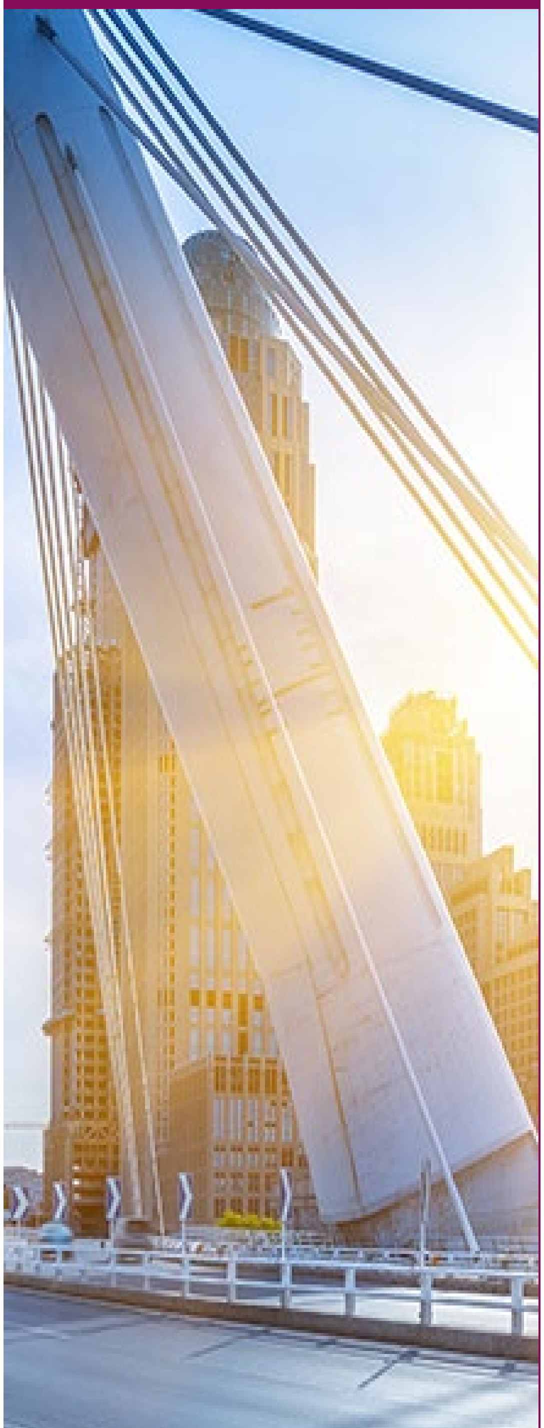
January 23, 2023

RICHARDSON Wealth

Market Ethos

The latest market insights from Richardson Wealth



Derek Benedet

A warning from Wile E. Coyote

One of the most iconic Looney Tunes' misadventures was the relationship between the Road Runner and Wile E. Coyote. The way the Road Runner always gets the better of the hapless coyote with his classic "**Beep Beep"** just as Wile E. happens to run off an unforeseen cliff into a deep gorge. Of course, with the delayed suspension midair before gravity suddenly decides to take over. **Markets, like Wile E., can be so singularly focused on one thing (inflation) that they can for better or worse be oblivious to approaching danger (recession).**

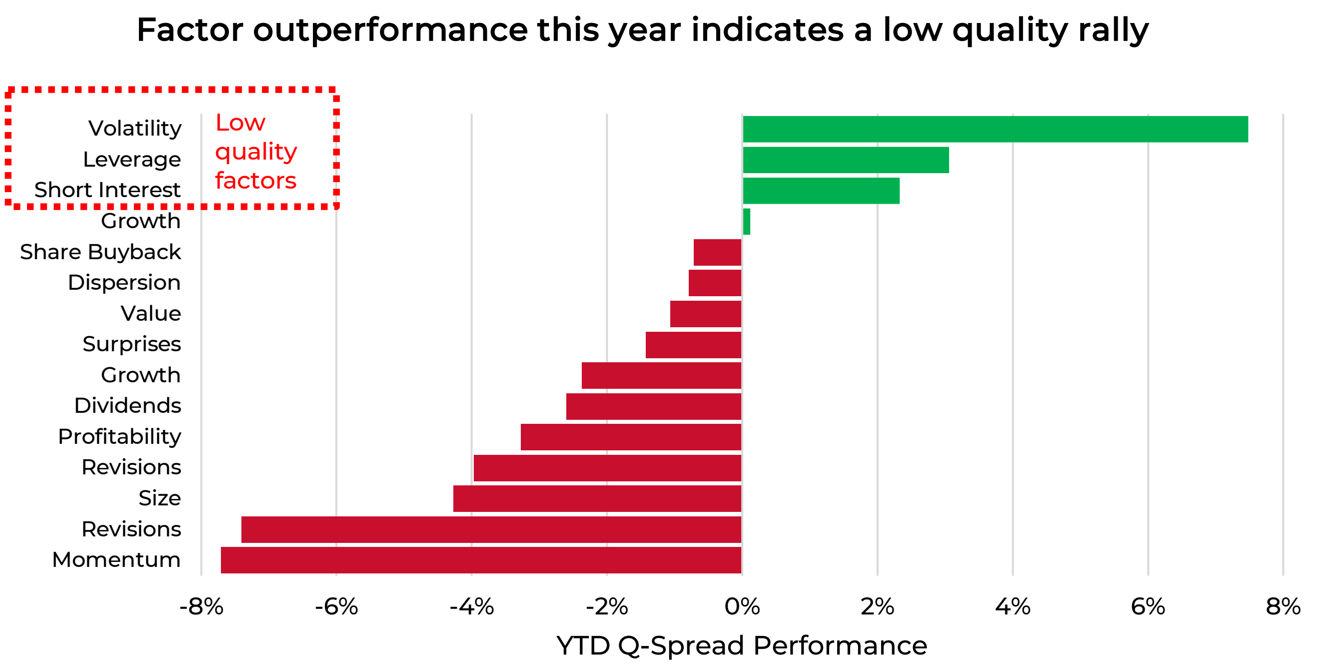
Markets are forward looking; they bottom well before the negative impacts of a recession ripple through the economy. At this point, the hope has been that cooling inflation is all that's needed for markets to catch a bid. However, with all the focus on inflation (i.e., the Road Runner), markets may be overlooking the real risk of an economic slowdown. We touched on this in our recent Market Outlook.

A synopsis of our outlook thoughts heading into 2023:

2023 should start off decently as inflation comes down a bit more, partially alleviating the markets' biggest fear. Plus, a little January effect could certainly help*. However, less inflation will start to accelerate slowing corporate earnings. And the wealth effect of falling equity/bond markets over the past year plus delayed economic impact of rate hikes and higher yields will cause economic growth to fall significantly. This could trigger the final leg down of the bear and create the better buying opportunity, hopefully sometime in the first half of 2023, as the market begins to look through the trough and rally back to be positive on the year.*

Are we there yet?

We're not at that trough yet—we're not even at the cliff's edge to see how deep the trough is—but it is approaching. You wouldn't know it by how markets have continued to run, in part thanks to the January effect, an observed seasonal increase in stock prices during the month that's particularly apparent following an aggressive tax-loss selling period.

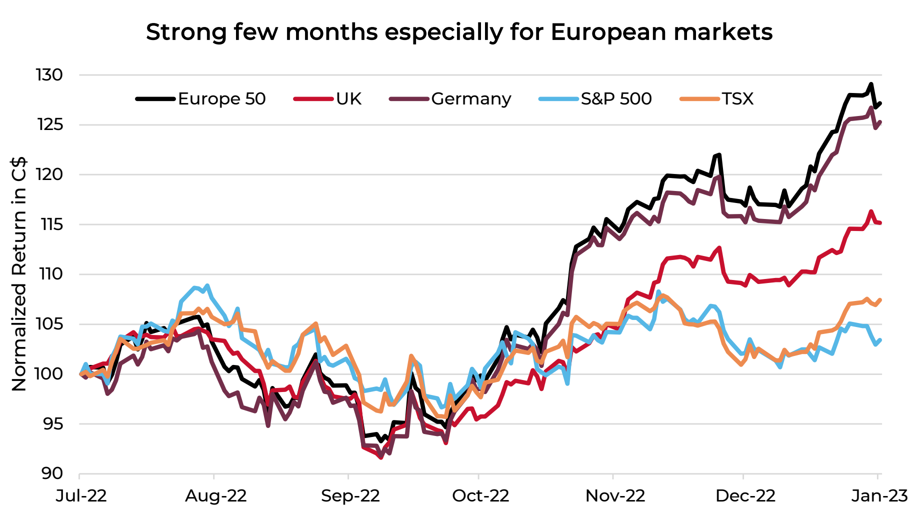


Source: Bloomberg, Purpose Investments

There was no shortage of losses to investors to sell last year, especially in some of the more hard-hit segments of the market. It's not surprising that some of those hardest-hit segments have been the biggest winners so far this year. Cyclicals have been big winners, and from a factor perspective, **the three best-performing Bloomberg Factors based on a Q-Spread (long first quantile, short last quantile) are 3M Volatility, Leverage, and Short Interest.** Value, Dividends, Size, and Profitability have all lagged.

Trending up

On the whole, market performance so far this year has been better than we expected. The S&P/TSX Composite is up 5.3%, the S&P 500 is up 2.3%, and the NASDAQ is up 4.9%. International shares, which we've been recommending as an overweight since last summer, have had a great run. Europe is up 8.5% YTD, and the Euro Stoxx 50 index is up 24% since the end of the third quarter. China moving past the zero Covid policy has disproportionately helped European shares, as the region is more closely tied to China and global growth compared with the U.S.



Source: Bloomberg, Purpose Investments

We continue to like Europe, but at this point we'd caution adding to it given the recent outperformance as seen in the chart on the right. **Some markets like the U.K. have also recently hit new all-time highs!** It would appear with the abundance of China optimism floating around that markets have gotten ahead of themselves.

Technicals

The S&P 500 now finds itself at a critical juncture. It's now up against the key downward-sloping trendline as well as the 200-day moving average, which have both proven to be stiff resistance levels. For more tactical and technically oriented managers, it's at a logical place to begin considering de-risking.

Momentum indicators, such the Relative Strength Indicator (RSI), are also not breaking out, indicating momentum may not be strong enough to break above overhead resistance. At present, the market has not shown any clear technical signs of breaking out of the bear market trend, but there are some positives worth mentioning. Breadth is decent, the equal weight index is showing more relative strength, and the market is continuing to make fewer 52-week lows on the last couple of pullbacks.

S&P 500

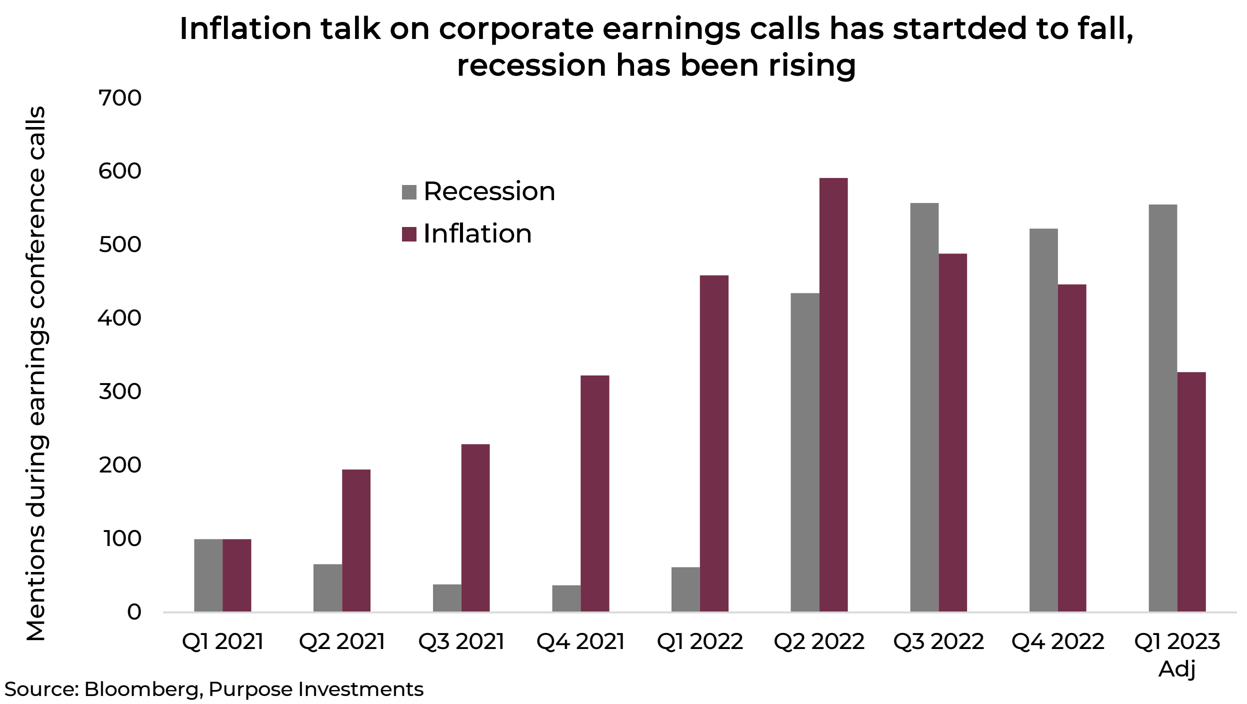
Value and Dividends remain attractively priced, and we like their defensive characteristics, but our third major portfolio tilt should be put on the back burner at present as we await a better opportunity.

Bad news may be bad news again

Inflation was clearly the biggest problem for markets last year: the uncertainty about how high it could go, how long it might last, and what the central banks would do to fight it. This uncertainty has been improving of late. Inflation has started to come back down, and investors have a reasonable idea of how far central bankers will go as some have started slowing the pace of hikes.

Helping fuel the view that inflation is coming back down isn't just in the monthly CPI and related inflation data releases, it has also been in the data showing the economy slowing. **For months now, weak economic data was welcomed by the markets, which feared inflation uncertainty over economic recession uncertainty.** This was the bad-news-is-good-news environment.

But that may be starting to change back to a more normal "bad-news-is-bad-news" again. Inflation is still likely the biggest issue but we have seen a number of trading days that experienced soft economic data coinciding with weak markets—clear evidence the transition may have started.



We have already seen this transition at the company level. Analyzing corporate earnings conference calls, we have seen a significant drop in management commenting on "inflation." Meanwhile mentions of "recession" have been on the rise. [Q1 2023 is adjusted as the earnings season is only partially complete.]

Portfolio considerations

Markets are up, China is re-opening, and Europe is apparently avoiding the energy crisis. But we are not convinced these things last. The mood in corner offices remains foreboding with caution in the air and job cut announcements beginning to pick up. The word 'recession' will be a hot topic as earnings season heats up and while equity valuations remain depressed, the recent move higher in stock prices warrants a degree of caution. "Beep Beep" doesn't just mean that the goal is close at hand—it's warning of more pain, whether it's falling off a cliff or the dreaded ACME anvil.

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

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