"If one tries too hard to be precise, one runs the risk of being so narrow as to be irrelevant" - R. J. Shiller

Conflicting signals from "equity vs bond" market and "actual vs survey" data has many investors confused. So elusive is the nature of this cycle that only time will tell what the market was precisely up to. Mindful of this uncanny backdrop, in our latest market insights, we first try to broadly cover the most pressing questions in investors' minds and then give a sense of portfolio positioning:

- What is US equity market signaling?
- What a FED pause may mean for the equity market?
- What is the lesson from history?
- What is the signal from 1Q23 earning season?
- What is the upside risk for equities?

What is US equity market signaling?

Considering YTD price action of equities, before and after the mini-banking crisis, three observations stand-out (table 1):

- Outperformance of mega-cap tech stocks YTD, both before and after the mini-banking crisis.
- Outperformance of cyclicals vs defensive before and defensives vs cyclicals after the mini-banking crisis.
- Re-rating of US equity market forward P/E multiple.

The fundamental explanation is that the market is signaling a low growth-low inflation outlook after the mini-banking crisis but also an end to policy tightening, hence the rotation from cyclicals to defensives (see highlighted columns in the table) and the outperformance of mega-cap tech, which drove equity market higher.

Table 1: 2023 returns and valuation.

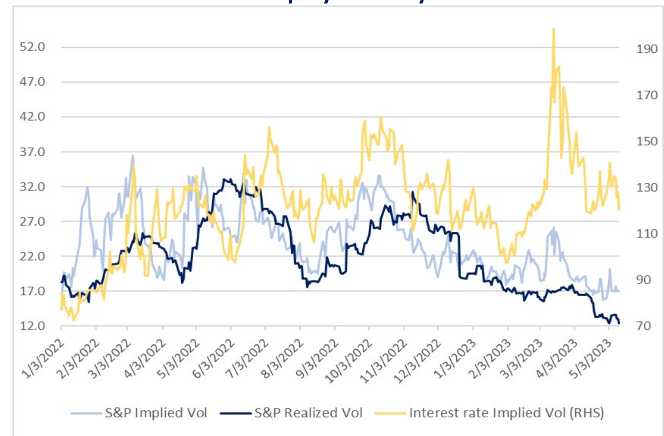
	Returns 2023			BEst P/E		
Index	**Before crisis**	**After crisis**	**YTD**	**Dec-22**	**Before crisis**	**Latest**
S&P 500 Index	**4.1**	**3.8**	**8.1**	**17.6**	**18.1**	**18.9**
S&P 500 Ex Tech	**1.1**	**1.1**	**2.3**			
S&P 500 Technology	11.8	9.8	22.8	22.6	23.9	26.8
S&P 500 Communication	11.2	14.6	27.5	14.5	15.1	16.9
S&P 500 Discretionary	10.8	4.1	15.3	23.4	22.8	23.6
S&P 500 Staples	-3.3	7.6	4.1	22.1	20.0	21.3
S&P 500 Utilities	-7.2	6.3	-1.4	19.7	17.3	18.3
S&P 500 Health Care	-6.5	4.5	-2.3	16.9	17.0	17.9
S&P 500 Energy	-2.1	-7.3	-9.0	8.2	10.3	10.1
S&P 500 Materials	5.0	-3.8	1.0	13.8	17.9	17.0
S&P 500 Industrials	4.0	-3.2	0.7	20.5	19.3	18.9
S&P 500 Financials	2.6	-8.7	-6.3	13.7	12.9	13.1
S&P 500 Real Estate	1.8	-0.8	1.1	30.3	35.4	35.4

Source: Bloomberg, BEst (Bloomberg estimates).
Before crisis (1st Jan to 7th Mar), after crisis (8th March to date).

The non-fundamental explanation is that market liquidity and bulls misreading bank term funding program (BTFP) as quantitative easing (QE) kept a strong bid on long duration (Tech) that drove equity market higher. This too is believable considering the huge divergence between interest rates and equities volatility (Chart 1).

Our reading is that the truth lies somewhere in the middle, considering an ok GDP growth, albeit slowing, on one hand and a narrow breadth (excluding-tech S&P is up only 2.3% YTD) amid an inverted yield curve (10yr-3mth -1.79%, 10yr-2yr -0.52%, real 10yr-2yr -0.79%) on the other.

Chart 1: Interest rates vs equity volatility.



Source: Bloomberg.

What a FED pause may mean for equity market?

Historically, a rate pause has been a welcome sign for equities with subsequent return of ~+20% on average (Table 2). However, before one gets too excited there are some caveats:

- Rate pause rallies were driven by P/E multiple expansion. For e.g., in Dec-2018 multiple increased from ~13x to ~18x and in June-2006 from ~14x to ~16x.
- Moreover, these rallies mostly happened in a low inflation and/or a flat yield curve environment.
- Also, prior to rate pauses, the equity market was falling more often than rising.
- Finally, in every tightening cycle, FED paused only after taking policy rate above YoY Core CPI.

Table 2: Returns amid rates pauses.

Pause	S&P 500 Rally/Drop	Inflation Regime	Yield Curve	Core CPI YoY	FFR less Core CPI
May-23	?	?	-1.3%	?	?
Dec-18	44%	Low	0.1%	2.1%	0.1%
Jun-06	28%	Low	-0.1%	2.3%	3.0%
May-00	11%	Low	-0.1%	2.4%	4.1%
Jan-95	166%	Low	0.8%	2.8%	3.2%
Feb-89	39%	High	-0.1%	4.7%	5.1%
Aug-84	104%	High	2.3%	5.3%	6.4%
Jul-81	-21%	High	-1.3%	9.9%	10.1%
Apr-80	-17%	High	-3.2%	10.7%	9.4%
Jun-74	-33%	High	-1.2%	6.2%	6.8%
Jun-69	-16%	High	-8.9%	6.1%	3.9%
Nov-66	29%	Low	-0.3%	3.0%	3.0%
Sep-59	10%	Low	NA	2.0%	1.5%
Aug-57	-21%	Low	NA	NA	3.0%
Average	**25%**				

Source: Barclays, Farro. (FFR = Fed Fund Rate). Yield curve (10yr-1yr).

Our reading is that the case for a 2006 or 2019 pause rally is not clear considering S&P P/E multiple > 18x, a sticky core inflation > FED fund rate, and an inverted yield curve with equity market up ~16% from its low.

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What is the lesson from history?

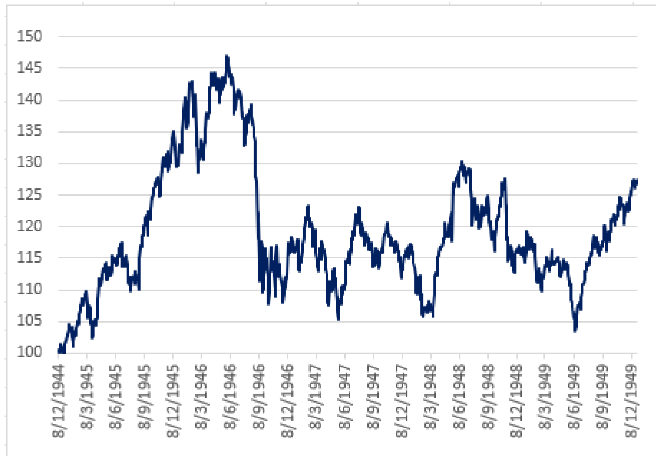
We consider financial markets history as one of the key factors in assessing and framing risk-return.

Comparisons have been made between today and the 1970s. However, we see more parallels to the late 1940s, the post war consumption boom that unexpectedly brought high growth and high inflation along with rising asset prices, in the backdrop of excess savings and price & interest rate controls.

To quell high inflation, the FED started tightening monetary conditions. Subsequently, S&P fell ~25% in 1947, then recovered ~60% of its drawdown in the next 12 months, only to fall again below 1947 lows in 1949 after the economy entered recession in late 1948. In short, recession took more time than what market initially anticipated.

Our reading is that we maybe witnessing a similar price action in post covid consumer boom amid QE followed by FED tightening, as a recession will take time to transpire given strong balance sheets of consumer (significant home equity and excess savings) and businesses (long debt maturity profile).

Chart 2: S&P performance 1944 to 1949 normalized.



Source: S&P 500, Bloomberg.

What is the signal from 1Q23 earning season?

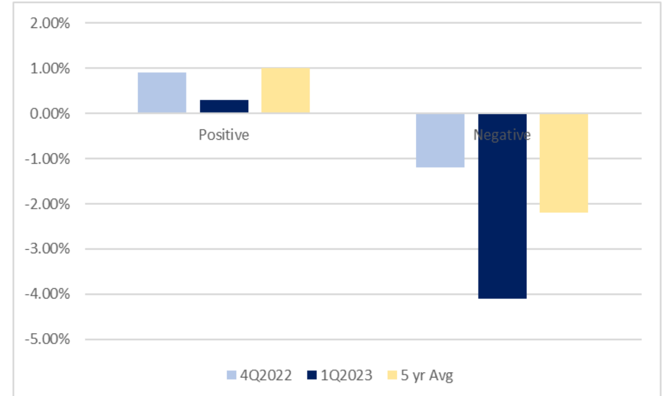
S&P 500 earnings season is almost over with >90% of companies having already reported. S&P 500 is on track to post ~-3.5% YoY decline in EPS in 1Q23. However, in markets it's more about expectations vs reality, which has been a tad better:

- The number and magnitude of EPS beats in 1Q23 have been higher than historical averages. In a typical quarter, about 75-80% of companies are expected to beat estimates.
- EPS estimates for 2Q23 were lowered by a smaller margin, -0.8%, than the historical average. In a typical quarter, earnings estimates are reduced during the 1st month of the quarter by -1.8-2.0%.
- Of the S&P 500 companies that have issued EPS guidance for 2Q23, the percentage of negative EPS guidance is below the historical average.

That said, what's even more interesting is, despite actual EPS and EPS guidance coming in better than feared, how has the market responded:

- S&P companies that have reported positive EPS surprises have seen a smaller price increase than average.
- Companies that have reported negative EPS surprises have seen a larger price decrease than average.
- Market reaction during 1Q23 earnings season is the opposite of the reaction seen during the 4Q22 earnings season.

Chart 3: S&P EPS surprise vs Avg price change.



Source: FactSet.

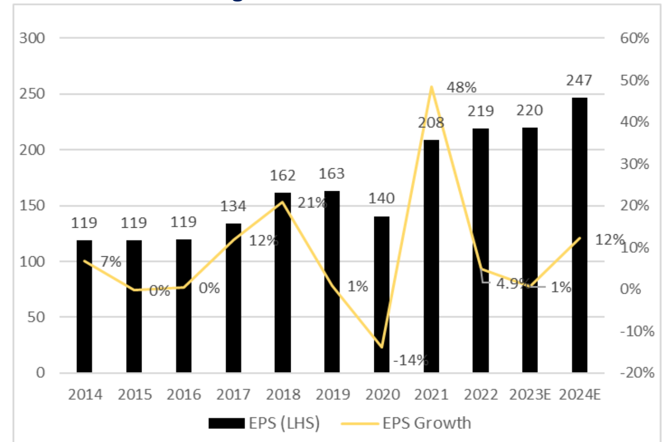
Our reading from the above is that the market is starting to get a bit worried about EPS growth estimates. Note that after a YoY decline in 1H23, consensus expects EPS growth to return in 2H23 followed by 11% EPS growth in 2024.

What is the upside risk for equities?

Let's first define upside risk. In simple terms, it means a high excess return (>6%) over that of a risk-free fixed income security in the same currency.

With analysts already penciling in return to EPS growth in 2H23 and 2024, which translates into 2019-2024 EPS CAGR of 8.7% (including inflation bump) compared to 2014-2019 EPS CAGR of 6.5% (including tax bump), and with equity risk premium compressed, the question then is what would help generate high excess returns.

Chart 4: S&P EPS and growth.



Source: FactSet.

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We think it could be this combo:

- EPS and margins recover as expected by analysts.
- FED pivots its monetary policy like it did in 2019.
- Growth in rest of the world surprises like 2006-2007.

Chart 5: FED Model (adjusted) risk premium.

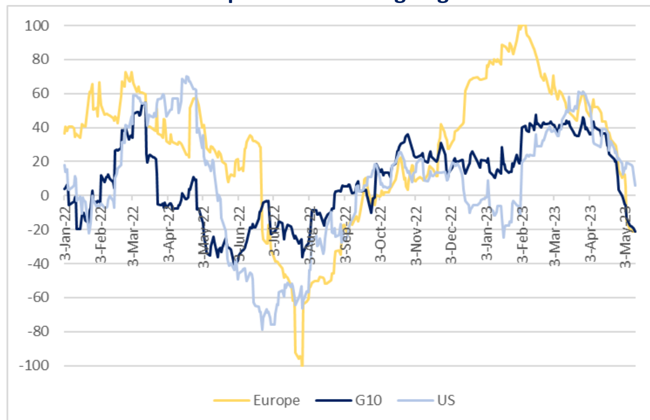
Source: Bloomberg, Farro. (S&P Earning Yield less US 10yr real yield).

Conclusion

We understand that the market – "wisdom of crowds" – maybe looking beyond yield curve inversions, nominal and real, and the risks, debt ceiling and quantitative tightening, on the horizon.

However, our reading is that equity market could be stuck between a rock (earnings recession in 2H23-1H24) and a hard place (no rate cuts + higher LT bond yields) with a friction free journey (rate cuts + no earnings recession) a low probability scenario.

Chart 6: Economic surprises are turning negative.



Source: Citi economic surprise indices.

Portfolio Positioning

This is where the rubber meets the road; as human beings we often tend to be long on words and short on action, especially in times of uncertainty. To get around this hurdle, one needs to first acknowledge that decision making can never be as precise as theory suggests and at the same time have a clear and easy-to-explain decision process. In that respect, it helps to work with approximations. After all, in matters of uncertainty it's probably better to be approximately right than precisely wrong.

So, first, no matter what the benchmark, a holistic approach that encompasses key elements of portfolio construction i.e., diversification (free lunch), value investing (avoid overpaying), collateral management (avoid forced selling) and positive convexity (optionality) remains of utmost importance.

Second, there are no easy answers, and a binary high-conviction positioning is doomed to disappoint most of us given the uncertain outlook that entails a wide range of outcomes with little clarity on their probabilities. That said, on balance, we see more downside than upside risk and for active portfolio management, recommend a barbell approach with following anchors:

- Defense is the best offence; carry is the best alternative.
- Quality is king, always. Value will stay relevant. High Growth will remain challenged.
- Secular trends remain powerful.
- Optionality is Attractive.

Within equities, we have an overweight stance on quality, and dividend along with an offensive overlay in equities exposed (irrespective of factor exposure) to secular trends i.e., global themes. In terms of sectors, we are overweight on healthcare and staples whereas neutral on technology. We believe that in the likely scenario of a typical recession or higher-for-longer interest rates, big-tech sector valuations will come under pressure. Meanwhile the healthcare sector looks relatively attractive both in terms of fundamentals and valuation.

Sectors	Stance
Technology	EW
Financials	UW
Healthcare	OW
Staples	OW
Discretionary	UW
Industrials	EW
Energy	EW

Factors	Stance
High Growth	UW
GARP	EW
Quality	OW
Value	EW
Dividend	OW
IG	UW
HY	UW

EW: Equal Weight, OW: Overweight, UW: Underweight

Finally, as always, if you (as an individual or an institution) find the reward of active management not worth the time and effort, the alternative is to just sit tight on passive vehicles with asset allocation in line with your risk appetite and let the market – "wisdom of crowds" – do its thing.

For further details on our active fund management capabilities and strategies, you can reach out to us at IR@farrocapital.com

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