at an "equal weighted" version of the same index, where all stocks have the same weighting, regardless of size, the "equal-weighted" S&P 500 rose 7% for the year. The "market-cap weighted" S&P 500 beat its "equal-weighted" twin by 10%, a beat led predominantly by mega-cap tech stocks. We can isolate this group of stocks even further by looking at the Nasdaq 100. Nearly 70% of this index is comprised of large-cap tech stocks, so it is no surprise that it closed 39% higher after the first six months of the year. However, this is not breaking news. We have all heard how the current rally has been led by large-cap tech stocks, being pushed higher by the advent of Artificial Intelligence.

But what about the rest of the stocks in the S&P 500, other than the 8 responsible for its recent move; what Barron's recently referred to as the S&P 492? A rally led by a small group of stocks has historically proven to be unsustainable. As a result, there is now an expectation by some investors that the current rally will broaden out to include the rest of the stocks in the market. Not just in the S&P 500, but also in other sectors and market cap ranges such as small and mid-cap stocks. In other words, the expectation is that the rally will sweep up many of this year's laggards. Although possible, we see it as unlikely that these laggards will provide the necessary strength to push the market meaningfully higher in the near term. The stocks that have not been able to keep up with the current rally are mostly interest sensitive companies with limited pricing power. We saw during this past earnings season that earnings decreased less than expected, contracting by 3% instead of the expected 8%. However, many companies that reported higher earnings were able to do so because of higher prices paid for their products, not because they experienced strong volume growth. In essence, inflation may have artificially supported earnings growth for some of these companies. If inflation trends down and volume growth continues to slow, we could see an earnings contraction, particularly for companies with limited pricing power. Another factor to consider is the Fed. Fed President Jerome Powell has said that the Fed will not cut rates until 2024 and could potentially even increase rates this year. He also stated that the direction and the pace of interest moves are independent from each other, a statement that leads us to believe that rates could remain higher for longer than the market anticipates. Coupled with a yield curve inversion that has proven to be the steepest in many years, these dynamics are likely to put pressure on interest sensitive stocks, many of which rely on access to capital for their operations. In short, although it is possible that the current rally will expand and "lift all boats", we do not see this as probable.

The topic of the Fed leads us to another headwind that is beginning to show in the data, which is the high likelihood of lower liquidity in the financial system. As part of its program to replenish its coffers, the Fed is set to remove a significant amount of liquidity from the system. Compounding this is the likely reduction in excess consumer savings. In 2020-2021, the amount of excess consumer savings that accumulated as a result of pandemic-relief policies peaked near $2 trillion. This number has decreased to close to $500 billion, and according to J.P. Morgan, could turn negative by the end of this year. At the same time, regulation on regional banks is to increase, potentially reducing lending from banks that constitute the lifeblood of small and medium sized businesses. As companies borrow less, particularly in the face of a looming recession, they will likely also spend less, potentially leading to lower employment and less cash in the pockets of American consumers. In fact, the amount of consumer credit card debt is increasing, a dynamic that is already beginning to translate into higher delinquency rates.

Faced with many potential headwinds, we cannot advocate chasing these markets higher, especially given their currently lofty valuations. Trading at 20X forward earnings, the S&P 500 is not exactly a bargain, and at 31X forward earnings, the Nasdaq 100 is closing in on its 10 year high near 35X. This brings us to the second point we discussed often in our meetings in the Southern Cone, which is how to approach the markets at this point. Protecting profits by taking some risk off the table is always an option, but an investor that does not want to do this could consider an allocation to quality-oriented assets. This could be done through ETFs such as the iShares MSCI USA Quality Factor ETF (QUAL). Although this ETF does hold stocks such as Nvidia, Apple and Microsoft, it does so at smaller percentages than the general indexes. Investors who do not wish to sell any of their exposure to the markets could also consider purchasing "insurance", either directly through the purchase of put options on some of the major indices, or through ETFs that short the index, such as the ProShares Short S&P 500 ETF (SH). It is important to note that we are by no means advocating selling completely out of the markets and going short. We are just saying that an investor that does not want to necessarily exit a position in the US markets could consider establishing a hedge to get some protection, much like purchasing insurance on a house.

With call options on the Nasdaq 100 at multi-year highs and put options on companies such as Apple at multi-year lows, some investors appear to be throwing caution to the wind, focusing only on the upside and ignoring potential downside. As we said before, we choose to follow a data-driven process and not fall prey to emotions. Barring meaningful changes in the data, we continue to remain cautious on the US equity markets. As a result, we believe that prudency, whether through de-risking, reallocating assets towards quality factors, or simply hedging, could prove to be the right strategy in the end.

As always, it is important to keep in mind that the investment ideas referenced here can exhibit high degrees of volatility and are not suitable for every investor. These investments are best considered on a case-by-case basis, based on a particular investor's willingness and ability to tolerate risk. If you need more information or would like to discuss these potential ideas in more detail, please do not hesitate to contact the Insigneo Research Team.

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