



AUGUST 2024 INVESTMENT STRATEGY OUTLOOK

The Four Most Dangerous Words in Investing: It's Different This Time

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Investment Strategy Outlook Executive Summary – August 2024

1. Equity markets were not in a healthy balance coming into this correction. Equity market positioning and flows were both approaching aggressive extremes of historical ranges according to multiple gauges (*sources: BofA Research Michael Hartnett; St. Louis Federal Reserve; NIAAM & Strategas Research Partners*). Put/Call ratios were complacent as were put-call skews in options markets. AAI & II investor surveys remain bullish (contrarian bearish), although we are beginning to see signs of data moderating this week. In addition, there were three extremely crowded trades across capital markets before this recent correction, which could take more time to properly unwind:
 - Long US Tech stocks. They were the main drivers of index performance in 2023 & 1H 2024, to a historical degree. Flows into technology related ETFs became extremely aggressive on an absolute or a relative basis (*source: Strategas Research Partners*). Broadly speaking, large cap technology stocks became historically expensive by most traditional valuation metrics. Various Mag 7 stocks have moved by \$200B - \$300B in a single day (both up & down) over the last couple of months. Sometimes with no stock-specific news whatsoever. For perspective, there are only 36 companies in the S&P 500 with a market capitalization in excess of \$200B. The 2x leveraged Nvidia ETF is in the top decile of most actively traded (highest volume) equity ETF's (*source: Strategas Research Partners*).
 - Short Japanese Yen. Short positioning in the Japanese Yen was historically crowded for most of 2024. This had been a one-way trade (weaker Yen) for more than two years. This was a source of a lot of "leverage" in the markets. The Bank of Japan is beginning to tighten monetary policy while other central banks are at the beginning of an easing cycle. Two big questions are now in focus for investors with regard to the Yen carry trade. (i). Will the Bank of Japan back away from their incremental tightening given the bomb that went off across their capital markets on Monday? (ii) How much leverage still exists in this carry trade, that will need to be unwound if the Yen strengthens further in the weeks ahead?
 - Selling volatility. The first 6.5 months of 2024 were a very low volatility environment, and the VIX got as low as 11. The VIX briefly spiked as high as 65 on Monday 8/5. Since 1990, the VIX has only traded higher than 65 during 2008 / 2009 financial crisis & the COVID crash in 2020. The VIX has come back to 25 +/- since then, which is far more typical. But the VIX could stay elevated above 20, which would signal a more volatile environment for the next few months as markets reposition to a more reasonable balance during the seasonally weak period of the calendar heading into the election.
2. Potential economic weakness / Fed Policy Error.
 - In a matter of two weeks investors and economists have shifted their primary concern from elevated inflation to weak economic growth, specifically in the labor markets. When looking at a broad array of data points we believe it is premature to conclude that severe economic weakness is around the corner. The economy is undoubtedly slowing, but the Federal Reserve views this as a necessity in the last mile of their inflation battle.
 - A plethora of economists believe the Fed should aggressively pivot to remove their restrictive policy stance. A few weeks ago, the Federal Funds futures market was expecting 0.50% of rate cuts in 2024. Federal Funds futures were fluctuating between 1% - 1.25% of rate cuts in 2024 for most of this week.
3. This is still a bull market until proven otherwise.
 - Corrections are a normal & healthy feature of bull markets. Markets become distorted without corrections, per our comments in #1.
 - Uptrends are still intact across US equity indices.
 - But crowded trades don't unwind in a single week, and Chris Verrone of Strategas Research Partners has been noting that markets rarely bottom in August, given the traditionally weak seasonal stretch of September / October lies ahead.
 - Forward returns are above average after a spike in the VIX occurs.
 - Mid-cycle slowdowns happen more frequently than recessions. The equity market sell-offs in 2015 / 2016 & 2018 had a similar feeling to the current situation in some ways.
 - A return to a more "normal" market environment would be welcomed by most investors. 3% - 4% bond yields, upper single digit equity market returns, increasing breadth in equity market participation and more normalized level of volatility (VIX 15-20). Maybe this correction was the catalyst we needed for this bull market to become more sustainable?

Investment Strategy Outlook – August 2024

When studying the history of the stock market one will quickly realize that there is rarely a “normal” environment. Rather, each market cycle has its own unique characteristics and narratives which define it and are often more obvious in hindsight. High / low inflation, high / low interest rates, geopolitics, high / low economic growth, especially accommodative / restrictive Fed policy, high / low tax regimes, large / small budget deficits, strong / weak currencies, etc. are all critical factors which influence markets over short to intermediate time frames. Regardless, of these regimes, the S&P 500 has compounded at roughly 9% +/- per year on average over the last 100 years.

Sir John Templeton is famous for saying that “the four most dangerous words in investing are ‘it’s different this time.’” Nonetheless, the post-COVID environment seems unique both from an investment and economic perspective. Shutting down the economy, then dumping unfathomable amounts of fiscal and monetary stimulus into the economy and financial system, clearly produced unintended consequences, namely inflation and the “normalization” of very large debts / deficits.

Unprecedented economic circumstances likely helped to accelerate some shifts in capital market dynamics over the past few years. Markets seem to move more quickly than ever as an increasing number of investors are willing to make bets with their capital for reasons other than what would be found in the Buffett / Graham investing principles playbook. The most notorious example of this is how the reddit meme stock traders began to target relatively less liquid stocks with high levels of short interest.

Gabe Plotkin is one of the new owners of the Charlotte Hornets. But not long ago he ran one of the largest and most successful hedge funds on Wall Street, Melvin Capital. It is estimated that Melvin Capital lost roughly \$7 Billion on their short position in GameStop stock (the Meme stock traders' largest success). Melvin Capital was down roughly -39% in 2021 (a very good year for the stock market) and subsequently wound down its operations. This remains a truly an unfathomable event, even in hindsight.

Another unique feature of the current market is how some large equity indices have become more concentrated among the heaviest weightings relative to any other point in the last 60+ years. The “Magnificent 7” stocks have effectively become their own asset class, as those 7 stocks now make up more than 30% of the S&P 500’s market capitalization and account for more than 20% of the S&P 500’s earnings. Good, bad or indifferent, these 7 stocks march to their own beat, both from a performance perspective (often uncorrelated to what the rest of the market is doing) and from a fundamental perspective (they have figured out how to grow the earnings almost regardless of the strength of the economy).

Having said this, market dynamics of the “Mag 7” versus the rest of the market were becoming increasingly out of proportion at the end of the second quarter. We would even go as far to say that we were witnessing some occasional meme stock “like” behavior in some of the Mag 7 stocks, which could be observed by \$2T - \$3T market cap stocks moving 5% +/- in a single day, often on no real detectable news. Nvidia has been the poster child for the spectacular earnings growth driven by AI spending over the last year and a half. It has been nothing short of incredible to witness one of the largest stocks in the world grow earnings by 100%+ in a single year. At the same time, day to day market fluctuations of Nvidia’s stock have become increasingly bizarre throughout the recent months. Nvidia announced their Q1 earnings in mid May of this year, and it was a “hall of fame” earnings report, as all of their earnings announcements have been for the last five quarters. But the most amazing thing about the May earnings report was the ensuing performance of Nvidia’s stock in the weeks to come. Nvidia added over \$1T in market cap during the month following this report (from mid May to mid June). For perspective, there are only six companies in the world (Mag 7 ex Tesla) who have a market cap over \$1T. Notably, Berkshire Hathaway, the company that the “greatest investor of all time” has spent the last 60 years building, is not included in the list of businesses worth in excess of \$1T.

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The first half of 2024 was strong for global risk assets as many investors believed in the “goldilocks” narrative for the markets. US economic growth was strong, inflation continued to make progress lower, and there was an unquenchable thirst for “AI” related stocks, which seemed to go up every single day, regardless of the macro or micro news flow. The July CPI release was a day that all investors were eagerly awaiting, as it was believed that an inline / cool number would set the stage for the Fed to begin cutting rates at their September meeting.

The July CPI figure was everything investors wanted and then some, but the follow-on reaction from the stock market has been anything but. Risk appetites seemed to change that day as we saw the first of many crowded trades begin to unwind. For the three weeks following, US small cap equities were the best performing asset class, and their relative outperformance was jumpstarted on the day of the CPI release, when they outperformed the NASDAQ by 5.5% on that single day. The importance of recalling this day is because it was our first glance of a crowded trade beginning to unwind. It seems that being long “high quality” in the form of secular growth stocks (i.e. Mega cap tech), and short “low quality” in the form of small cap stocks was an extremely consensus trade among some institutional investors (i.e. hedge funds).

This rotation continued within markets until late last week when we experienced the seemingly toxic combination of the Fed holding rates steady at their July meeting while they “wait for more data” (Wednesday), weak manufacturing data and a spike in jobless claims (Thursday), and a payroll report well below expectations on Friday. This sparked a traditional “risk off” move where all stocks and commodities (excluding gold) were sold off in equal proportions, while safe haven assets (high quality bonds) were bought heavily as interest rates plummeted.

In a matter of days, narratives went from “goldilocks” to a Fed policy mistake and recession scare. Little did we know, last week was only the appetizer for what awaited global equity markets on Monday 8/5.

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US equity futures traded down sharply on Sunday night as the Asian markets opened for trading on Monday 8/5. Japan was the center of attention, as their local equity markets declined by 12% - 13% that single day, due to a massive carry trade unwind. Various strategists had been noting for several weeks that short yen positioning was historically extreme, but few investors would have imagined that we would witness such a violent unraveling of this trade in a single day.

Most central banks around the world began to raise interest rates in 2022 when they realized that inflation was becoming a serious issue for the global economy. However, after decades of deflation, the Bank of Japan kept their interest rates pinned around 0% in a continued effort to “reflate” their local economy. As central bank policies / interest rates began to diverge between Japan and the rest of the developed world, the Japanese Yen started to meaningfully depreciate against most other global currencies, including gold. This was the capital markets’ way of showing Japanese policy makers that there will be unintended consequences to massively suppressing interest rates. During this time, the Bank of Japan served as an endless buyer of Japanese Government bonds, in order to keep 10-year JGB yields below their stated 0.25% cap. Although the Bank of Japan was “successful” in controlling their interest rates, the consequence was that their currency was the release valve and was torched in the years to come. The Japanese Yen went from roughly 100 Yen / 1 USD in March of 2022 to around 160 Yen / 1 USD in July 2024.

Large institutional investors are global players and have the sophistication to access any capital market in the world. Despite the “price of money” rapidly increasing in most currencies over the last few years, investors can still borrow Yen for close to 0%, thanks to the Bank of Japan’s extremely easy interest rate policy. Human beings always follow incentives, and thus unsurprisingly, global investors have been borrowing money from the cheapest source of capital that exists (Japan). If “free money” were not enough, investors were further rewarded by this trade when they effectively “sold” the Yen that they borrowed, and in turn bought short term government bonds in another currency. This trade was beneficial to investors in two ways. First, there was an endless supply of high-quality government bonds around the world which offered a positive “carry” relative to the investors borrowing costs. Second, most currencies have been appreciating vs. the Yen for the last few years, and this only magnified the profitability of this carry trade. However, the ultimate payoff of the Yen carry trade came to investors who bought US tech stocks (or other risk assets instead of government bonds) over the last couple of years. Shorting the Yen (on margin) to purchase US tech stocks was likely one of the greatest carry trades of all time while it lasted.

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The fundamental catalyst for the unwind of this carry trade, is that the depreciation of the Japanese Yen finally reached a pain point for Japanese policy makers. Thus, the Bank of Japan began to pivot their policy stance in an effort to prioritize defending their currency. Although Japan is an export heavy economy (export economies typically like a slightly weaker currency), they import most of their energy sources (oil & natural gas) which are priced in US dollars. In other words, imports, most importantly energy sources, were becoming more expensive for the Japanese as their currency continued to depreciate. This likely became a point of legitimate pain, for Japanese citizens and businesses alike, as inflation was being imported from the rest of the world to them, serving as a tax on the economy.

Over the last couple of months, the Bank of Japan has directly intervened (buying Yen: selling US dollars) in currency markets in an attempt to stop the depreciation of their currency. On numerous occasions this was only effective for a couple of days at a time, until the prevailing trend of a weaker Yen resumed. But late last week, the Bank of Japan instituted a surprise interest rate hike (just as most other central banks are beginning to cut rates) and stated that “a weak currency is a reason to tighten monetary policy.”

This ignited a spark in global currency markets as the Yen began to rapidly appreciate against most other currencies. Monday August 5th was the day that the newfound Yen strength became an issue for global markets, and likely caused various investors (including Japanese citizens who were hedging against an endlessly weaker currency) to unwind a portion their carry trades consisting of short yen / long other assets (Japan stocks, US tech stocks, etc.). For highly levered players, this likely caused some forced selling / margin calls.

This is likely more than many of you wanted to know about the Yen carry trade, but it sets the stage for us to attempt to think about where we go from here.

As of Monday 8/5, the S&P 500 was down roughly -9% from its all-time highs from 7/16/24. Roughly 1/3 of this decline happened as US tech stocks sold off while virtually all other areas of the US equity market performed very well (but the S&P 500 is close to 50% technology related stocks now). Roughly 1/3 of this selloff occurred around the newfound growth scare / potential policy mistake by the Fed late last week. And the final 1/3 of this correction was very mechanical in nature, occurring in a single day, due to the unwinding of the Yen carry trade.

Thus far, we continue to view this as a healthy and overdue correction within the context of a bull market. Corporate earnings expectations for 2024 & 2025 remain firm, and as always, will be the most important factor for equity market returns in the months and years to come.

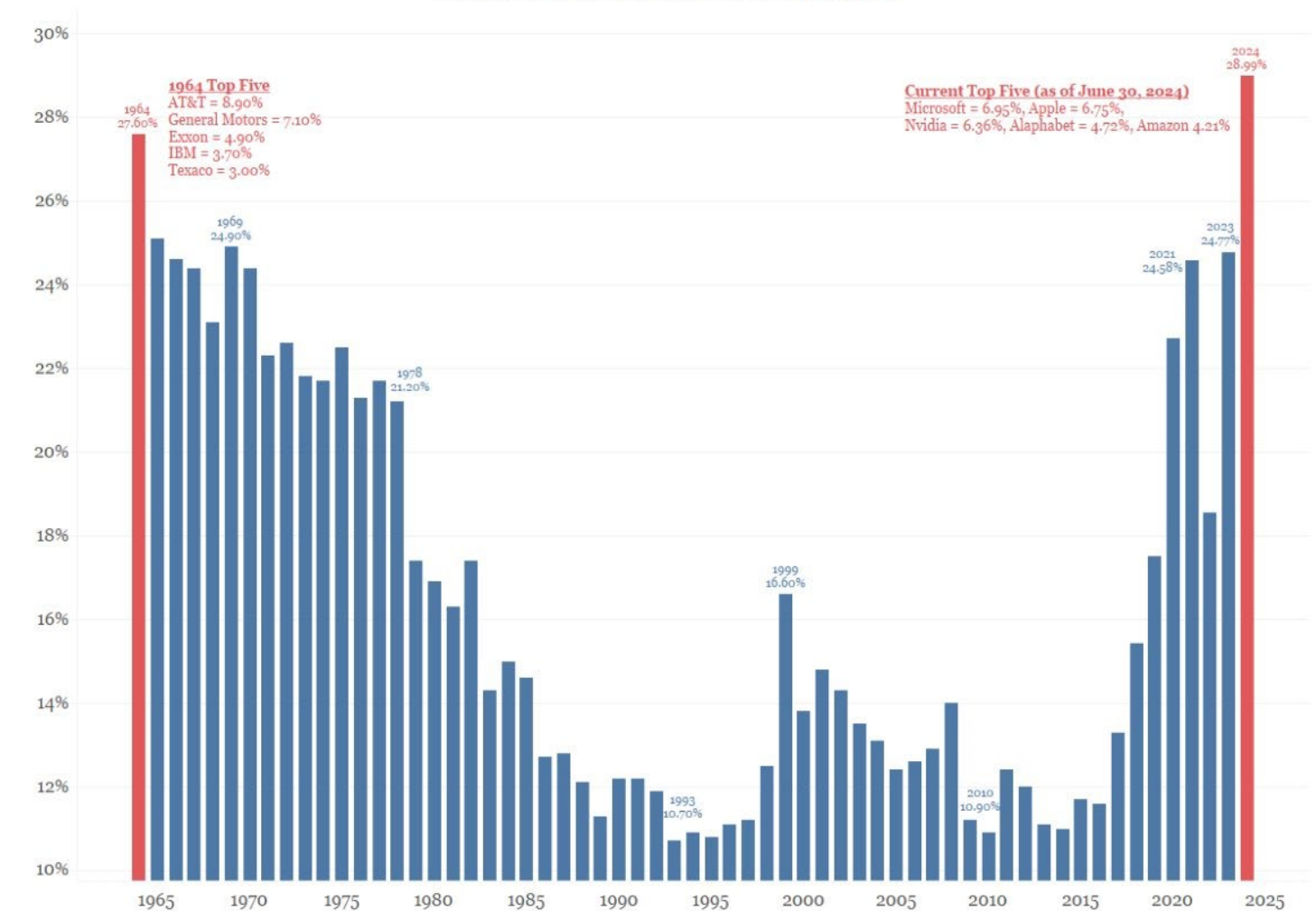
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The S&P 500 Index is More Concentrated Than Ever

Prior to the recent rotation out of mega cap tech names, the S&P 500 Index was more concentrated in the top 5 names than it has been at any other point in the last 60+ years. The top five names in the index (AAPL, MSFT, NVDA, GOOG & AMZN) accounted for approximately 29% of the market cap of the S&P 500.

This contrasts with the top five names accounting for less than 11% of the S&P 500's index weight at the secular lows in 1993 & 2010.

The Five Largest Stocks in the S&P 500



Source: S&P, Dow Jones, Bloomberg

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Source: @SmartReversals & Bianco Research

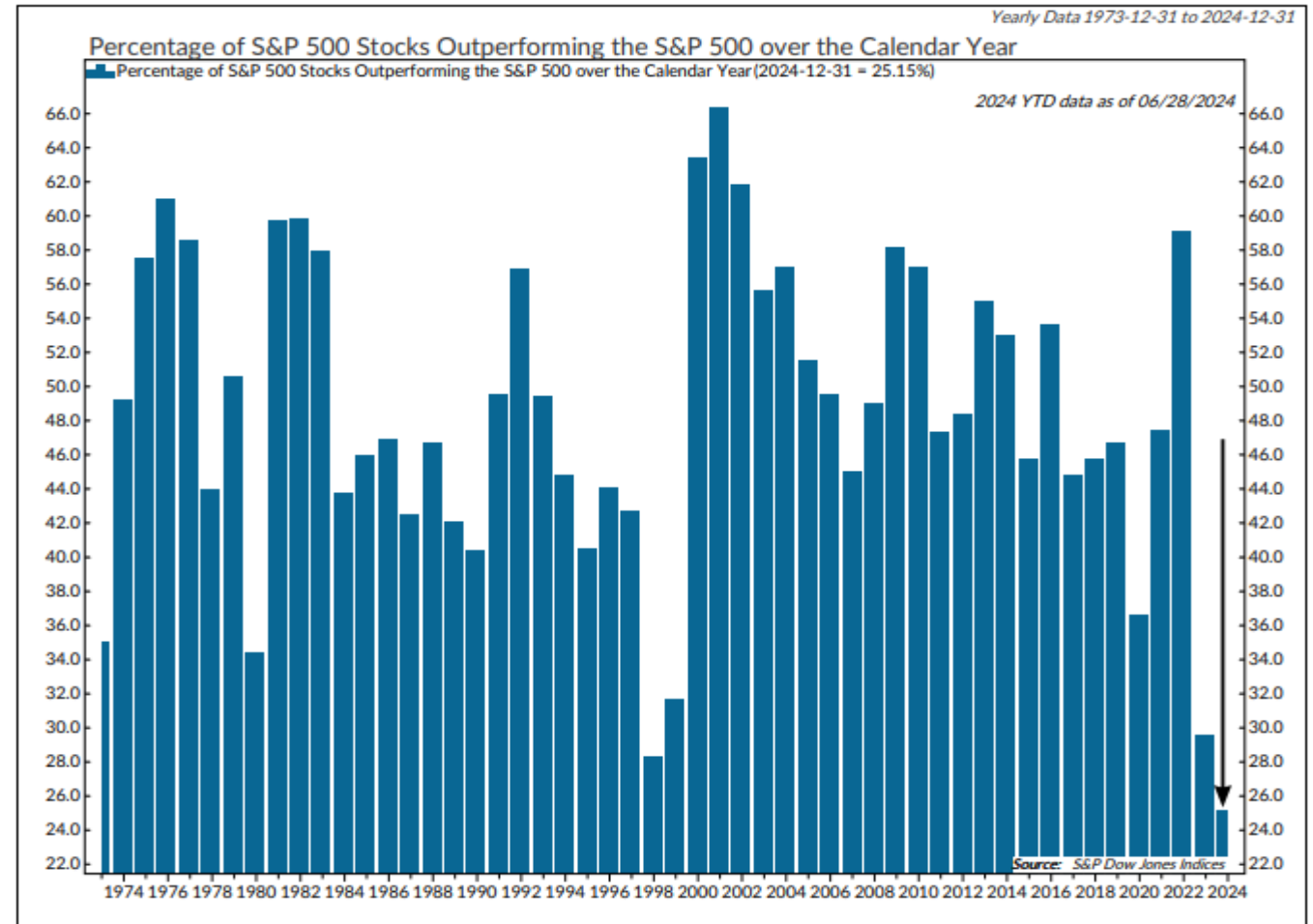
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Index Concentration Has Been Rewarding for Investors in 2023 & 2024

Excluding the last month, the historically high index concentration among the top five (29%+/-) and top ten (39% +/-) names has been an incredibly friendly dynamic to investors for the last year and half.

The S&P 500 has produced very strong returns in 2023 & 2024 despite a historically low percentage of stocks achieving returns above the index returns.

On pace for record low % of stocks beating S&P 500



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Source: NDR Research & @edclissold

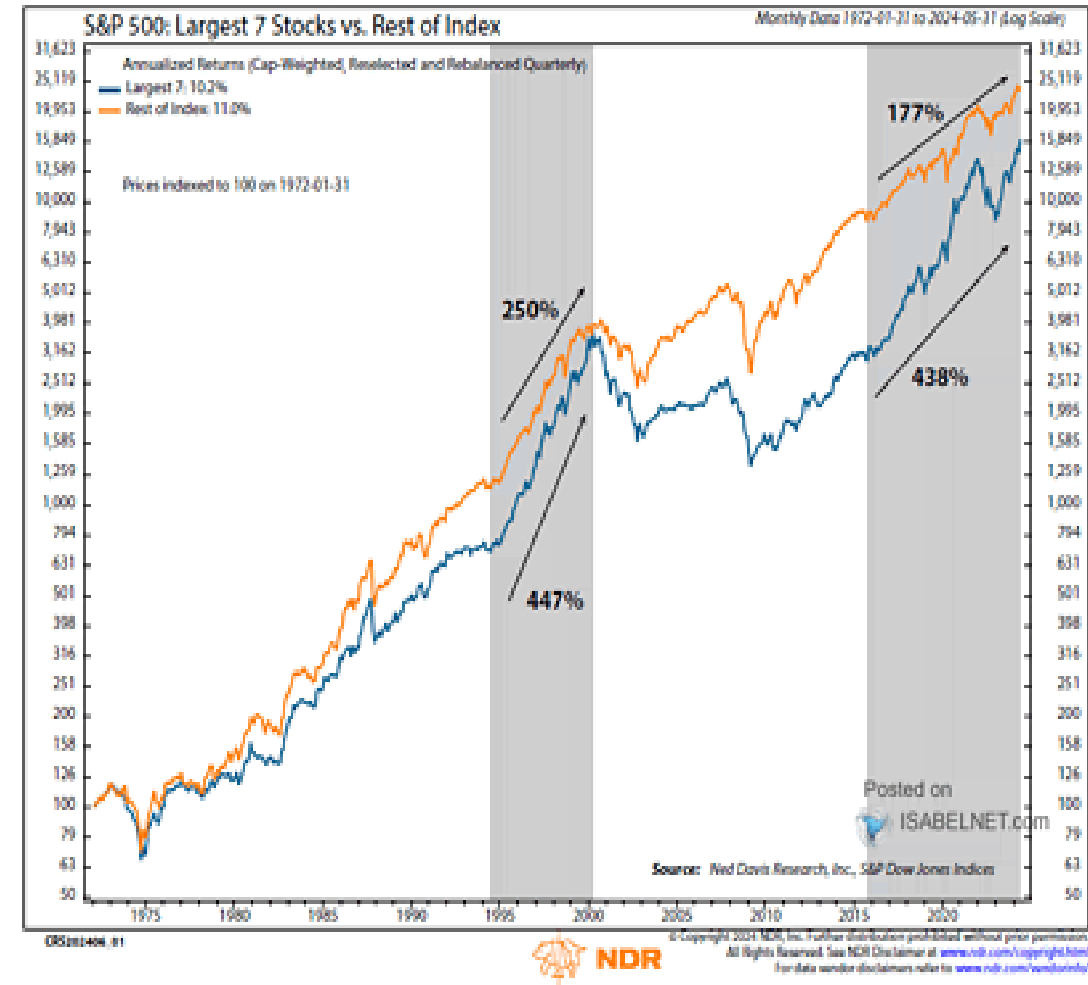
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Largest 7 Stocks vs. the Rest of the Index

There have been two distinct time frames where the largest stocks have sustainably outperformed the rest of the index. These instances occurred in the late 1990's and 2017 – 2024.

As a group, the bottom 493 stocks in the S&P 500 have tended to outperform the top 7 names in the S&P 500 during other time frames over the last 50 years.

The Largest 7 outperformed over two historical periods



Source: NDR Research & @edclissold

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Technology Stocks are Much More Expensive Today Than They Were 10-15 Years Ago When This Phenomenal Run Began

A plethora of market prognosticators have mentioned how the Mag 7 stocks seem to have both offensive and defensive characteristics to them.

On one hand, investors are betting that they will be some of the primary beneficiaries from the AI industrial revolution of which we are likely in the early stages.

At the same time, these stocks also have fortress balance sheets (ex TSLA) and have also been the best secular growth stories in the market for ten years and running, regardless of the strength of the economy.

It is difficult to debate the above facts. The biggest question investors must grapple with right now, is “how much good news” is already priced into these stocks?

In mid-July, the Technology sector was trading at its highest PE ratio on record, outside of the tech bubble. These valuations will not be sustainable if profit margins begin to compress for technology stocks.



Source: Charles Schwab, @KevRGordon & Bloomberg

Stock Market Concentration Will Likely Be Susceptible to Gravity, Eventually

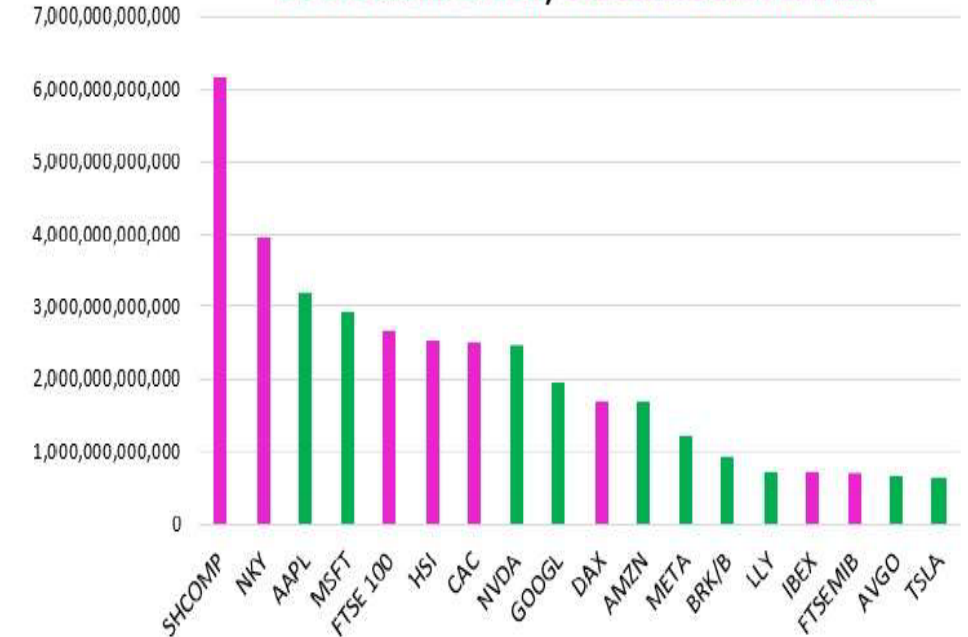
In their quarterly letter at the end of June, Akre Capital offered some fascinating perspective regarding part of the reason as to why it becomes difficult for the largest companies to continue to outperform indefinitely.

“The S&P 500 currently boasts three companies with market capitalizations of \$3 trillion or more: Apple (\$3.3T), MSFT (\$3.4T) and NVDA (\$3.1T). The monetary value of all “final” goods and services produced by the United States – a.k.a. Gross Domestic Product or “GDP” – was \$27.4 trillion in 2023. In other words, these \$3 trillion+ market cap companies are currently valued at approximately 12% of GDP – each.

Assume that investors in these three companies expect their market capitalizations to compound at 15% annually over the next decade. Assume US GDP growth of 3% annually over the same period. Satisfying these conditions would require the respective market capitalizations of Apple, Microsoft, and Nvidia to grow from nearly 12% of GDP today to nearly 36% of GDP by 2034. Combined, the value of these three businesses would then equate to 107% of US GDP.

The sheer size of these numbers suggests to us that this outcome is unlikely. The value of any group of businesses bears some relationship to the size of the economy in which they operate. For publicly traded businesses, that relationship is called the ‘Buffett Indicator.’”

Market Capitalizations - US\$
US Stocks in Green; Global Indexes in Pink



Source: Akre Capital & 22V Research

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US Economy

Multiple “flawless” recession indicators have triggered over the past few years, including inverted yield curves, negative US Leading Economic Indicators, Manufacturing gages in negative territory, etc.

These indicators caused many investors to believe the 2022 bear market was a precursor to an inevitable recession. This of course did not occur, and if / when a recession happens, it will be accompanied by its own, separate bear market. Thus, the 2022 bear market was an inflation scare, where an ensuing recession did not immediately happen.

Somewhat ironically, US Real GDP has been strong, and has grown at (2%) trend growth or above for the last 6 quarters.

Having said this, we are now at a point where economic growth is clearly slowing; the question is how much and how fast?

Strategas Research Partners Don Rissmiller 8/4/24

Bottom line: There’s a case the Fed should have already cut rates, but we don’t want to jump to the panic of a recession/crisis. It’s early, but the Atlanta Fed’s tracking estimate for U.S. real GDP in 3Q is running at an acceptable +2.5% q/q A.R. Productivity (which was a solid +2.3% q/q A.R. in 2Q) has been helping support growth.

We believe the Fed is set to follow what other central banks are doing (eg, the Bank of England last week) and move toward a more neutral monetary policy. In anticipation, relief for interest rate sensitive sectors like housing & mfg is already starting given the rally in the bond market (the 10-year Treasury finished last week at 3.8%). Notably, U.S. pending home sales rose +4.8% m/m in July. Such rate relief & pent-up home sales should help keep the small cracks in the economy from turning into big cracks now.

22V Research Dennis DeBusschere 8/4/24

We think the economic data will stabilize, and recession risk remains low – less low than last week, but still low. But, it won’t pay to try and monetize that view by leaning into Cyclical economic sectors and shorting Defensive and Low Vol for at least a few more weeks. In the meantime, expect a violently flat market backdrop as the sharp de-grossing/short-term oversold condition is met with continued fears of a possible recession. The Fed is going to aggressively ease and be pro-growth going forward the question is if you believe that easing will have a positive impact on economic growth longer term. We think it will. If a negative feedback loop has already started, being long Defensives makes sense. We are fading that view.

Goldman Sachs 8/4/24

The chances of a U.S. recession in the next 12 months have risen from 15% to 25%, a team of Goldman economists led by Jan Hatzius said on Sunday, flagging a July employment report that looked “weak across the board.”

Apollo Torsten Slok 8/4/24

There are no signs of a slowdown in restaurant bookings, TSA air travel data, tax withholdings, retail sales, hotel demand, bank lending, Broadway show attendance, and weekly box office grosses. Combined with GDP in the second quarter coming in at 2.8%, the bottom line is that the current state of the economy can be described as slowing, but still a soft landing.

KKR Henry McVey 8/6/24

This ‘bump’ is not the end of the cycle, and it reminds us when we stick to our Rolling Recovery, Rolling Recession thesis versus the traditional synchronized global recovery. From a portfolio construction perspective, we continue to remain overweight diversification, including an emphasis on non –correlated assets. Overall, though, our view is that this shock will take some time for investors to re-assume a risk on posture. Therein lies the opportunity for patient capital.

Source: Strategas Research Partners, 22V Research, Goldman Sachs, Apollo & KKR

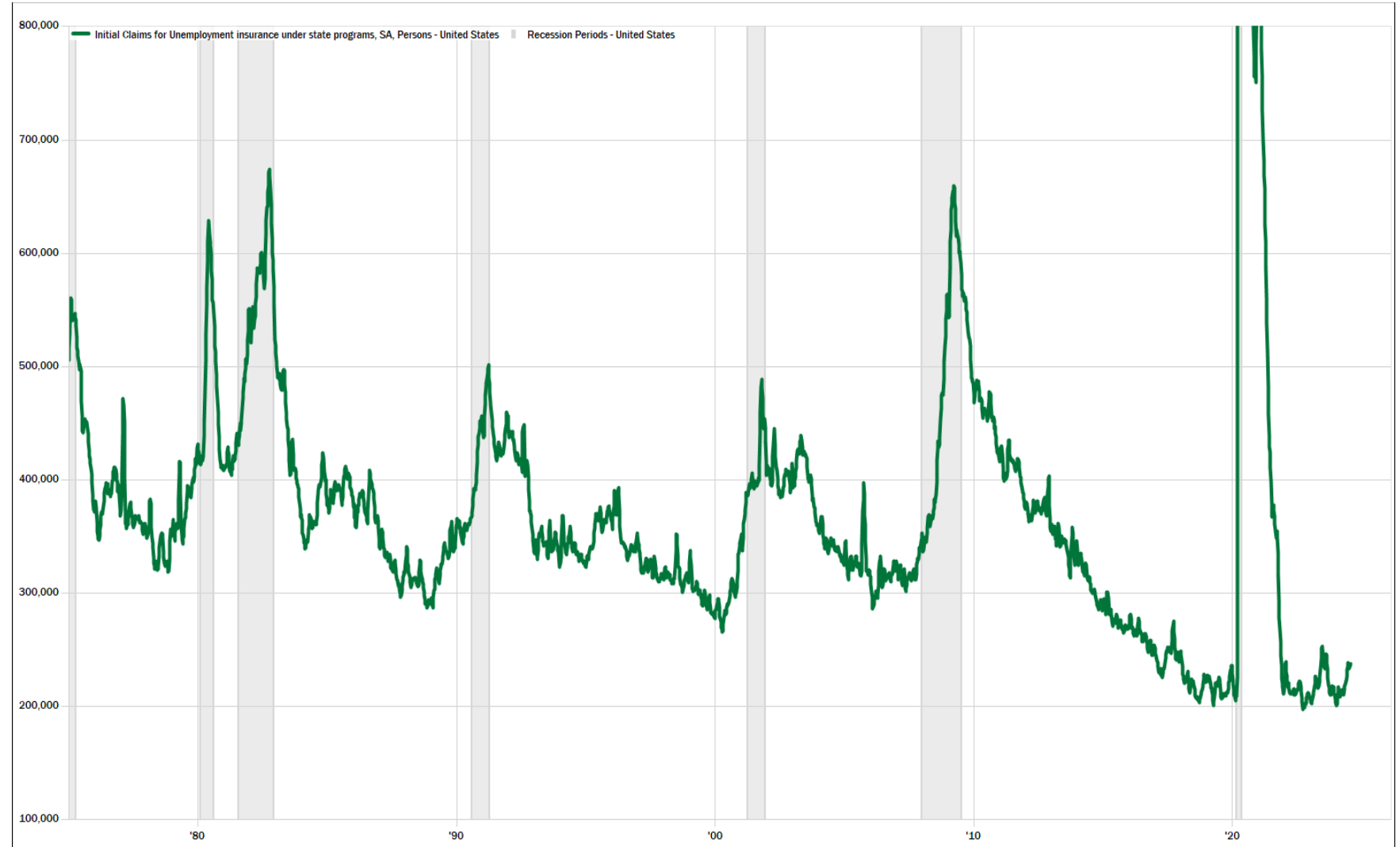
Initial Jobless Claims

After a couple of years of obsessing over every piece of inflation data possible, the market will no longer be as sensitive to this data (barring any large upside surprises).

Economic growth is now the primary concern for market participants. The good news is that the Fed is likely to aggressively pivot and become more sensitive to their “full employment” mandate, now that their “price stability” goals have largely been accomplished.

The strong labor market has been the primary reason that the US economy avoided recession over the past few years.

Weekly initial jobless claims are now the single most important high frequency economic data point. Last week’s reading of 250,000 remains low by historical standards. But this data tends to trend and the 260,000 – 300,000 area will be interpreted as a warning sign for the economy.



Source: MBL Advisors & FactSet

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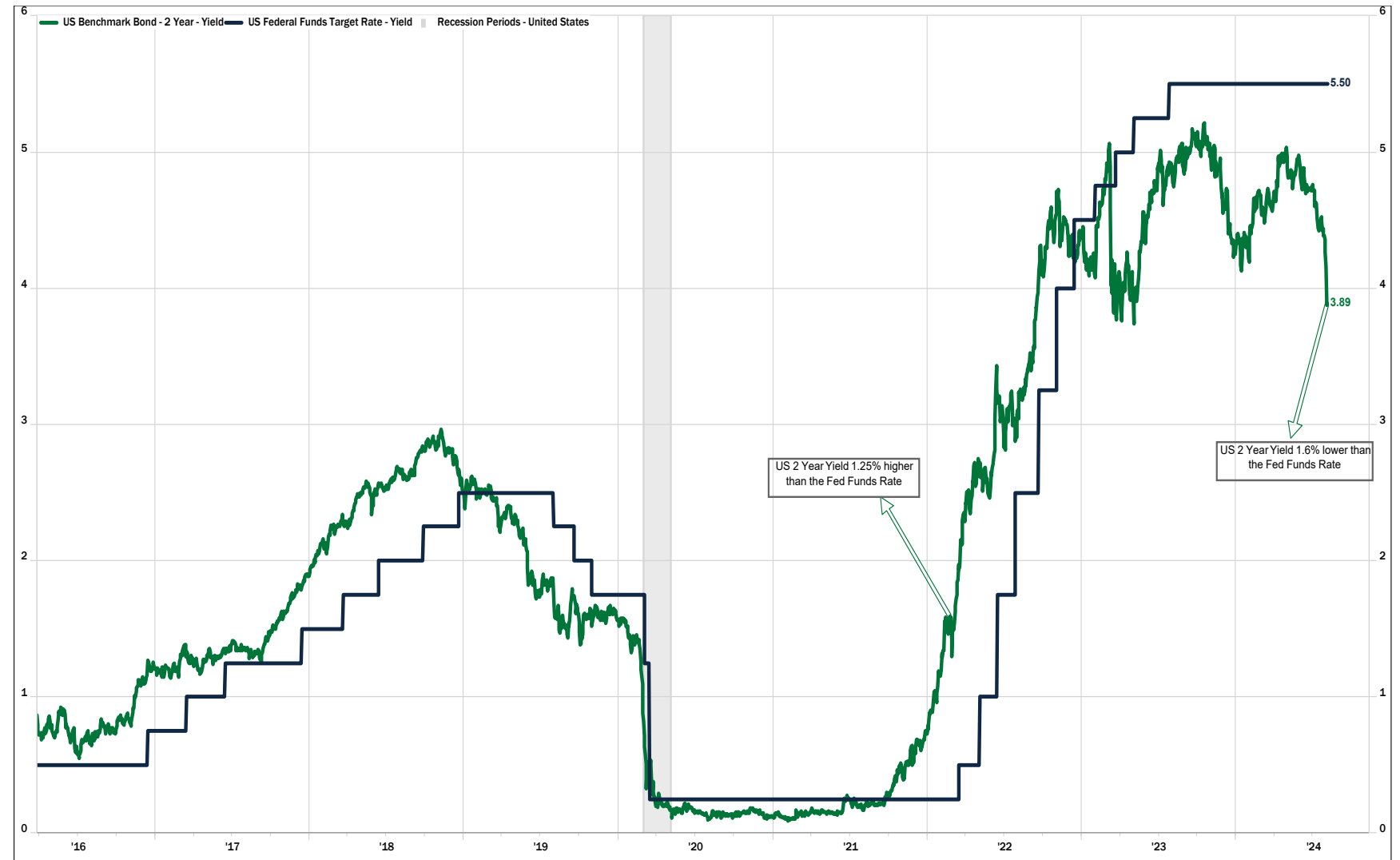
US 2 Year Yields (green) vs. Federal Funds Rate (blue)

Capital Markets often have a faster and more accurate interpretation of the current investment environment than investors / strategists / economists.

In this regard, the bond market is once again screaming at the Fed that they are behind the curve. This is the precise situation that occurred in the fall of 2021 when 2-year US Treasury yields started to accelerate to the upside while the Fed held rates steady at 0% and continued to conduct QE. The bond market was telling the Fed that they had a major issue with inflation, while the Fed stuck to their “transitory” thesis.

The only difference today is that yields are moving lower instead of higher, but we are back to a point where the spread between 2-year US Treasury yields, and the Fed Funds rate is historically wide.

The bond market’s message to the Fed is that they are once again behind the curve, as their policy rate is far too restrictive given the slowing growth dynamics in the economy.



Source: MBL Advisors & FactSet

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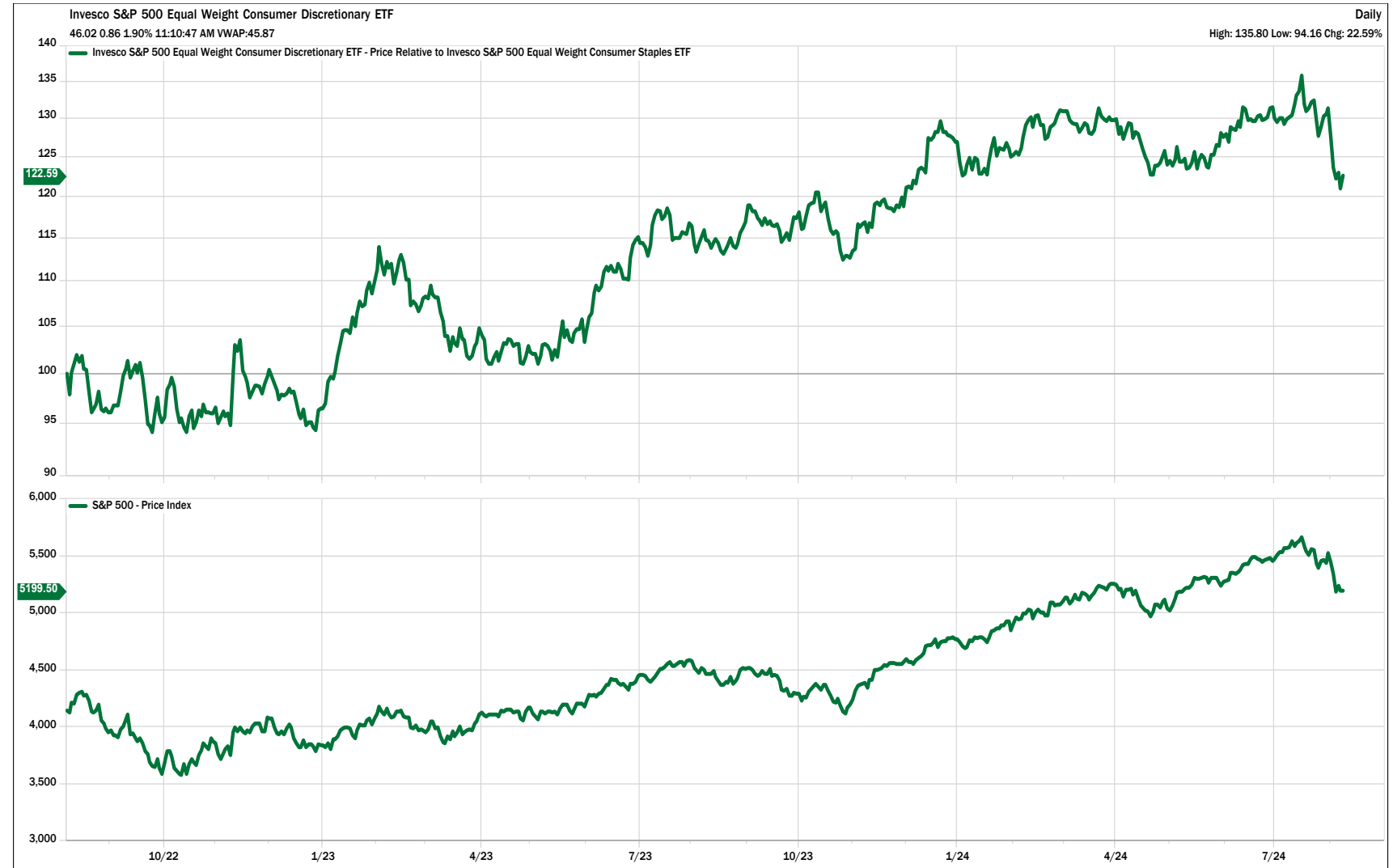
Equal Weight Consumer Discretionary Relative to Equal Weight Consumer Staples (top): S&P 500 Index (bottom)

The stock market's "opinion" of the economy is certainly less optimistic than it was a couple of months ago. One of the more troubling aspects of this correction is the reality that consumer discretionary stocks are breaking down relative to the consumer staples sector, along with the broad market. This is a notable tone change relative to the last year and a half.

In addition, credit spreads have begun to moderately widen, albeit from very tight levels.

Finally, most commodities outside of gold are not acting well, possibly signifying lower economic growth and inflation expectations.

These risk barometers will be important to watch in the months to come. Even in an optimistic scenario, they could be signaling that we are in more of a "late cycle" environment moving forward.



Source: MBL Advisors & FactSet

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“Run of the Mill” Correction, So Far

US equity markets were statistically overbought and expensive with sentiment and positioning extremely bullish before this correction started. In this regard, the recent selloff is extremely healthy thus far.

Savita Subramanian noted several important statistics in her note titled "Hello Volatility" on 8/5/24.

- Since 1930, there have been 98 10%+ corrections, but the S&P has still managed to return nearly 25,000%.
- 5%+ pullbacks occur more than 3x times a year on average.
- 10%+ pullbacks occur 1x per year on average.
- 15%+ corrections occur every other year on average.
- 20%+ bear markets occur every 3-4 years on average.

Distribution of S&P 500 Max Intra-Year Drawdown (Since 1945)						
	2024					
	2021					
	2019	A 5% to 10% max drawdown occurs				
	2014	in 35% of years.				
	2013					
	2012					
	2006					
	2005					
	2004		2023			
	1996		2016			
	1994		2015			
	1992		2007			
	1991		2003			
	1989		1999			
	1988		1997			
	1986		1984			
	1985		1979			
	1983	1978		2018		2022
	1976	1975		2011		2020
	1972	1971		2010		2009
	1968	1960		2000		2008
2017	1967	1956		1998		2002
1995	1965	1955		1990		2001
1993	1963	1953		1982		1987
1964	1959	1950		1981		1974
1961	1952	1949		1980	1973	1970
1958	1951	1948		1977	1966	1962
1954	1945	1947		1969	1957	1946
	0% to 5%	5% to 10%	10% to 15%	15% to 20%	20% to 25%	> 25%
# of Observations	7	28	20	11	3	11
% of Observations	8.8%	35.0%	25.0%	13.8%	3.8%	13.8%

Source: Strategas, Bloomberg, 8/5/24

Source: BofA Global Research & Strategas Research Partners

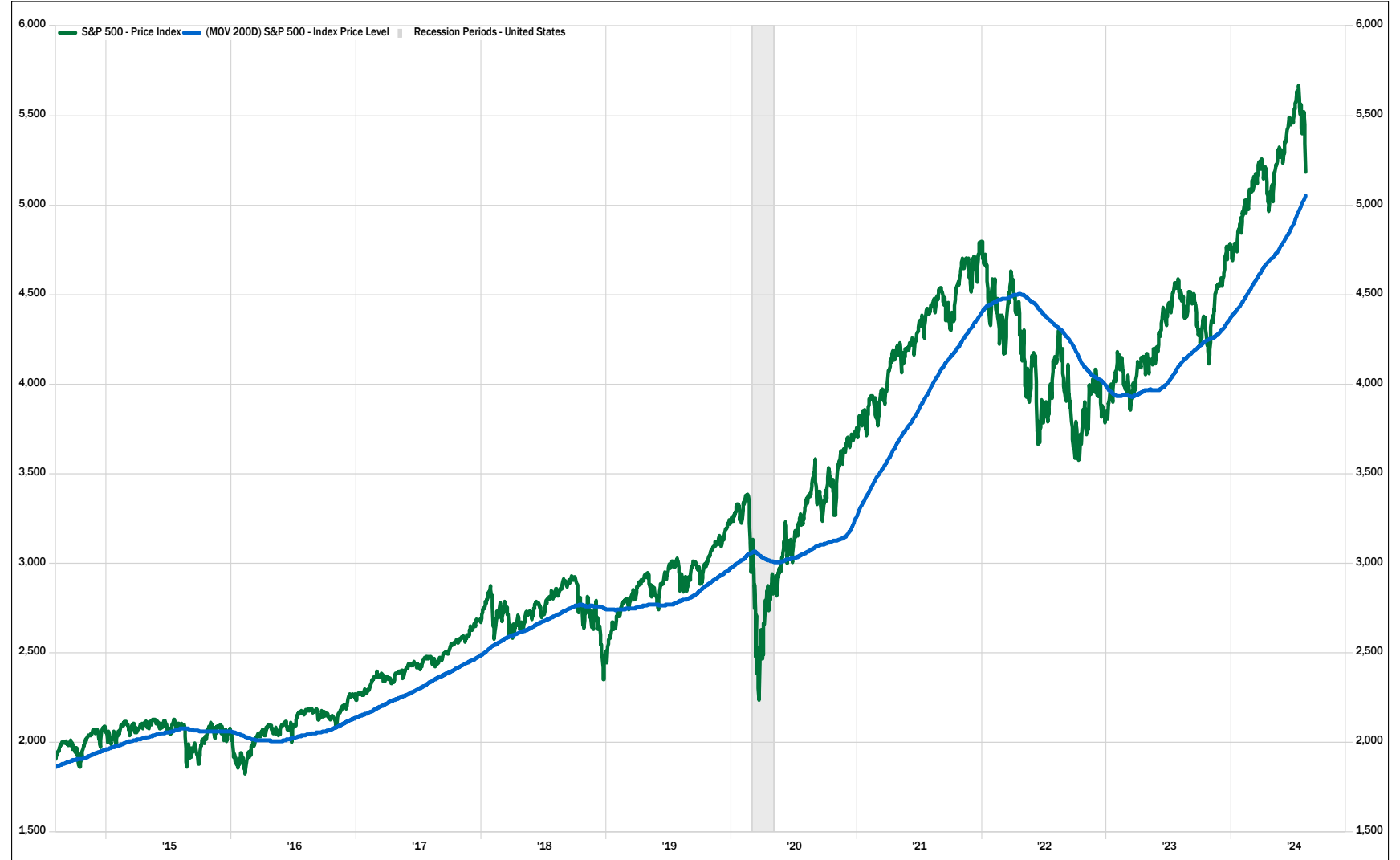
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S&P 500 Index & 200 Day Moving Average

The S&P 500 remains above its upward sloping 200 day moving average, although an eventual test of this moving average will be inevitable at some point.

When the S&P 500 (or any security / index) trades below its 200-day moving average, this does not necessarily mean a bear market will occur. But the bulk of the declines during major bear markets (outside of true black swan events like COVID) occur when an asset is trading below its downward sloping 200 day moving average.

Fighting against prevailing trends is usually not a rewarding strategy for longer term investors.



Source: MBL Advisors & FactSet

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Buying Equities After a Large Spike in the VIX Tends to Produce Above Average 6 Month Returns

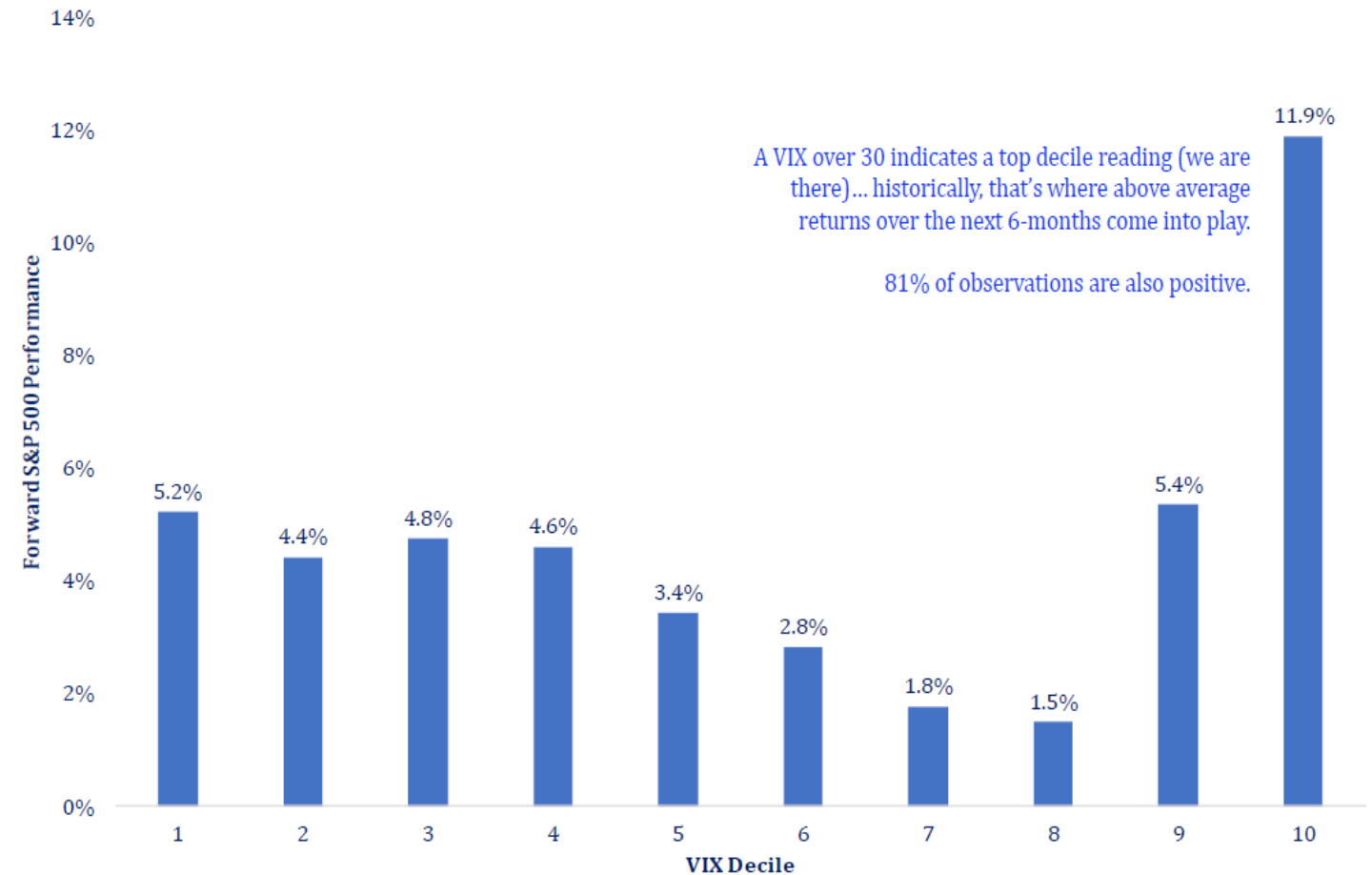
The VIX briefly spiked to 65 on Monday morning, a level that has rarely been registered over the last 35 years. Forward Returns tend to be strong following a spike in volatility, measured by the VIX. On average, 6-month forward returns are +11.9% and are positive 81% of observations. The VIX curve is also inverted which tends to be another good contrarian buy signal.

Conversely, most other oversold indicators have not yet triggered. Two opposing things are often true at the same time in this business. 6-month forward returns could be solid from these levels, despite this correction possibly needing more time to run its course, according to a plethora of other indicators. We will have more conviction that we are closer to a bottom when we begin to see a higher percentage of indicators trigger. Some of these indicators include the following:

- AAI Bull vs. Bears & II Bull vs. Bears (investor sentiment remains bullish)
- Put / Call ratios spiking further (these are getting close)
- Less than 20% of stocks above their 50-day moving average (currently 44%)
- NIAAIM Exposure Index below 30 (currently 84)
- NASDAQ / SPX futures positioning turn bearish (currently neutral)
- A test of the 200-day moving average coincides with more reasonable valuation support for the S&P 500

Forward 6-Month S&P 500 Performance by VIX Decile

Data Since 1990



Source: Strategas, Bloomberg, 8/5/24

Source: Strategas Research Partners

Investment Strategy Outlook – August 2024

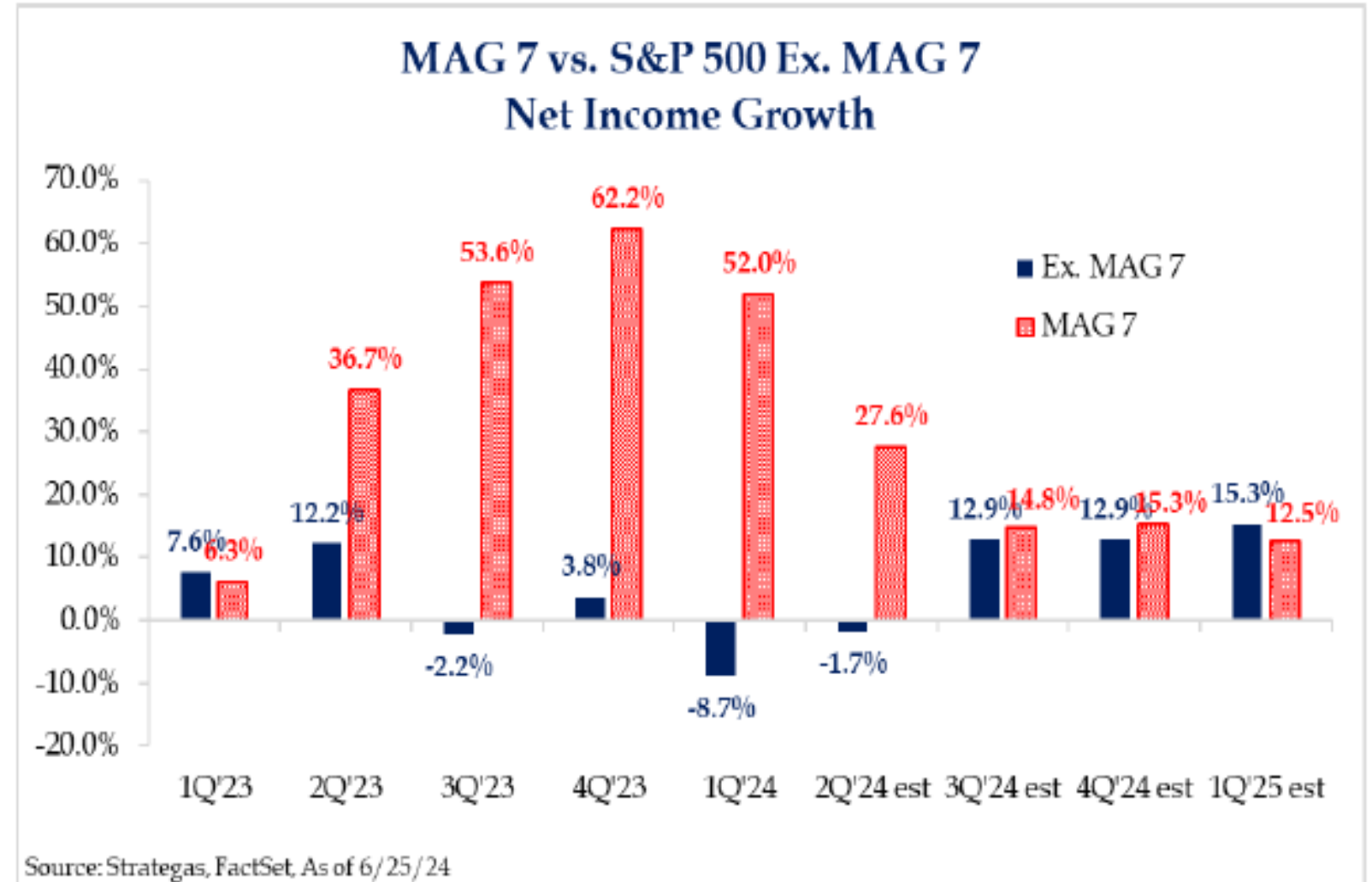
Market Participation Will Broaden if Earnings Come Through

S&P 500 Year-over-Year earnings growth is around +11% as we approach the end of Q2 earnings season. This is clearly very respectable, and earnings growth estimates for the next several quarters remain firm.

This is in stark contrast to the last year when Mag 7 companies were the only businesses who were able to grow earnings, and did so at an unbelievable clip, largely thanks to AI.

A broadening out of earnings growth beyond Mega cap tech would be an extremely welcomed event for most investors.

Nvidia earnings announcements have become of the most important data points for the entire market each quarter. They report Q2 earnings after the market close on 8/28.



Source: Strategas Research Partners

Investment Strategy Outlook – August 2024

In summary, we are in the throes of what could be a very typical 10% - 15% correction associated with a mid-cycle slowdown. According to JP Morgan, the average peak-to-trough correction since 1980 is roughly -14% (and this is skewed to the downside by some big down years such as 2008). Media outlets will explain this correction with various narratives such as a growth scare, a Fed policy mistake, the carry trade unwind, etc.

All of these story lines have plenty of truth to them, but we simply believe that this market was long overdue for something more than a 4% - 5% correction, in order to flush out some of the excesses which had been building up for months. Resetting sentiment (not there yet), positioning (not there yet) and valuations (not there yet) should ultimately be healthy for extending the durability of this bull market. If we can get through this seasonally weak period for markets without too much further technical damage being done to the tape, a traditionally stronger seasonal period may await us after the election.

Both in markets and in “life” more broadly, we seem to have normalized the traditionally abnormal in countless ways over the last several years. Some of the “abnormal” things which we have “normalized” include the following:

- Multiple tried and true recession indicators gave false signals in 2022 / 2023. This eventually led investors to become somewhat insensitive to bad economic data, so long as it was accompanied by lower inflation expectations.
- Massive amounts of fiscal and monetary stimulus have become a default stance for our policy makers. We are running budget deficits at sizes never seen outside of wartime, even though the unemployment rate spent most of the last couple of years around multidecade lows. Even when the Fed was tightening monetary policy during their rate hiking cycle, they began to inject liquidity back into the financial system through less conventional methods as a response to the regional banking crisis in the spring of 2023. Financial conditions are looser today than they were when the Fed began to hike interest rates in March 2022 (truly unfathomable). Both equity market valuations and inflation are at levels that most of us would have never dreamt of prior to COVID.
- The asset management industry has done its best to solidify crypto currencies as a multi billion-dollar asset class, despite being on very few people's radar prior to 2021.
- High frequency trading has become a dominant factor in daily trading volumes, and a non-insignificant number of “investors” speculate with 0 dated options (option contracts that only exist for 1 day).
- “Work from home” has become normalized as center city office space continues to empty out across America.
- And we won’t even get started on the characters in Washington D.C. who assure us that they act “in our best interest!”

Investment Strategy Outlook – August 2024

It might take a very long time for the situation in Washington D.C. to resemble normalcy. But it seems as though we are on the right path in the economy. Interest rates should settle out at more “normal” levels, which we haven’t seen since prior to 2008. Inflation will likely maintain a level in excess of the Fed’s stated 2% target, but this comes after a more than a decade of consistently undershooting that target due to deflationary pressures which persisted from the financial crisis. An economy that grows around 2% in real terms and 5% in nominal terms should be a solid environment for corporate profits. This correction could be a catalyst that returns capital markets back to a more well-balanced state of being. This would include interest rates that settle out in the 3% - 4% range, inflation in the 2% - 3% range, equity markets which produce 8% - 10% annualized returns on average, and have more broad participation beyond Mega cap tech stocks, equity market PE multiples become more palatable at something less than 20x forward earnings, winners and losers are driven by fundamentals rather than strictly if a business “has” AI or “not.” To be clear, we would not bet against the Mega Cap Tech stocks, and they consist of meaningful positions in our portfolios. Rather, we simply believe it would be emblematic of a healthy market for there to be more than one game in town.

There will undoubtedly be endless surprises that come our way, as is always the case with investing. Diversification is “admitting” that we don’t “have” all the “answers” and therefore, need to be prepared for a wide range of outcomes. We look forward to discussing this with you in more detail over the days and weeks ahead.

Sincerely,



Brian Gift, CFA

Bob Farrell's 10 Investing Rules

Bob Farrell is a legendary Merrill Lynch strategist who published his timeless list of 10 investing rules several decades ago, a version of which can be found here: <https://www.investopedia.com/articles/fundamental-analysis/09/market-investor-axioms.asp>.

We have written about Bob Farrell's rules on multiple occasions in the past. Nonetheless, the simple brilliance of these rules always amazes us each time we observe them. They seem to be especially useful in this current environment!

- **Rule #1. Markets tend to return to the mean over time.**
- **Rule #2. Excesses in one direction will lead to opposite excesses in the other direction.**
- **Rule #3. There are not new eras – excesses are never permanent.**
- **Rule #4. Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways.**
- **Rule #5. The public buys the most at the top and the least at the bottom.**
- **Rule #6. Fear and greed are stronger than long-term resolve.**
- **Rule #7. Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names.**
- **Rule #8. Bear markets have three stages – sharp down, reflexive rebound and a drawn out fundamental downtrend.**
- **Rule #9. When all of the experts and forecasts agree – something else is going to happen.**
- **Rule #10. Bull markets are more fun than bear markets.**

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