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RICHARDSON Wealth

Market Ethos

The latest market insights from Richardson Wealth

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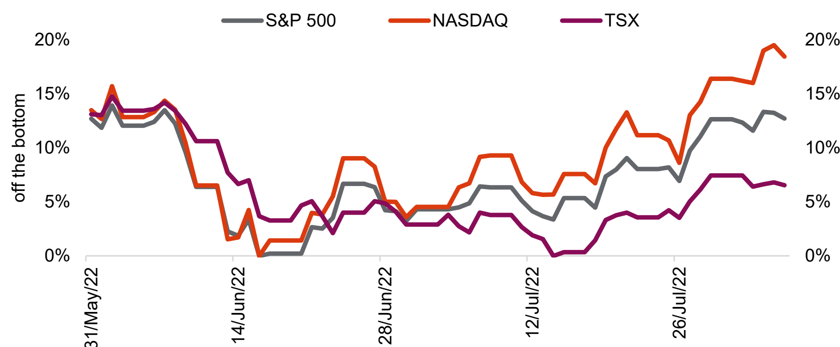
Why is the market so happy?

The tech tilted NASDAQ has risen +20% since mid-June. Still materially down on the year, but a 20% rise over seven weeks is both significant in the size of the advance and duration. Other markets, which were not down as much, have also risen nicely. S&P +14%, TSX +8%, Europe +11%, Japan +10%, Canadian bonds +5%, US bonds +4%, US high yield +5%, US long bonds +8%. This market recovery has given rise to many questions: is the bottom in, or is this a bear market rally? Or even more simply, why is the market so happy?

Still down big on the year, but that is a big bounce



Source: Bloomberg, Purpose Investments

Given the stream of negative headlines, one might wonder, what is behind recent market advances? US consumer prices surprised to the upside, so inflation isn't going down yet. Of the 25 major central banks, 19 raised rates in the past few weeks, including a 100 bps move by the Bank of Canada. The U.S. posted a second consecutive quarter of negative GDP growth, often coined (unofficially) as a recession. Add to this continued war in Ukraine, pending energy issues in Europe and material posturing around Taiwan. With such strong headwinds, why is the market so happy?

More important than slapping a narrative on this recent market advance is whether or not the factors helping this move are sustainable. We believe there are **four key drivers** providing a tailwind for this market. Two of these will prove fleeting while the other two could last but are very data dependent (aka it could go either way).

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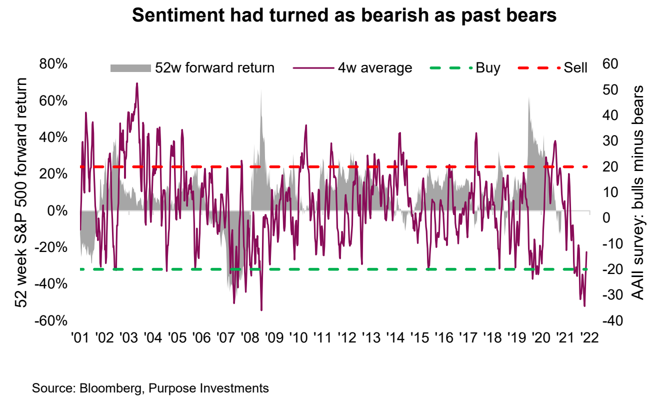
Sentiment

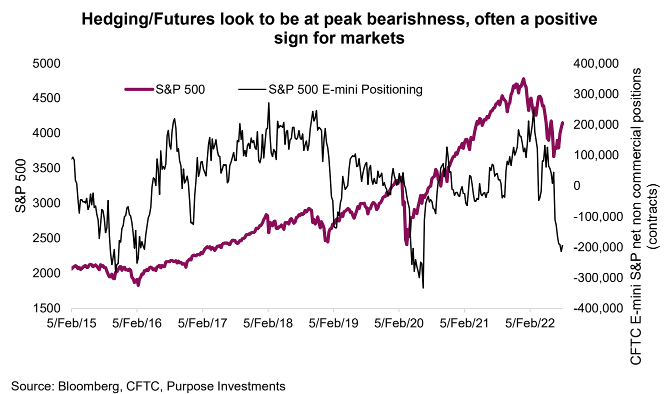
The one constant with markets as that they overreact in both directions. And when sentiment gets to bearish extremes, there is often a bounce on the horizon. No doubt the investor mood this year has deteriorated and June was no exception. The percentage of bearish respondents in the American Association of Individual Investors survey reached almost 60%, a level seldom seen except in the troughs of bears.

Even more impactful has likely been the quants, hedge funds or whoever you want to bucket in the 'fast money' category. The fact is, the number of bearish bets against the broader market has reached negative extremes last seen in market troughs. The second chart on the right is non-commercial or speculative futures and options positions on the S&P. The official data is delayed by a couple of weeks, but anecdotal data points to these negative bets being closed over the past few weeks. That puts upward buying pressure on the market, which certainly helps. As managers of a quant strategy, we are part of this mix having increased our equity weighting from 36% in mid-June, to over 50% by mid-July and now almost 70%.



Source: Bloomberg, Purpose Investments

The quants and fast money will not be able to make this a sustainable rally. For that, you need broader inflows which have remained muted over the past month. This could change as positive performance is a strong lure for many, but there's limited evidence for that at this point. This positive will likely prove fleeting.

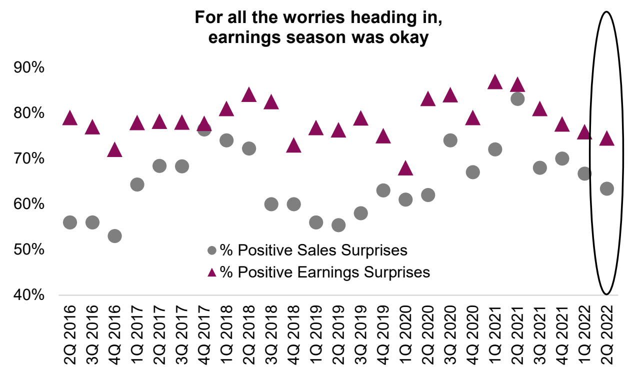


Source: Bloomberg, CFTC, Purpose Investments

Earnings

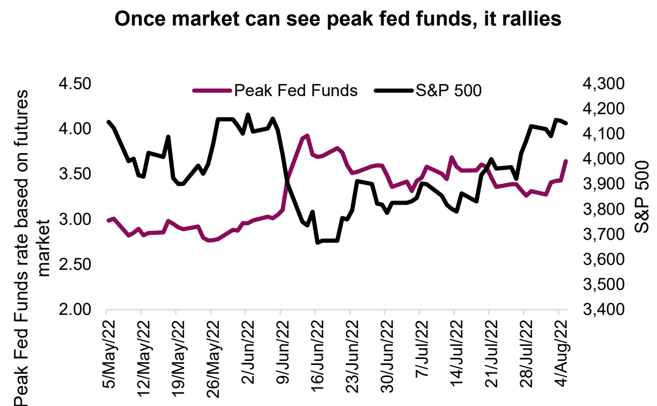
Everyone was down on this earnings season. Estimates remained elevated and had not really seen many downward revisions despite slowing economic growth, continued cost pressures, labour shortages, currency gyrations … This may have been the most common comment among strategists, that earnings estimates were still too high and had to come down. But once again, earnings season went well, and certainly didn't disappoint.

But don't get too excited. Firstly, this is very backward-looking as we're looking at Q2 which ran from April to June. And corporations, being optimistic about their future, will keep guidance as long as possible before disappointing the market. Make no mistake, the economy is slowing, costs are still elevated, earnings and margins are still at risk. This positive reaction to Q2 earnings season, will likely prove fleeting.



Inflation & Fed reaction

Much of the first half of 2022 was a story of inflation surprising to the upside and bond yields rising. This was followed by central banks reacting to the obvious and raising overnight interest rates. We continue to believe that once the market can see the light at the end of the tunnel for rate hikes, there will be a strong rally. As market concerns migrated from inflation to recession risk around mid-June, peak rate expectations moved sooner and lower. And markets rallied.



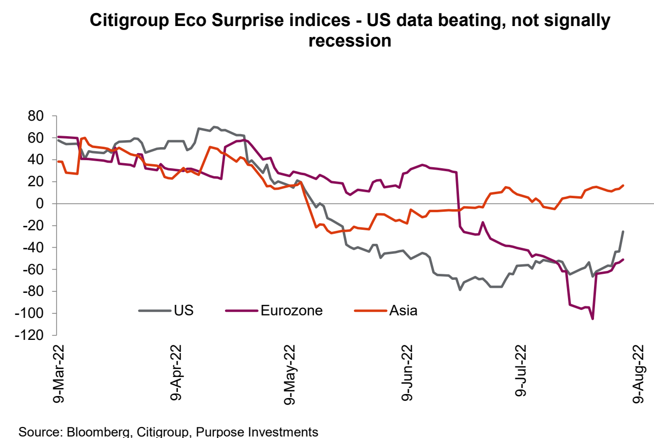
Source: Bloomberg, Purpose Investments

The recent strong payroll data has triggered a bit of an upward move in expected peak rates, and this may be slowing the current market advance. Our view is headline inflation will begin to fall soon and do not believe Fed Funds will reach the current levels priced in as the peak in early 2023. The economy is slowing and inflation pressures are softening.

Add this up and you could see a decent and sustained rally in the market. But this could change quickly based on the data if inflation remains even more stubborn. This is very data dependent.

Improving economic data

Slowing economic data and then a second consecutive quarter of negative US GDP, has caused recession talk to become very loud over the past couple months in the U.S., Canada and many pockets globally. The TSX, which is more sensitive to the global growth trends than the S&P, bottomed in July and started moving higher. The S&P is more sensitive to rate expectations given its longer duration growth characteristics, while the TSX is more of a global economic growth barometer.



Source: Bloomberg, Citigroup, Purpose Investments

While the recession chorus has grown louder, the good news is the economic data improved in July and into early August. Please note we are not claiming the recession risk is gone, more that we are painting a picture as to why markets continued to rally into August. This is a fine line: if the economic data improves too much, inflation persists for longer.

Recession talk has quieted a bit given the recent data. Not sure how long that will last, but it is a positive for now.

Investment Implications

Bear markets or periods of weakness end when they end. There isn't a siren or signal that marks that point in time, there isn't a magnitude of decline either. Months after the bottom, a narrative gains enough popularity that includes why it ended when it did. Bear markets end when the aggregate behaviour of investors (dollar weighted of course) changes. That could have been in mid-June but this does look and feel much more like a bear market rally, grabbing onto some improved news from a starting point that was very oversold.

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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*This report is authored by Craig Basinger, Chief Market Strategist, Purpose Investments Inc. Effective September 1, 2021, Craig Basinger has transitioned to Purpose Investments Inc.

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