



Insigneo Weekly Dispatch

Momentum is a Powerful Force

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“Priced for perfection, yet we keep on rallying.” These words were spoken by Bloomberg anchor Jonathan Ferro during an interview earlier this week. Jonathan was interviewing Bob Doll, Chief Investment Officer at Crossmark Global Investments. At one point during the interview, when asked how he was positioned given the current market environment, Bob answered “Fully invested but biting my fingernails”. I thought this conversation brilliantly encapsulated the scenario faced by investors in US equity markets.

As of the time of this writing, the S&P 500 stood a mere 2 points away from 5,000. I do not mean 2 full percentage points, I mean two points out of 5,000, or approximately .04%. So, we are basically there, nearing the high end of our 2024 price target of 5,100 for the S&P 500 in a scenario that prices in a soft landing and no recession. Keeping an objective view, let us consider some other strategist’s targets on the Street like Goldman Sachs and UBS, whose price targets stand at 5,100 and 5,150 respectively. That is 2% and 3% higher than where we stand. We are all aware that the market is pricing in a soft landing and 5 to 6 rate cuts this year. However, the market also appears to be pricing in continued positive earnings growth. If we think about it though, why would the Fed need to cut rates 5 to 6 times this year if the economy is healthy and companies are experiencing earnings growth? If a soft landing appears likely, the Fed might only need to cut 2 or 3 times, not 6. If earnings growth weakens and a recession appears likely, then the

Fed might need to be more aggressive with monetary easing. The market's expectation of a soft landing and positive earnings growth coupled with aggressive rate cuts seems counterintuitive. Assuming an equal chance that each individual event may or may not happen, the math tells us that the probability that these three events happen all together at once is very low at 12.5%. So why would anyone take a seemingly counterintuitive bet with a close to 87% chance of not happening, in order to capture 2%-3% upside? Especially if we consider the fact that the risk-free rate currently stands above 4%. The answer, in one word, could be momentum.

Like a fast-flowing river, momentum is a very powerful force that drags everything in its course, sometimes including smart investors. Consider this: If you are an investment manager that uses the S&P 500 as a benchmark, you need to have exposure to the magnificent 7 stocks (Amazon, Alphabet, Apple, Meta, Microsoft, Nvidia, and Tesla), or risk getting left behind by your benchmark and your peers. These 7 stocks alone represent nearly 30% of the S&P 500. Not having exposure to them would mean that an investor using this benchmark would not have exposure to nearly one-third of the market. Do not get us wrong, most of these are great companies, but like it or not, many investors have had to purchase these stocks irrespective of their valuations, simply to keep up with the market. Considering that on average, 7 to 8 out of every 10 Large Cap funds underperformed the S&P 500 in 2023, you better believe that most of these managers do not want to get left behind again.

In a recent report, JP Morgan highlighted the extremely concentrated nature of the S&P 500, citing that the largest 10 stocks in the index represent over one third of its weight, a level of concentration not seen in the last 50 to 60 years. The report further points out that the momentum driving this concentration appears to be continuing in the early part of 2024. At the time of this writing, the market cap-weighted S&P 500 index had outperformed its equal-weighted counterpart by 4.3%. Said differently, an S&P 500 where all stocks have the same weight had risen a mere 0.6% for the year, while the same index, with its current overweight in the Magnificent 7 had risen 4.9%, nearly 8 times more. Compounding the problem of overconcentration, or narrowing market breadth, is the fact that the Magnificent 7 group is becoming more like the Magnificent 5. To illustrate this point, consider that two of the Magnificent 7 stocks, Apple and Tesla, are down for the year, -2.8% and -24.3% respectively. Despite the underperformance of these stocks, the market-cap weighted index still outperformed its equal-weighted twin. The market's hopes now lie on the shoulders of such a small number of stocks that cracks in the earnings expectations of some of these companies could spell trouble ahead. So far this earnings season, earnings appear to be in good shape for most of these companies. But we are starting to see that expectations are becoming too lofty, to the point that sometimes good earnings are not good enough for the market. Weaker than expected outlooks, or one of a myriad of other possible headwinds lurking in the wings, could lead to a selloff in this narrow group of stocks as investors look to protect gains.

Expectations could prove to be the market's main roadblock going forward. As we mentioned before, along with earnings growth, the market is also pricing in a soft landing and a meaningful number of rate cuts. Initially priced in to start next month, the Fed put an end to that expectation, stating at its meeting last week that March could be too premature to start cutting rates. Exactly when the Fed starts its rate reduction campaign is less important than how aggressive this campaign turns out to be. We have been on the camp that the first cut would not come until the middle part of this year. Although the market has now pushed back its expectation of the first rate cut from March to a date range more in line with our views, it still expects an aggressive level of cuts. However, the Fed appears in no rush to start cutting rates, let alone cutting them aggressively. Both Minneapolis Fed president Neel Kashkari, and Richmond Fed president Tom Barkin were out this week attempting to dampen market expectations, stating that the economy currently appears to be on a strong footing and that more time was needed to assess the big picture. Assertions were made that consumer demand appears healthy, the job market is strong, and inflation is on the right track, concluding that the Fed can afford to be patient. Based on the Fed's current stance, the market's expectations of aggressive rates cuts this year could be met with disappointment, which could put downward pressure on stocks. On the other hand, as we pointed out before, if the Fed does need to take a more aggressive stance on monetary policy, it may be because the economy proved to be weaker than expected, creating an environment that would pressure earnings growth and could also put downward pressure on stocks.

The market appears to have backed itself into a corner, leaving only a very narrow corridor of possibilities to meet its lofty expectations, with a lot of room for error. Yet, momentum appears to be dragging many market participants further along this path. So, what is one to do in this current environment? As we have stated many times in previous reports, keeping a long-term perspective is a key premise in a sound investment strategy, so panic selling is not the answer. However, maintaining a quality stance in an equity portfolio or protecting gains through attractively priced put options on the S&P 500 could prove to be sound ideas. Also, deploying cash into investment-grade bonds, therefore locking in still attractive rates while capturing price appreciation potential as rates trend down over time, could also prove to be another good alternative. I have been an equity analyst most of my career and strongly believe that appropriate exposure to this asset class is crucial to any long-term investment strategy. But I have also seen momentum act as a very powerful force that cuts both ways. When its waters get too strong, sometimes it is better to take the proper precautions and not get swept away. ■



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