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What's Next for Stocks and Bonds?

April 1, 2024

For two years now almost everyone has been predicting the next recession, all the while predicting that the Fed will cuts rates to prevent one from happening. Markets started 2023 expecting the Fed to start a string of six cuts in March 2023. Now consensus is starting to form around "no recession" and maybe as few as one cut in 2023. The economy remains strong. Q1 turned out to be one of the best quarters for stock prices in years. The stock market is now officially "overbought". Naturally that brings fears of a sell off to the forefront. JP Morgan's chief market strategist is one of the most vocal about that possibility. This morning, April 1, 2023, Mike Santoli of CNBC offered a coherent assessment of the markets. No fear, just facts. It's worth a read. Here it is, unedited.

The tenacious tape

"The behavior of the market itself is perhaps the strongest selling point for a bullish outlook from here.

The way the market has acted (resolutely strong, no notable pullbacks, constant rotation, broadening participation) and why (a firmer economy, earnings upturn, Federal Reserve looking to ease, bond yields in an unthreatening range) are tough to assail. The key negatives are generally factors that remain latent and often unhelpful for long stretches in a bull market (elevated valuation and widespread investor optimism).

There are historical studies flying fast around Wall Street detailing what tends to come next after strong and persistent rallies similar to what we've seen year to date and since the late-October market low.

After the S&P has returned 10% or more in a first quarter? Truist Wealth counts 11 prior instances since 1950. The index continued higher the following quarter nine of those 11 and was up the remainder of the year all but once. That once was 1987, one of the most extreme reversal years in history, which started with a blistering 21% return in its first three months.

The index is also now up five straight months for the 29th time ever. All but one of the previous episodes saw the market higher nine months later, which in this case would take it through 2024.

Bespoke Investment Group calculates that as of Thursday's close the S&P 500 has remained statistically overbought (one standard deviation above its 50-day average) for 50 days for the 12th time. Here, too, strength usually begot more strength, but less emphatically.

None of these moments proved to be an absolute market top. Three months later bulls had an 80%-plus win rate, though average gains were smallish. Forward returns over the ensuing year were around the historical average for all periods, nothing special. The most recent prior instance of reaching 50 days this overbought was in early 2018, when a buying climax after a year of relentless gains gave way to an implosion of the "short volatility" trade and stirrings of a trade war, setting up a messy year, albeit with the Fed trying to tighten policy.

One can make the case that the tape won't remain as unflappable as it's been for much longer while still granting that the weight of the evidence argues against a consequential market peak being at hand. Note that in those prior 11 times the S&P entered the second quarter up at least 10%, the smallest pullback the rest of the year was 4%, and those were in the 1960s.

Not a Fed-driven market

It's been gratifying to see the market pile up the performance and style points as it has, even with the prevailing outlook for Federal Reserve rate cuts this year being deferred and diminished. I started arguing last November that with disinflation progress to that point, good economic news became good news for stocks. And I've invoked the blessed soft landing of 1995 — when the Fed pivoted after a harsh tightening campaign even as unemployment kept falling and stocks ripped to new records — repeatedly, going back more than a year.

The Fed's stated eagerness to preserve a chance for a soft landing, rather than insist on a lot more economic slowing before getting less restrictive, affirmed this view. And so, going from a loosely projected six or more quarter-point cuts starting in March this year to perhaps three cuts beginning midyear has been fine with equity investors.

This can only remain the case, of course, if the economy continues to hold up well and inflation doesn't buck higher again. If the strong fourth-quarter GDP and first-quarter tracking estimates above 2% real growth are near the ongoing trend, there's no reason to fear a patient, data-dependent Fed.

If recent signs of consumer fatigue and loosening labor-market conditions gather pace, it wouldn't take much to get a "Fed is behind the curve" scare running through markets.

Joe Kalish, chief global macro strategist at Ned Davis Research, has been bullish on bonds and still is overweight them, but feels the likely easing scenario is already priced into intermediate- and long-term Treasuries. Last week, he suggested a somewhat cozy consensus about the economy and rate path and argued that with economic readings now so close to the Fed's own targets (unemployment rate, inflation, GDP, etc) and the Fed data-dependent, "It wouldn't take the data to move much in either direction to upset the consensus."

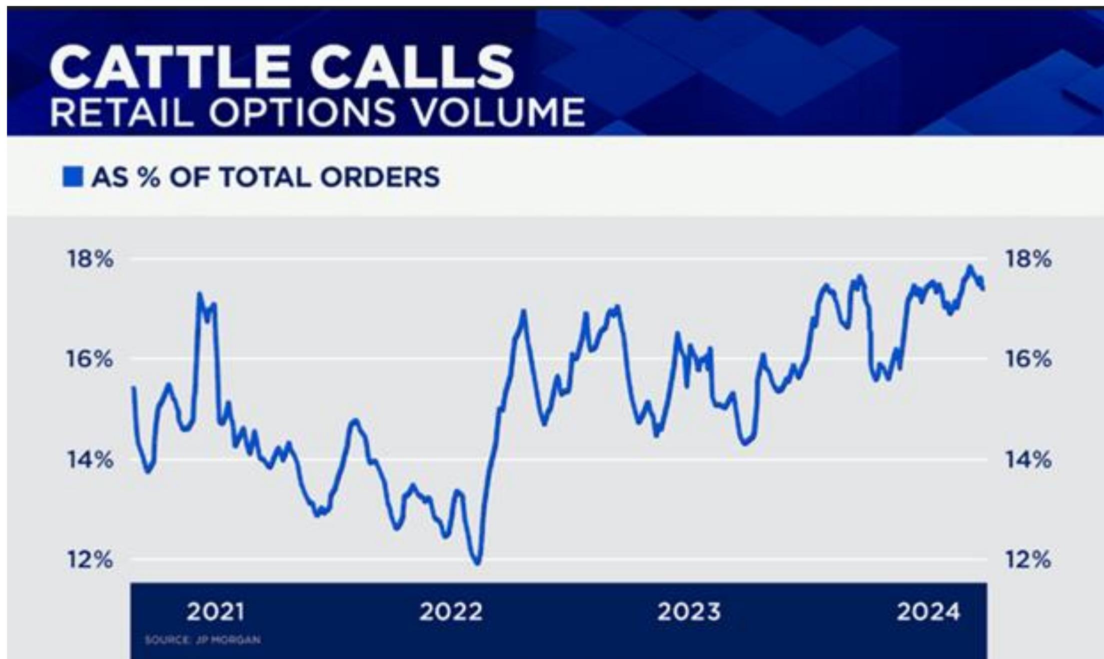
He notes the way bond-market implied volatility has rolled over to two-year lows as a sign of emerging complacency that could be jarred by any deviation from the assumed path. Low Treasury-market volatility is closely correlated with higher equity valuations. Treasuries are the water in the plumbing of global capital markets, and when the pressure in the pipes is steady, the whole system can hold a favorable equilibrium.

Kalish's point about data-dependency might seem simply like saying "stuff happens." There are no compelling reasons yet to predict the economy is about to veer into a ditch or quickly accelerate. But perceptions can shift in a hurry. It's worth recalling where the macro narrative was six months ago ("Huge Treasury supply is sending yields up to levels that will kneecap the economy") and six months before that ("The Fed broke the regional banks and must ease quickly as recession odds soar").

A cheekier bull

As the rally has rolled, animal spirits have flowed anew, the AI-investment obsession has raised the metabolism of the market and traders are opting to play faster and looser again.

JPMorgan finds that retail traders are again accounting for a heady proportion of all options orders, comparable to the peak pandemic speculative phase that topped out in early 2021.



Source: JPMorgan

This is, to a large degree, simply how smaller traders now engage with stocks, with options volume growth secularly outpacing cash equities. And much of this volume is initiated as options sales to harvest premium income — a bet on continued market calm that could, at some unknowable point, build to an excess.

The Conference Board's Consumer Confidence survey released last week showed a huge upward swing in the percentage of respondents who thought stock prices would be higher in the coming year.

Source: Conference Board

When this survey pool – not designed to represent active investors – grows suddenly aware of an ongoing rally it's worth looking out for signs of one-sided belief in the bull case. Though Bespoke notes that a swing like this from very low to very high optimism has sometimes happened closer to the start of big market advances than the end.

Citi's Levkovich Panic-Euphoria gauge, made up mostly of market-based readings with a smattering of opinion surveys — peeked up into the Euphoria zone by week's end. In this indicator, Euphoria is defined as the conditions associated with a higher-than-average chance of negative returns in the coming year.

A lot of this is simply a typical bull market engendering typical bull-market behavior. It's wrong, or at least premature, to observe optimistic return-chasing and percolating speculative action in a scolding, reflexively contrarian way.

Sure, Robinhood and Coinbase shares are each up more than 50% year to date and the crypto crowd is flexing their beer muscles again. But none of those things is back to where things stood even three years ago and more importantly, the broader market has been rather orderly and "in gear," while overall investor equity inflows are not yet running on tilt. Let's not forget that while the S&P is up 10% in three months, it's up less than that since all the way back on Jan. 3, 2022.

It all makes for a spicier, high-energy market, one with plenty of themes to play or bet against.

The AI investment boom is undeniable, and increasingly central. An S&P 500 index investor is now effectively putting at least 15 cents of every dollar in stocks that are driven mainly by AI excitement (totaling the index weights of Microsoft, Nvidia, Broadcom, AMD and just a few others). Once-staid industrial manufacturer Eaton Corp. trades at 30-times forward earnings, 75% above its ten-year average, because of AI data-center demand for electrical gear.

Exciting or sobering, depending on one's point of view, or perhaps a blend of both - much like the market itself right now."

All the best,

Paul Krsek
CEO
5T Wealth, LLC
Main (707) 224-1340
Cell (707) 486-7333
Paul@5twealth.com

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