

Can You Trust the New Bull Market?

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Since the low in mid-October the S&P 500 is up over 24% – technically, a new bull market has officially been born. Much of this has been led by the well documented mega-cap heavyweights. This strength though is still rather remarkable when you consider the fact that the Fed has been aggressively raising interest rates at the fastest pace in over forty years and is likely not done yet. We'll look at some interesting things happening beneath the surface.



The optimism that investors have been expressing via stock prices looks like it's already looking past the recession that hasn't happened yet and if we do have one for it to be rather mild. Or, you could argue that there's already been rolling recessions in various parts of the economy. Some prominent examples: housing related stocks fell by over 40% in the seven months that ended in mid-June last year, technology stocks for the ten months that ended in mid-October fell by over 34%, and S&P 500 itself fell by over 25% to its low in mid-October last year. The market is ever forward looking and presently it appears to be discounting an economy that has already absorbed the bulk of the rate increases as reflected by the significant downdrafts that occurred in 2022.

Over the past fifteen months the Fed has raised rates by 500 bps and this past week didn't raise rates for the first time since they began raising rates in March of last year. What has this 500 bps accomplished to date? The CPI was at 7.9% in February 2022 when they began raising rates and it's now at 4.0% in the most recent reading (of note, this is the eleventh month in a row that it has fallen and it's at its lowest since April 2021). One of the Fed's preferred readings on inflation, the Core PCE, is now at 4.7%. This is down from 5.4% in February 2022 – the Fed would like to see this much closer to 2%. So, we can clearly see that much further progress is needed on this metric. In February 2022 unemployment was 3.8% – today it's at 3.7%. I think it's safe to say the Fed has done a good job to date of significantly raising rates while keeping the labor market fully employed. But, as mentioned, there's more wood to chop to get inflation closer to target.

The mega-cap stocks have led the way in this market rally, the rationale being that their business models will thrive even if we go into a recession. However, the broad market hasn't kept pace with the uber-hot stocks like NVIDIA and Telsa. The S&P 500 Equal Weight Index is up 18.2% since its low reached at the end of last September compared to the S&P's 24.7% from its October low.

Just recently, we're finally seeing some encouraging signs of the market broadening out. It obviously remains to be seen if this will last, but since June 1st the S&P Equal Weight is up 5.8% compared to the S&P's 4.5%. Also, small-caps and mid-caps are also outperforming the S&P 500. The Russell 2000 and the S&P 400 Midcap indices are up 6.2% and 6.5% respectively compared to the S&P's 4.5%. This is healthy and would be a major boost to the market if this can be sustained.

So, can you trust this bull market? It's worth noting that the VIX, credit spreads, and financial conditions appear to be on the optimistic side. The Volatility Index (VIX) is currently at its lowest since mid-February 2020 – this is right before Covid-19 hit the markets. As well, high yield credit spreads and the Goldman Sachs Financial Conditions Index are both lower now than where they were at the start of the year. Perhaps this is due to a strong economy, unemployment that is low and stable (for now) and consumers, in general, continuing to spend. But this just reinforces the likely need for further rate increases if inflation remains stubbornly higher than the Fed's target. The rally in equities is welcomed, but stock prices right now are essentially forecasting that the Fed's fight to bring down inflation has already been won. History tells us that this is still very much TBD.



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