Macro Musings

Myles Zyblock, MA, CFA
Chief Investment Strategist

Kien Lim
Associate Strategist – Macro Research

Jason Nguyen, MBA, CMT, CFA
Associate Strategist – Quantitative Research

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Turning that frown upside down

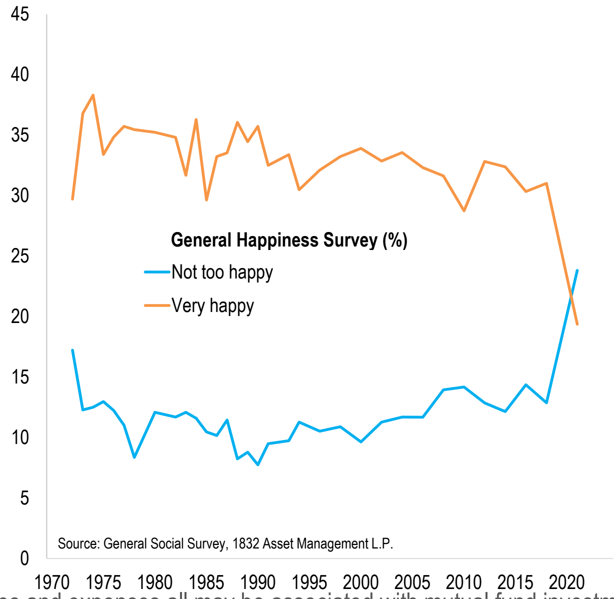
For the first time in at least a half century, the share of downbeat Americans has surpassed those who feel content. The pandemic, trust in government, and economic policy are among the important reasons behind this newfound generational malaise, according to results from the General Social Survey (**see Chart of the Week**).

The last bastion for American optimism was reflected in the equity market, that was until recently. Investors have been in a foul mood for the better part of the past two months, finally joining the larger population. Stocks have dropped while bets on further declines have surged.

Much of the recent negativity on Wall Street can be traced back to a late-November speech, when Chairman Powell discouraged the use of the word 'transitory" when describing the inflation backdrop. This set off a chain reaction which filtered from interest rate expectations, to stock market valuations and prices.

In some areas of the market, the hit to share prices has been large. And, yet, there is no economic recession in sight. It is important to remember that policy-set interest rates are likely to rise because there is no longer a need for them to be anchored at the emergency set level of near-0%. This is a good thing. While it is impossible to pick a bottom in the market, the time to dip one's toes into stocks is usually soon after everybody else has rushed for the exits. The few remaining optimists can and often do use widespread pessimism to their advantage.

Chart of the Week: Not a lot of Happy in the Happiness Survey



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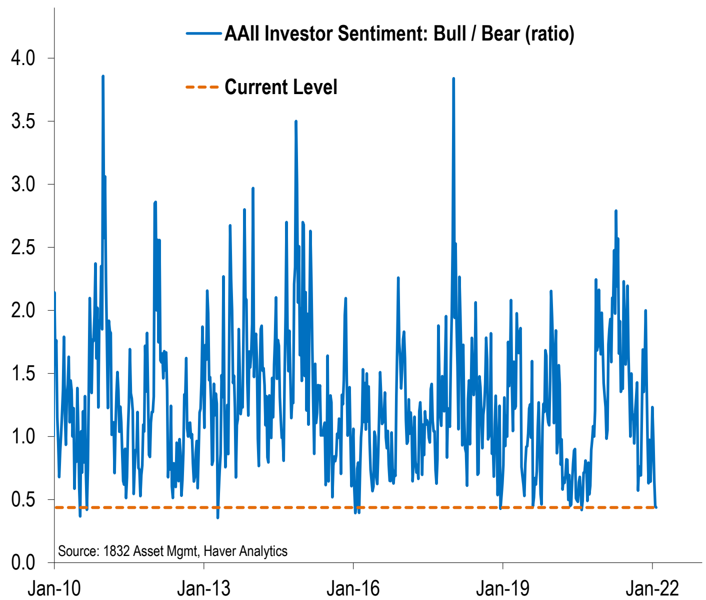
Sour Mood

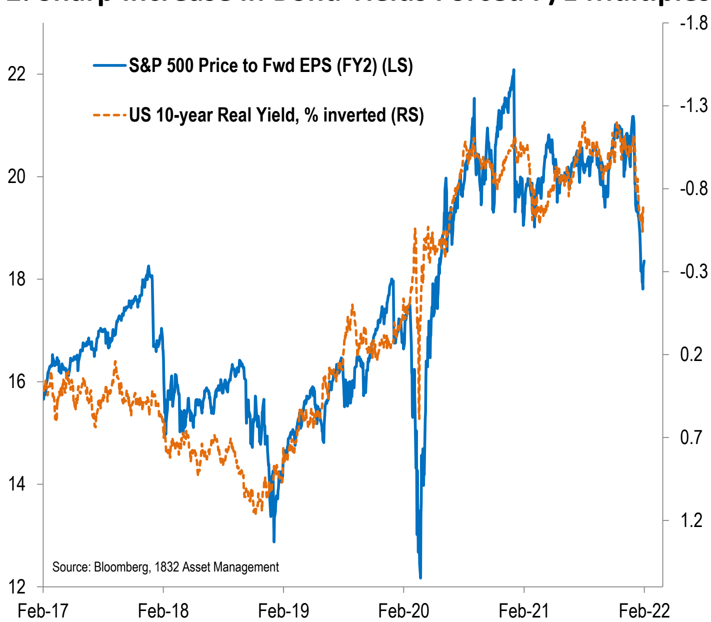
Equity sentiment has deteriorated in rapid fashion since late November of last year. Industry surveys show that the proportion of bulls to bears is at 44%, which is within the lowest 3% of all readings since 1987 (Figure 1).

Figure 1: The Equity Bull-Bear Sentiment Gauge is Depressed



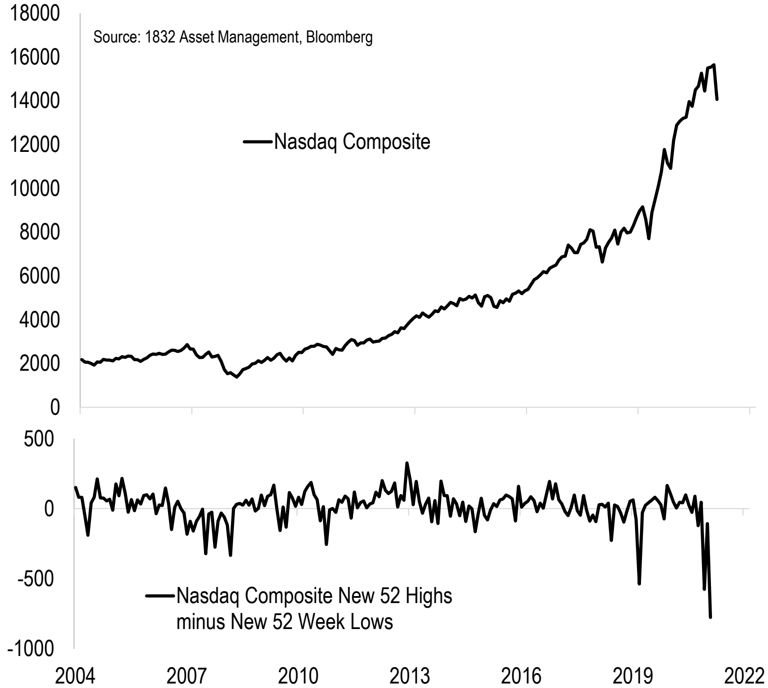
The mood soured shortly after Federal Reserve Chairman Powell's pronouncement that the use of the word "transitory" was no longer appropriate to characterize the inflationary backdrop. His change in tone catalyzed a shift in perception; that the Fed might no longer be as patient about waiting for the inflation dust to settle before determining the appropriate level of interest rates.

Figure 2: Sharp Increase in Bond Yields Forced P/E Multiples Lower



Financial market participants accelerated their expectation for a policy tightening cycle. The number of 25 basis point rate hikes for the coming year quickly jumped from 2 to almost 5, which is where this stands today. The spasmatic re-pricing forced market interest rates higher and placed a significant amount of downward pressure on equity valuation multiples (Figure 2).

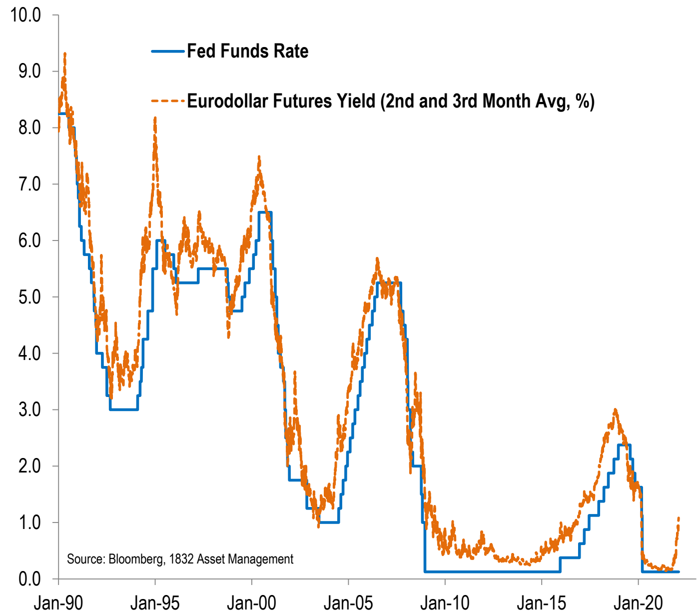
Figure 3: Substantial Internal Damage in Many Corners of the Equity Market



Some of the hardest hit areas of the equity market have been in the themes that were most popular in the 12-18 months following the March 2020 pandemic low, including “decentralized finance”, social media, “innovation”, and clean energy. The Nasdaq Composite has been among the hardest hit of the major equity benchmarks, down by as much as 19% at its recent low. Based on the number of companies making new 52-week highs versus new 52-week lows, this sell-off generated more internal damage than most everything seen since the great financial crisis (Figure 3).

We are confident in the view that the Federal Reserve will be raising interest rates in 2022. They might lift rates by 100 basis points, or slightly more, before the year closes out. There are three things to keep in mind on the state of monetary policy. First, 121 basis points of tightening is already in the price of fixed income markets (Figure 4). The Fed will now probably need to signal even more than this for the financial market jitters to continue. Second, even if the Fed raises rates by 100-125 basis points this year, that would still leave inflation-adjusted interest rates in deep negative territory. Over the past few decades, economic recoveries have never stalled with interest rates in the negative domain. Finally, ask yourself, are interest rates likely to rise because economic growth is weak or strong? I vote for the latter.

Figure 4: Close to 125 basis points of Tightening Already Priced



We have looked at this latest equity market sell-off from a few different angles. Most roads are leading in the same direction: that the time to dip one's toes into stocks is usually soon after everybody else has rushed for the exits. We will share a couple of these analytic adventures with you. The first is where we looked at subsequent equity price returns for different levels of that AAII bull-bear ratio highlighted earlier in the report. As we said, the current reading is 0.437. From this level of pessimism, stocks have been up 91% of the time over the following 12 months and delivered an average return of close to 25% (Figure 5).

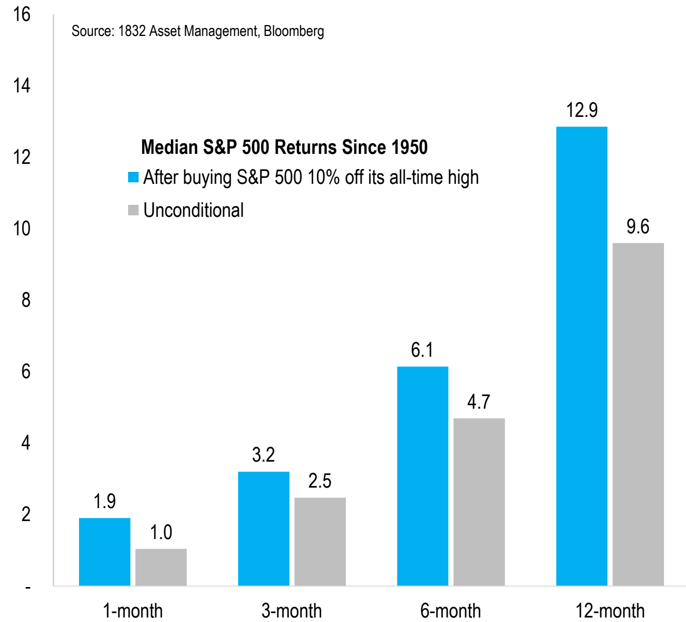
Figure 5: AAII Bull/Bear Ratio and Subsequent Equity Market Returns

AAII Bull vs Bear Ratio Under	Frequency	S&P 500 Average return in subsequent				% of positive returns in subsequent			
		1m	3m	6m	12m	1m	3m	6m	12m
< 1.0	35.2%	0.8%	2.8%	5.7%	12.0%	65%	72%	73%	82%
< 0.9	28.7%	0.6%	3.1%	5.8%	12.1%	63%	72%	73%	82%
< 0.8	20.7%	0.4%	2.8%	5.4%	11.1%	59%	67%	69%	78%
< 0.10	14.5%	1.0%	3.2%	6.1%	11.9%	63%	68%	70%	78%
< 0.6	6.3%	1.3%	5.9%	12.2%	18.0%	58%	65%	81%	88%
< 0.5	**2.7%**	**3.5%**	**8.6%**	**19.7%**	**25.1%**	**73%**	**73%**	**91%**	**91%**
Unconditional (Since 1987)		0.7%	2.2%	4.7%	9.6%	64%	69%	73%	78%

Source: 1832 Asset Management, Bloomberg

We also looked at how stocks did after having fallen by 10% from their prior all-time high. This seemed relevant because the S&P 500 had declined by just over 12% from its peak set early in January to the local low reached on January 24th. Over the next 12 months, they were up, on average, by about 13% (Figure 6). We have both conditions in play right now: a lot of pessimism and a sizable price drop.

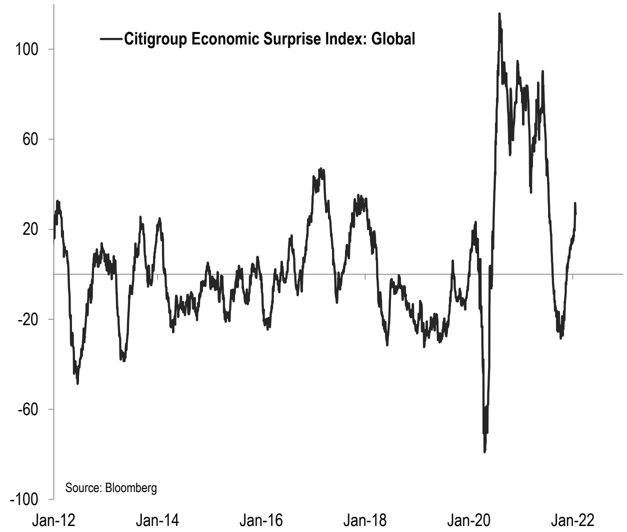
Figure 6: Market Returns Following a 10% Drop from All-time Highs



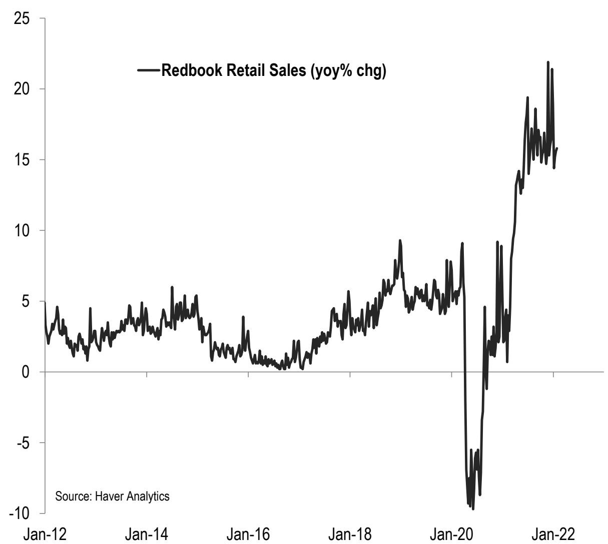
Bottom Line: It is near impossible to pick a bottom in the stock market and to do so with consistency. That being said, the current negativity embodied in share prices points to fairly attractive odds of price asymmetry in the equity investor's favor for the next 9-12 months.

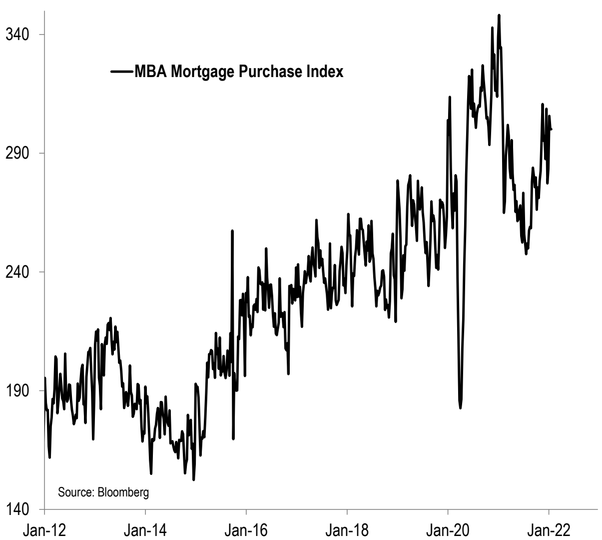
High Frequency Data Tracker

Economics



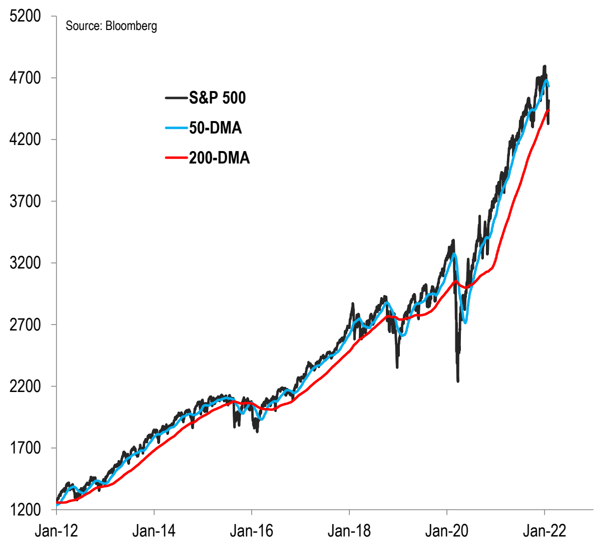
- The Global Economic Surprise Index has moved further above the zero-line which suggests that the number of positive data surprises has been greater than the negative ones.
- Weekly retail sales activity has accelerated slightly over the previous reading and currently stands at +15.8%.
- Mortgage activity has reaccelerated since the start of the year according to the MBA Mortgage Purchase Index.

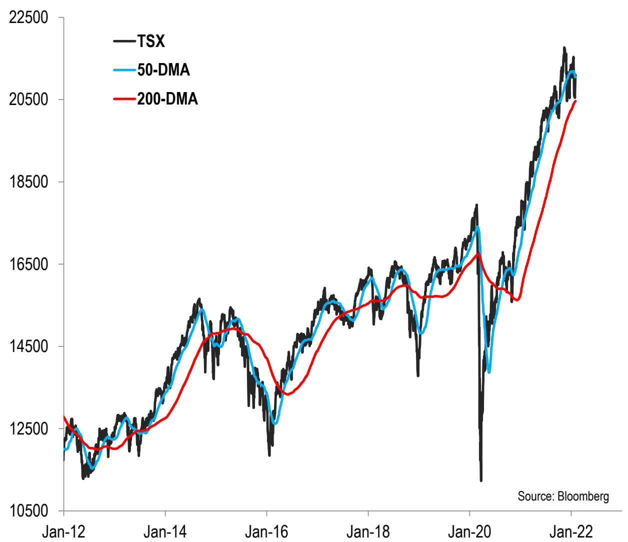


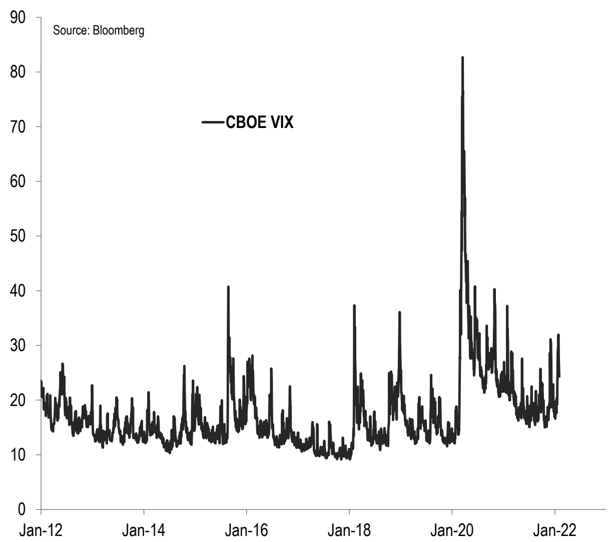


Equities

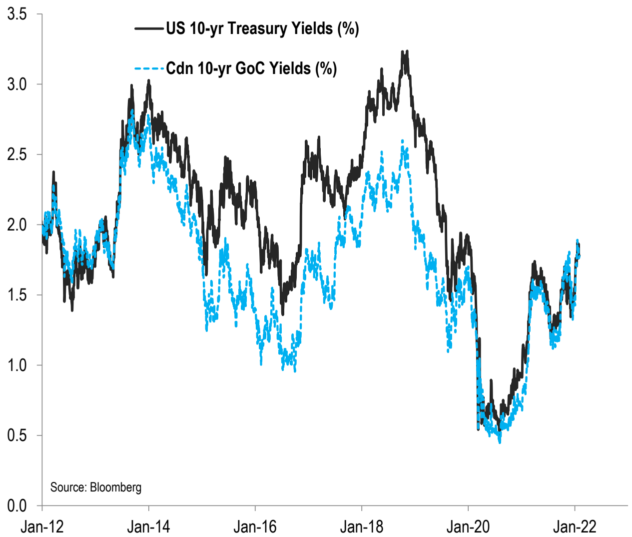
- The S&P 500 has recovered some of the losses after the sell-off in January and is currently trading above its 200-day moving average again.
- The TSX has also pulled back from its sell-off and is holding within its consolidation range.
- The VIX Index has now dropped below the 25 level after a bout of volatility pushed it to a year-to-date intra-day high of 38.9 on January 24.



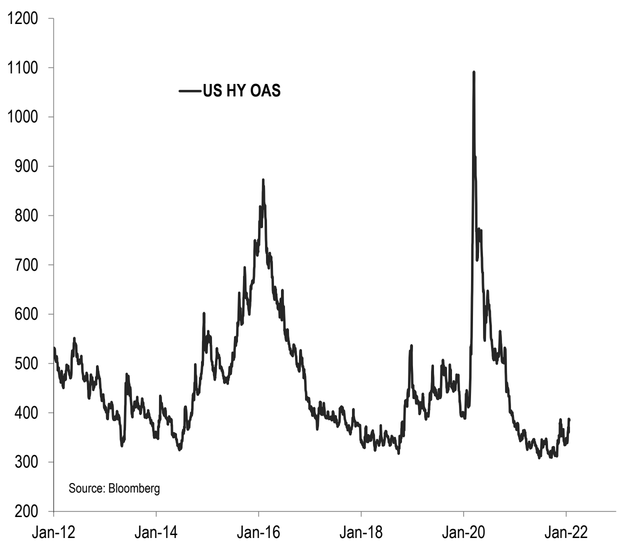


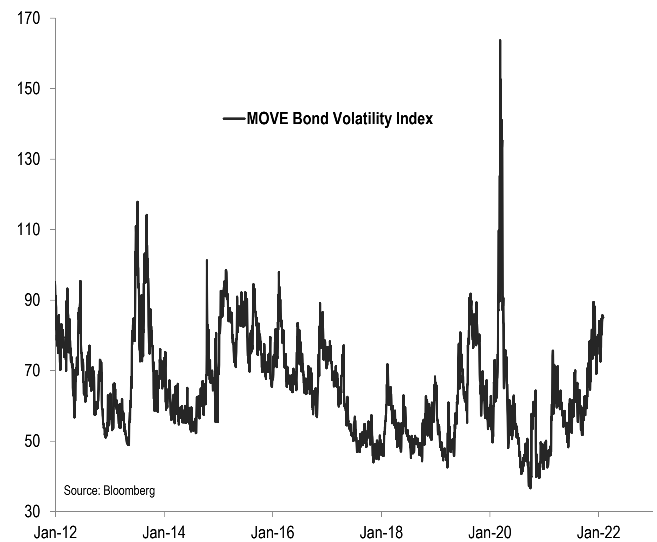


Fixed Income

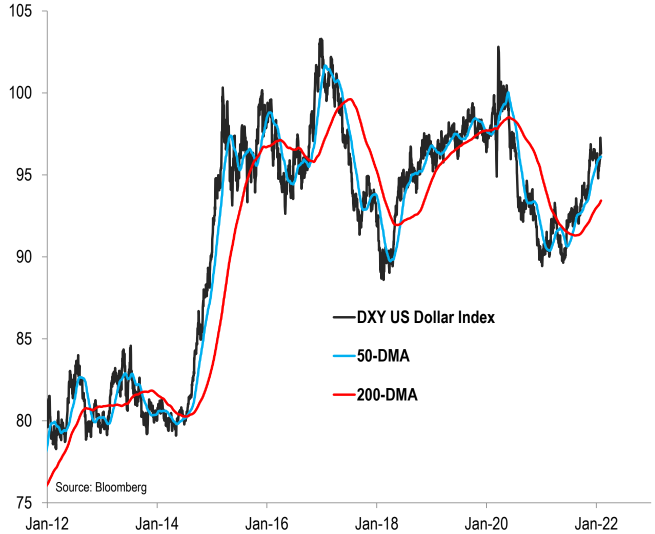


- U.S. and Canadian 10-year government bond yields have been on an upward trajectory with both sitting at 1.8% currently.
- High yield spreads have started to tick higher again with the risk-off tone that entered in January to start the year.
- Volatility in the bond space, as measured by the MOVE Index, has remained elevated.

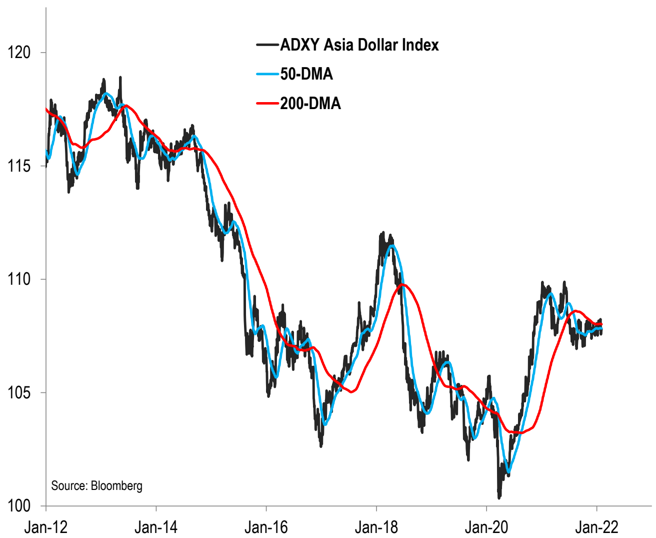


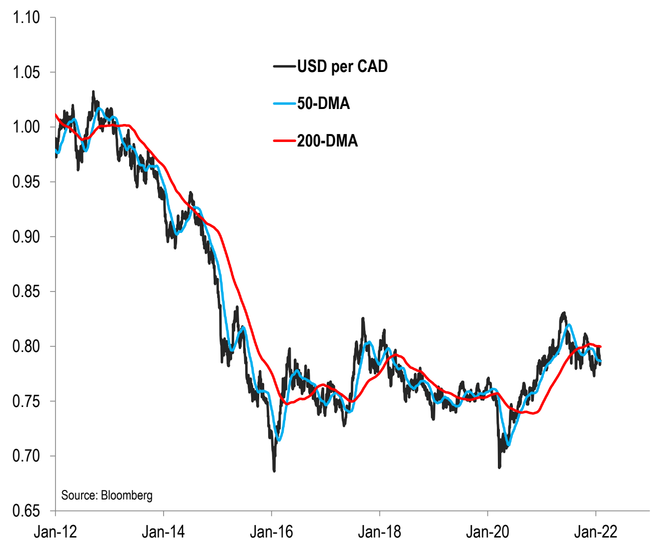


Currencies

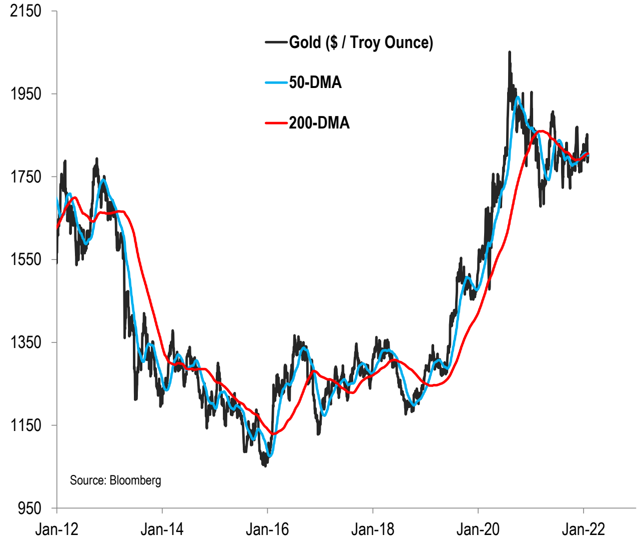


- The DXY Dollar Index has been on the rise, reflecting the USD's strength. Support has been provided by its relatively strong economy and its central bank that has signaled its intention to raise policy rates.
- The ADXY Index, a basket of Asian currencies versus the USD, is attempting to break out higher after a period of consolidation.
- Strong energy prices have helped the Canadian dollar offset some of the USD's strength in 2022.





Commodities



- Gold bullion prices have been moving sideways for more than a year and have converged on the moving averages.
- The WTI crude price has broken to its highest level since 2014 and is consolidating its gains above the $88/barrel level.
- Copper prices remain in a volatile consolidation phase as the global economy continues to recover.