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SLIMMON'S TAKE > TAKEAWAYS & KEY EXPECTATIONS

# Equity Market Commentary

SOLUTIONS & MULTI-ASSET | APPLIED EQUITY ADVISORS TEAM | SLIMMON'S TAKE | JUNE 2023


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## NOW WHAT?

1. We used the following table during our Q4 2022 and Q1 2023 quarterly webcasts:

   Historically, after a 25% decline as we saw last year, the 1-year return for the S&P 500 roughly doubles its long term average to +21.6%.

   **A necessary "go" time** to become more aggressive in equity exposure.

**When the S&P 500 has been down 25% or worse since 1950**

| Peak | Trough | +1 Year | +3 Years | +5 Years | +10 Years |
|---|---|---|---|---|---|
| 12/12/1961 | 6/26/1962 | 31.2% | 69.2% | 94.8% | 171.1% |
| 11/29/1968 | 5/26/1970 | 32.2% | 44.3% | 27.9% | 97.5% |
| 1/11/1973 | 10/3/1974 | 1.4% | 23.8% | 42.0% | 188.4% |
| 11/28/1980 | 8/12/1982 | 43.9% | 81.2% | 238.6% | 403.9% |
| 8/25/1987 | 12/4/1987 | 14.7% | 34.1% | 96.8% | 387.1% |
| 3/24/2000 | 10/9/2002 | 0.2% | 1.9% | 21.5% | 38.3% |
| 10/9/2007 | 3/9/2009 | -6.9% | 3.7% | 61.2% | 209.6% |
| 2/19/2020 | 3/23/2020 | 56.4% | ??? | ??? | ??? |
| 1/3/2022 | 10/12/2022 | ??? | ??? | ??? | ??? |
| **Average** | | **21.6%** | **36.9%** | **83.3%** | **213.7%** |

Source: Hamilton Lane, Ycharts, October 4, 2022. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results. See Disclosure section for index definitions.

However, the S&P 500 **is up just over 21.6%** since the October 12, 2022 lows.

*Does that mean the S&P 500 is due for a pause, or worse, some correction?*

2. On the one hand, according to Bank of America:

   *After crossing the +20% mark from the bottom, the S&P 500 continues to rise over the next 12 months **92%** of the time, returning on average of 19% dating back to 1950.*[1]

3. On the other hand, consider:

   A. Risk-on (beta) has quickly become very overbought short-term.
   B. The US Treasury will likely drain $400 billion of liquidity over the next month to refill their Treasury General account (TGA), an account they had to draw down during the deficit ceiling debate.
   C. In my experience, previously undiscussed geopolitical issues generally pop up in the summer.

   *All ingredients for some sort of consolidation.*

4. Investors' appetite for 5% short-term instruments (the biggest inflows YTD) is consistent with the "fear" stage of an equity market cycle.[2]

   5% is a heck of a lot more attractive than the potential to lose money in equities, as was the case in 2022.

   However, I believe the only consistency in the investing business is the fear-to-greed-to-fear cycle. Economic and geopolitical conditions change, but behaviors simply do not.

   So, its only a matter of time until fear moves to FOMO (fear of missing out…the precursor to greed). At that juncture 5% will **not** look attractive, and underweighting equities will be a source of criticism.

5. The number one question I receive from advisors is: *"When is the pullback coming so I can put cash to work?"*

   Markets rarely give investors what they want.

   Therefore, despite an overbought market and plenty of reasons for near-term caution, **I have a hard time seeing the market correcting much.**

6. What is an investor who is looking to increase exposure in equities supposed to do?

   Last year, I advocated increasing exposure with every subsequent 5% decline. Down 15%, then down 20% and then down 25%.

   Unfortunately, I do not see that fat pitch coming this year.

   Too many want it.

   Therefore, I would advocate averaging cash in over the summer on a monthly basis.

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[1] Bank Of America Five FAQs. June 9th, 2023.
[2] Bank of America Global Fund Managers Survey. June 13th, 2023.

7. Averaging in over the summer makes sense to me, because I continue to think another leg higher is coming this fall.[3]

The market historically does well in a down earnings year[4] for two reasons:

A. It has already anticipated the weak earnings year by selling off the previous year.
B. As the year progresses, it begins to anticipate an earnings recovery in the following year.

2023 is following the script:

A. I expect earnings are going to be lower than last year.
B. The market was down last year.
C. The market is up YTD.

The consensus estimate is for the S&P 500 to earn **$247 in 2024** versus $220 this year.[5]

That's a big jump.

Historically, the market puts a **big** multiple on recovering earnings in advance of them.[6]

You could say to me, "Andrew, that consensus is too high".

Could be true, but we won't know that until next year.

In the meantime, unless Q2 earnings are a disaster (NOT what we are hearing cumulatively from companies), I believe it's unlikely analysts will be cutting next year's number anytime soon.

**And that is how you get another leg higher this fall.**

8. Poor breadth is NOT a sign of imminent market weakness as many bears suggest.

*Weak breadth/narrow market leadership has been a high-profile bearish talking point. S&P 500 up 13% thus far this year vs just 3% for equal-weighted S&P 500. However, some firms have pushed back against concerns about the quality of the year-to-date upside in stocks. BofA recently argued that history suggests weak breadth itself isn't a precursor of market weakness. Pointing out that in years of megacap leadership since 1986, the market was up the subsequent year nearly 75% of the time. Average gain was 12%, with median gain at 16.3%.*[7]

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[3] Dollar Cost Averaging is a program of regular investment that cannot assure a profit or protect against a loss in a declining market. Since such a program involves continuous investments regardless of fluctuating share values, investors should consider their financial ability to continue the program though all market cycles.

[4] Strategas, December 16, 2022.

[5] Factset consensus estimates as of June 9th, 2023.

[6] Jurrien Timmer, Fidelity Investments, June 2023.

[7] Factset Market Intelligence. June 13th, 2023.

9. Narrow leadership amongst mega-caps is problematic for active management.

Let me be direct:

While I am proud of our market call year-to-date, it has been a brutal year for our long-only active strategies.

As has been well documented academically, high active share strategies produce higher excess returns over time than benchmark hugging strategies.[8]

Active share is a measure of how much the strategies differ from the index.

Applied Equity Advisors runs high active share strategies.

However, we can't produce high active share by just owning a handful of mega-caps.

So, in years like this, our portfolios will struggle on a relative basis.

The good news is that narrow breadth never lasts. [9]

Therein lies the opportunity.

Other stocks start to participate, and that is likely good for high active share going forward.

More stocks participating ***plus*** Asia starting to kick into gear:

Suffice to say, I'm sleeping better this month, thank you.

10. So how could I be wrong?

Historically, equities rally when the yield curve is inverted until it un-inverts.[10]

An un-inversion normally occurs when, for example, the two-year yield drops on slowdown fears below the 10-year yield.

That's when the equity returns have historically turned negative over the next six months.

If we see the real yield on the two-year plummet, that would be an indication the economy is weakening faster than what I hear our companies tell me.

That would suggest the $247 earnings for next year is too high, thus challenging the "earnings recovery thesis" next year.

**But that's not happening today.**

[8] Antti Petajisto, January 2013.
[9] Bloomberg.
[10] Bloomberg.

The yield curve has become even more inverted, given the rise in the two-year yield.

This tells me that an economic contraction caused by the Fed tightening is still a ways away and not imminent.

11. While the macro backdrop is clearly behaving very, very differently , 2023 reminds me of 2020:

    A. As the market started to rally in March 2020, investors sat back to wait for the "retest" of the low.
    B. Yet as the market continued to push higher throughout 2020, the likelihood of the "retest" proved less and less likely, thus forcing capitulation back into the equity market.

Sound familiar?

*Andrew*

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