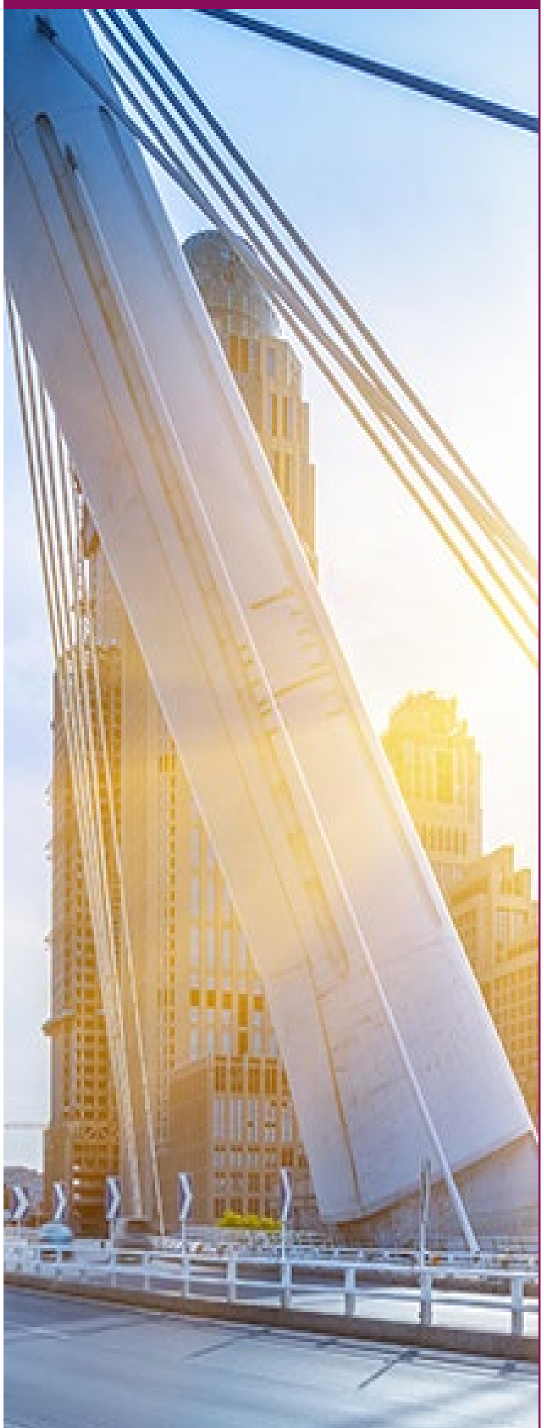
November 29, 2022

Market Ethos

The latest market insights from
Richardson Wealth



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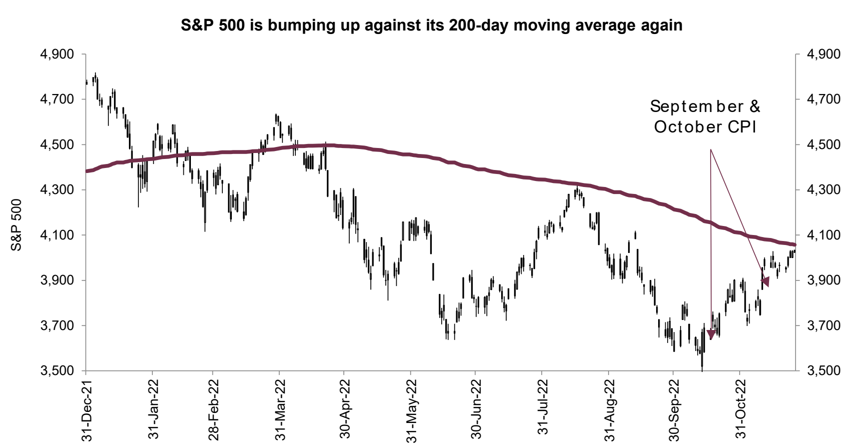
Do we believe in a Santa Claus rally?

The term ‘Santa Claus rally’ is a term coined over the years for a good reason. Data back over a century reveals that December has the highest probability of any month to be in the green for the TSX and S&P 500 – 77% and 76%, respectively. The average gain for the TSX at 1.9% is the highest among all months, while the S&P 500’s average of 1.4% is a close second place after July. This time of year is usually kind to equity portfolios.

With the TSX and S&P 500 charging ahead by 6% and 8% respectively in October, and up 5% and 4% so far in November, Santa certainly came early this year. This does raise the question though: will this Santa Claus rally make it all the way to Christmas? The holiday is a mere four weeks away, which does sound like it is quickly approaching (must start shopping soon). However, four weeks in this ‘bear’ market is a long time, and the market is already rather extended. The S&P 500 is once again bumping up against its 200-day moving average. The bear market rally of the summer months reached this measure as well before making an about-turn.



Source: Bloomberg, Purpose Investments

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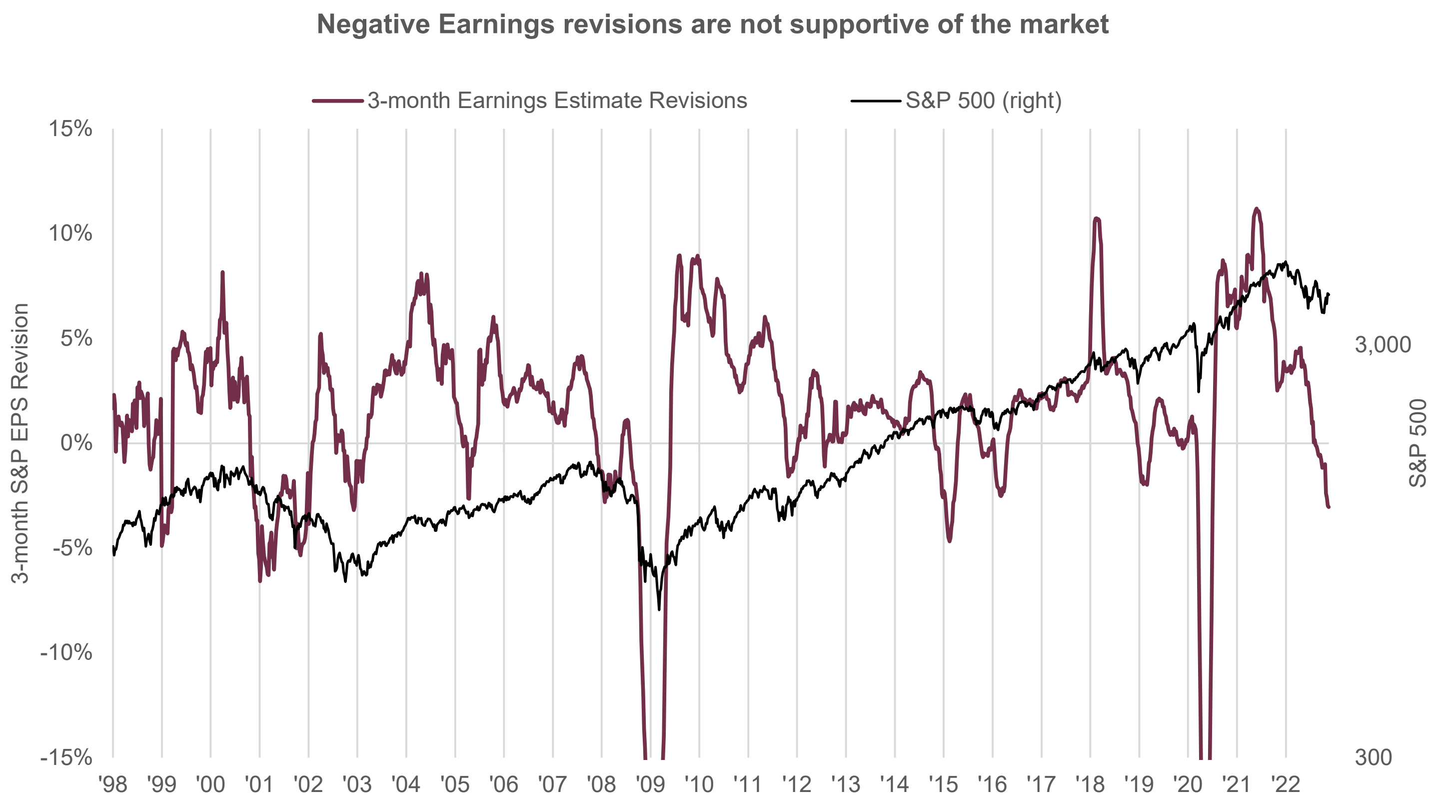
Our contention has been clear: at the first sign of slowing inflation —which is the root cause of this bear market — there was going to be a strong rally in equities and bonds. That is pretty much what is occurring, kick-started by the September US CPI report that indicated inflation may have stopped rising. The October reading provided more evidence that inflation may be starting to come back down. Of course, the inflation data wasn't even a big improvement, but after months of simply getting worse and worse, sometimes just not getting worse is good news.

This does look and feel like a bear market rally. S&P 500 market breadth, measured by the % of index constituents trading above their 50-day moving average, has reached 90% or about 450 companies. It was two months ago that only 15 companies were trading over their 50-day. This bounce has been very widespread. This is also near the peak in market breadth during the summer rally that ended mid-August.

Hope may not be enough

So, is this advance for real, or will the recent optimistic fever among investors get trounced once again? The truth is, whenever the final bottom of this bear market is reached, the bounce off the bottom will largely be predicated on 'hope' with little fundamental support. That does fit the bill with this bounce. But at some point, hope won't be enough, and the fundamentals must begin to improve. **Today however, the fundamentals are not improving and, in fact, continue to go in the opposite direction**.

Financial conditions continue to tighten, even with the bounce in the market. Our market cycle indicators are very low and weak. Even the U.S. economy, which remains the relative bright spot, has a year-over-year change in the Leading Index Ten Economic Indicators of -2.7%. Negative readings of this index have a good track record of warning of a material slowdown in economic activity. And then we have earnings. The 3-month revision to earnings estimates for the S&P 500 has turned negative (chart). Unfortunately, this too often lines up with periods of market weakness.



Source: Bloomberg, Purpose Investments

Finally, sentiment is not very bearish anymore and valuations have risen. **Based on the AAII survey, over 60% of investors were outright bearish in late September; now, only 40% of investors are**. This is a contrarian indicator — the more that are bearish, the better for returns going forward.

Impact on portfolios

Maybe the fundamentals will turn around, inflation will cool quickly and smoothly, economic activity will stabilize, and earnings estimates will enjoy positive revisions … maybe. We are going to get another inflation reading in a few weeks as the Fed meets around mid-December. Based on the price bounce in the market, the news had better be good, otherwise the disappointment will prove painful.

This rally may continue, and who knows, maybe it will make it to Xmas. However, after a bounce like this, we would not be shy about taking some off the table, with the belief that better buying levels will materialize as the market may yet make its way under some mistle-toe with us in tow.

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

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