Market Note

New Bull or Bear Market Rally

8/4/2022

Aaron Dirlam, CFA®, CAIA®
Chief Investment Officer

Paul Courtney, CFA®, CAIA®
Director of Research

Summary

- The "pain trade" rally we outlined in Market Scenarios & Risk Levels is well underway with Technology stocks and high yield bonds up 15.2% and 7.0%, respectively, since July 6.
- The rally has cleared excessively bearish sentiment, which is no longer at levels historically associated with significant upside in stocks.
- The Treasury yield curve, as proxied by the 2s10s spread, is inverted by 37 basis points and suggests growth is slowing sharply while real-time inflation forecasts suggest inflation could remain stubbornly high in the coming months.
- A Fed pivot would be positive for risky assets, but inflation is far from the Fed's target and they may need to tighten further into a sharp slowdown against a backdrop of above average valuations—we believe patience and some caution are still warranted.

Market Scenarios

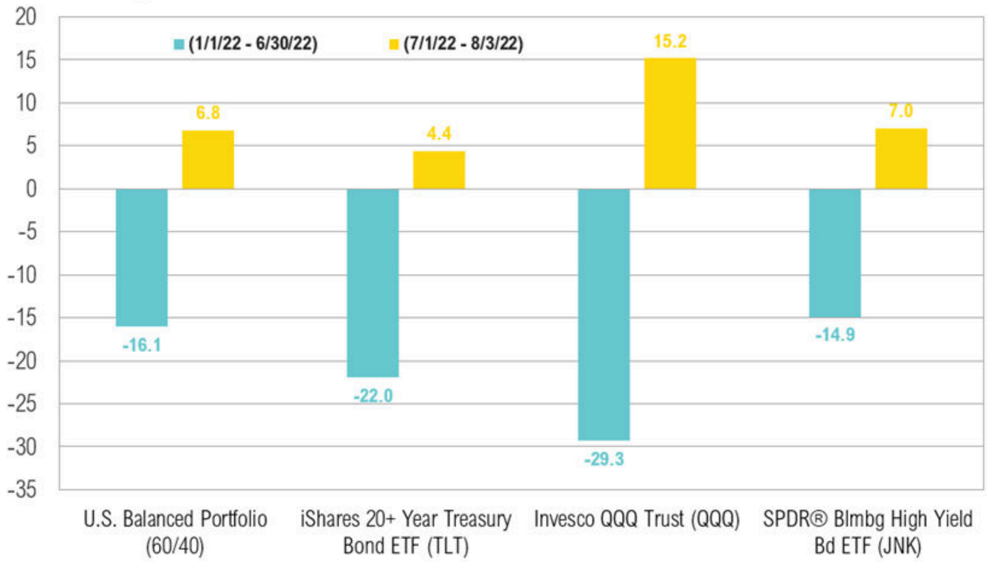
In our July 6, 2022 market note Market Scenarios & Risk Levels, we outlined the potential for a return to the "Goldilocks/deflation" trade that could catch markets flat-footed from a positioning standpoint and benefit some of the most out-of-favor assets, including technology stocks and high yield bonds. An excerpt from that note is below:

> "As markets continue to tilt away from an inflationary tone to more of a recessionary one, we want to make sure portfolios are not left flat-footed for multiple outcomes and timeframes. Below we want to lay out two of those scenarios for consideration.
>
> A return to the "Goldilocks/deflation" trade
>
> While this scenario may seem counter-intuitive given the U.S. economy may be on the brink of a recession, a resumption of the deflation trade could mean that longer duration bonds rally, technology stocks outperform, credit spreads contract (high yield bonds outperform), and inflation hedges including commodities lag. We fully acknowledge that technology stocks rallying into a slowing economy and potential recession may seem like a low probability event but given how much longer duration assets have lagged over the last six months, we do not want to underestimate the potential for this to play out. A catalyst for this could be the recent decline in commodity prices, which, if it continues, will result in a decline in inflation fears, providing some cover for the Federal Reserve to ease back from their hawkish stance. While we are not positioned for this per se, we want to make sure we consider that this may be short-term "pain trade" (the trade that seems least likely, that fewest market participants are positioned for, and that may play out as a result). Whether or not this scenario could play out for more than a few months would come down to whether or not inflation inputs (and headline inflation) roll over dramatically and stay low versus just pausing before rising again."

The rally described above is well underway with technology stocks and high yield bonds up 15.2% and 7.0%, respectively, since July 6. Longer-duration bonds have underperformed high yield bonds, but they have performed well in absolute terms. Inflation hedges including commodities have lagged.

July Rally Compared to the First Two Quarters of the Year

Total Returns, %



Source: Morningstar

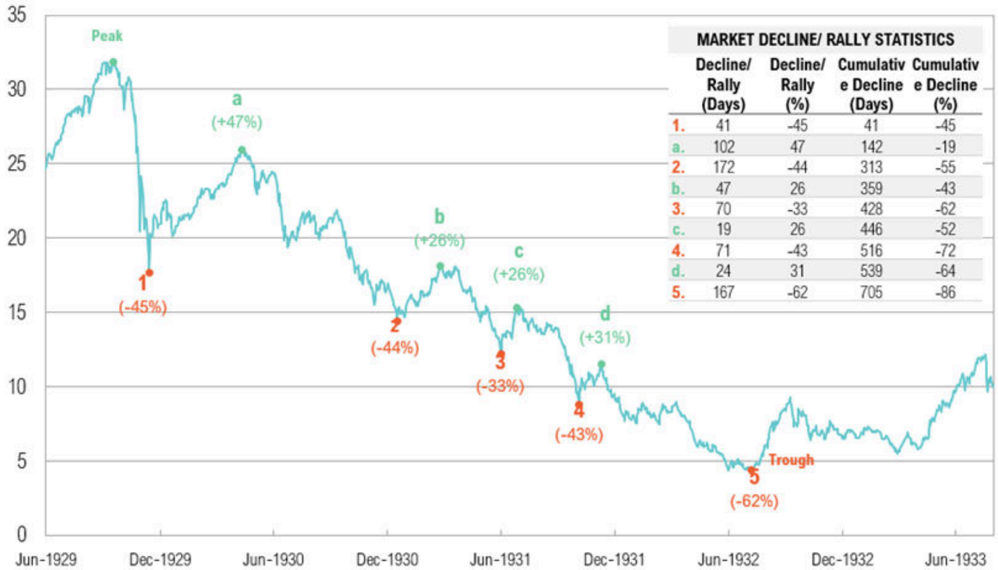
While there are promising signs that inflation is decelerating, it may require more than just a deceleration for the Fed to pivot (versus just pausing) back to an easy-money stance. Until that pivot occurs, the lagged impact of higher rates and the expected ramp up in quantitative tightening due in September will likely limit the upside for longer-duration risky assets.

Bear Market Rallies

In the charts below we present some context for the current rally. During the bear market that started in 1929 and continued through the Great Depression, there were at least four significant rallies that all ultimately failed. The average duration and percentage gain for them was 48 trading days and 33%, respectively.

Bear Market Anatomy: 1929 Crash & Great Depression

S&P 500 Index



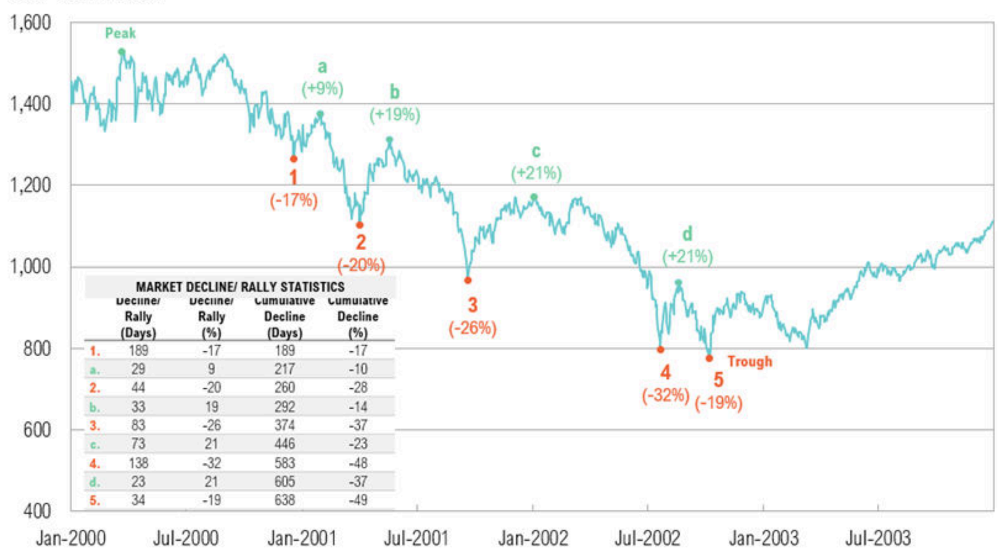
	Decline/ Rally (Days)	Decline/ Rally (%)	Cumulative Decline (Days)	Cumulative Decline (%)
1.	41	-45	41	-45
a.	102	47	142	-19
2.	172	-44	313	-55
b.	47	26	359	-43
3.	70	-33	428	-62
c.	19	26	446	-52
4.	71	-43	516	-72
d.	24	31	539	-64
5.	167	-62	705	-86

Source: Bloomberg. *Days are represented by trading days.

Similarly, during the unwind of the Tech Bubble, the average bear market rally lasted 40 trading days and took the S&P 500 higher by 17.5%.

Bear Market Anatomy: Tech Bubble Bursting

S&P 500 Index

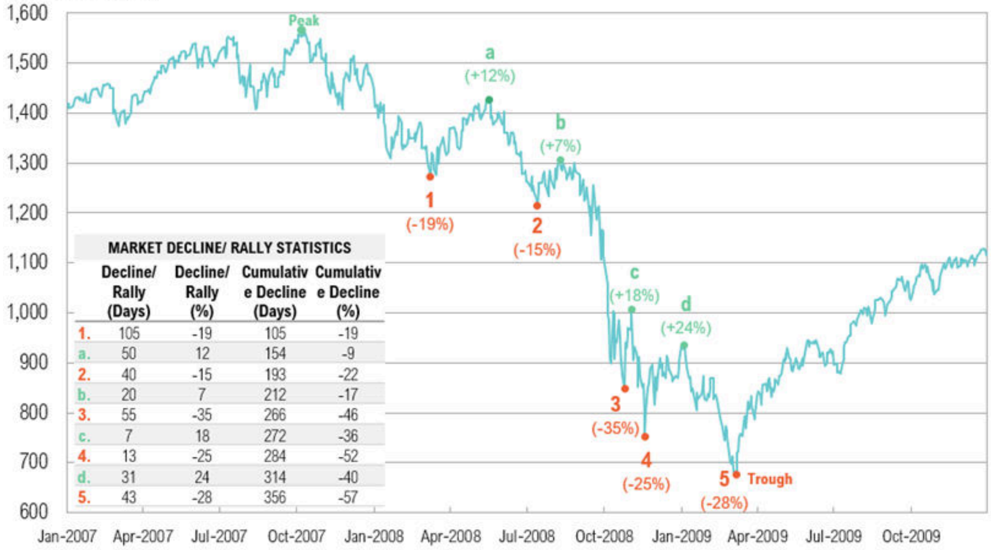


	Decline/ Rally (Days)	Decline/ Rally (%)	Cumulative Decline (Days)	Cumulative Decline (%)
1.	189	-17	189	-17
a.	29	9	217	-10
2.	44	-20	260	-28
b.	33	19	292	-14
3.	83	-26	374	-37
c.	73	21	446	-23
4.	138	-32	583	-48
d.	23	21	605	-37
5.	34	-19	638	-49

Source: Bloomberg. *Days are represented by trading days.

Bear market rallies during the larger stock rout associated with the Global Financial Crisis averaged 15.3% and lasted an average of 27 trading days. The entire decline lasted 514 days.

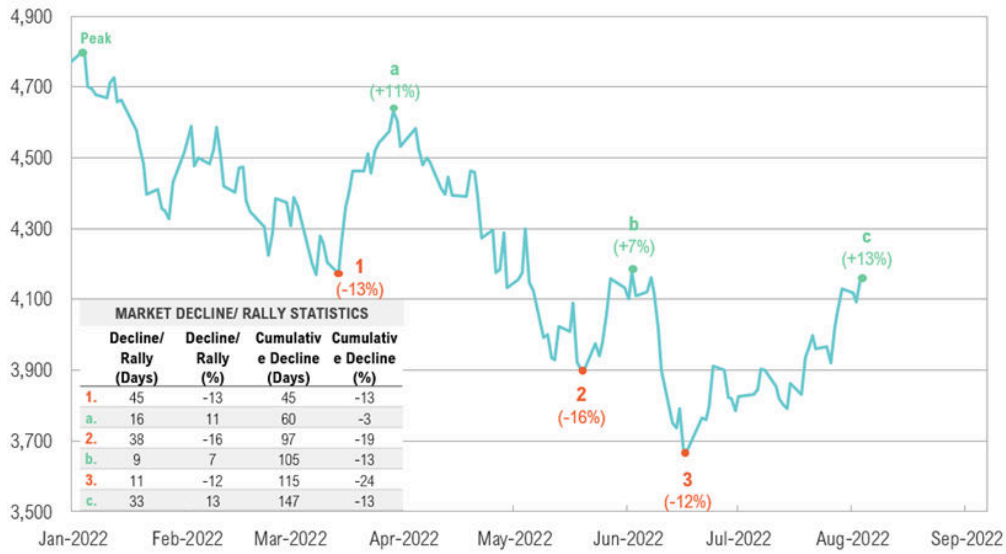
Bear Market Anatomy: Global Financial Crisis
S&P 500 Index



Source: Bloomberg. *Days are represented by trading days.

The current rally from June 16 has taken 33 trading days for a gain of 13%.

Bear Market Anatomy: 2022 Inflation Shock & Slowdown
S&P 500 Index

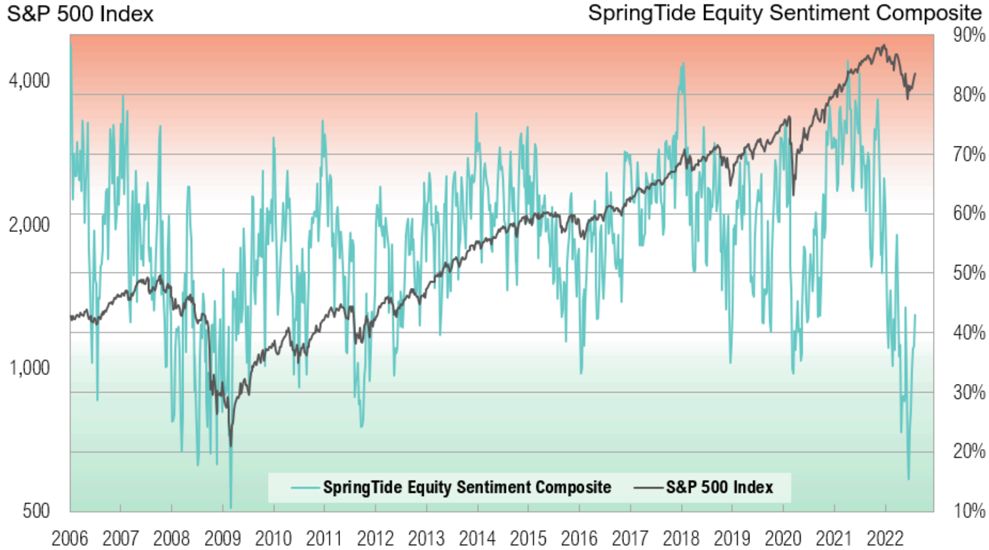


Source: Bloomberg. *Days are represented by trading days.

The average bear market rally presented across all the examples above has lasted about 34 trading days and has carried stocks higher by 19%. If we exclude the Great depression, the average rally has lasted 29 days for a gain of 14%, roughly in line with where we are today.

The catalyst for the current rally was extremely negative sentiment suggesting market positioning had become tilted away from longer-duration risky assets and towards a general risk-off posture and inflation hedges. The SpringTide Equity Sentiment Composite, a blended aggregate of multiple U.S. equity sentiment measures, hit 15% on June 24, the lowest level since the Global Financial Crisis. Since that time, sentiment has approved and currently is at 43%.

Equity Sentiment Back Above 40%



Source: AAII, Investor's Intelligence, TD Ameritrade, NAAIM, UofM, Standard & Poor's, Gallop, CBOE, SpringTide calculations

Despite many examples of significant bear market rallies that ultimately failed, sharp rallies with strong participation across sectors and market capitalizations, as the current rally has exhibited, should still be respected given what they *may* communicate about the health of the market. The challenge lies in separating signal from noise, which we attempt to do below.

The table below summarizes every instance in the last five decades where stocks declined more than 7.5% in a month and then rallied at least that much in the subsequent month (as just happened in June/July). On the surface, each one of the examples provided an attractive entry point for stocks as forward 12-month returns averaged approximately 30%.

Sharp Reversals in Stocks Can Be Attractive Entry Points

	S&P 500 Fwd Total Returns, %				Shiller	Inflation	Fed Fnds	Real FFR	
Date	1M	3M	6M	12M	P/E	(CPI)	(%)	(%)	Note
10/31/74	-5%	4%	18%	20%	9.0	12.1%	10.1%	-2.0%	• Fed pivots, start of aggressive rate cutting cycle • Inflation at 11.5% in June and the Fed Funds Rate at 13%. Rates were cut to 9.25% in November, and further to 8% in December. • Recession ended in March 1975 with the Fed Funds Rate at 5.5%.
10/31/02	6%	-3%	4%	19%	23.4	2.2%	1.8%	-0.5%	• Fed in aggressive easing mode. • Near end of a prolonged easing cycle and multi-year bear market in stocks. • Fed cut interest rates by 50bps to 1.25%, a new 40-year low. It was the first cut of the year following 11 cuts in 2001.
3/31/09	9%	15%	32%	47%	15.0	-0.4%	0.2%	0.6%	• Fed in aggressive easing mode after taking rates to zero and starting QE. • Rates at 0% & expected to stay there after 200bps cut in the end of '08. • QE: purchase of an additional $750bn MBS, $100bn agency debt and $300bn long-term treasuries over the next 6 months.
1/31/19	3%	9%	10%	19%	29.5	1.6%	2.4%	0.8%	• Fed pivot with inflation under 2% and growth slowing. • Fed indicated no more rate hikes following 9 hikes in 2018, ended balance sheet roll-off program at the end of September. • Reduced GDP growth and inflation expectations.
4/30/20	5%	12%	12%	44%	36.6	0.3%	0.1%	-0.3%	• Fed embarks on massive easing via rates and aggressive QE. • Rates cut by 250bps. • Ramps QE, provides up to $2.3 trillion in loans, expands access to its paycheck protection program liquidity facility.
7/31/22	??	??	??	??	28.9	9.1%	2.5%	-6.6%	• Fed potentially near a pause, but still hiking rates and about to ramp *quantitative tightening*. • Rates hiked by 75bps with an additional 50bps expected by market. • Inflation expected to drop from 40-year high of 9.1% in coming quarters.

Source: Bloomberg, SpringTide calculations

However, based purely on duration and size, the stock market rally that began on June 16 is, if anything, unremarkable. While sharp reversals like the one that occurred last month coupled with a major Fed pivot are much more significant, we believe it is the Fed pivot that makes them significant, not the rallies themselves.

The Fed Pivot

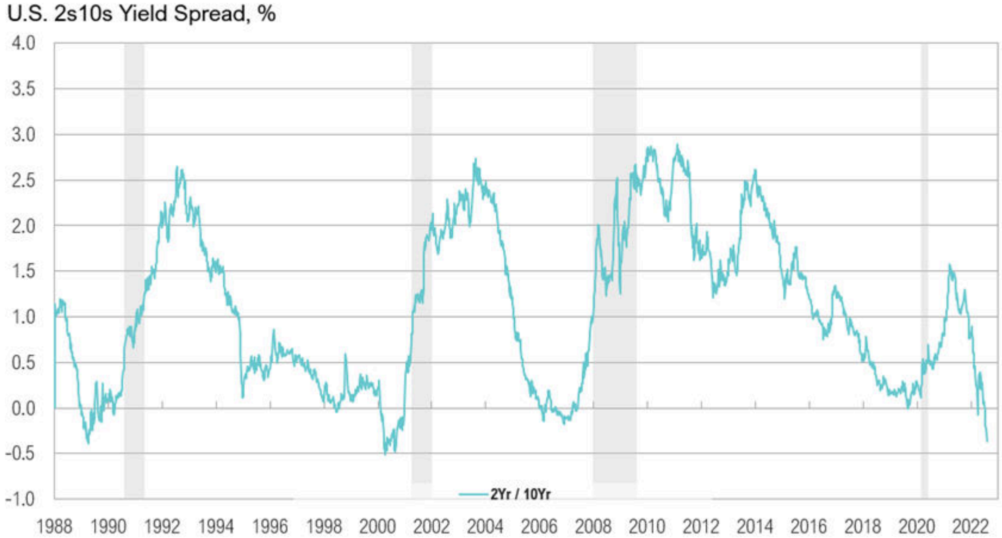
The recent rally was also helped by the dovish interpretation of Fed Chair Powell's comments at the July 27 Federal Open Market Committee (FOMC) meeting. There were at least three reasons for this interpretation: (1) Powell acknowledged current economic weakness, (2) he pointed out that the hikes made thus far would continue to impact the economy with a lag and (3) he said that the current Fed Funds rate was "right in the range of" the Fed's estimate of the neutral rate. Taken together, this implied the Fed was nearing the end of the current hiking cycle and would be making future decisions based on incoming data rather than guiding multiple meetings into the future.

Despite the market's dovish interpretation, the FOMC hiked interest rates by an additional 75 basis points and plans to accelerate the pace of the balance sheet reduction ("quantitative tightening") to $95 billion per month in September. Further, Powell reaffirmed the Fed's commitment to getting inflation back down to their long-term target of 2%. In the days following the meeting, this commitment to get inflation back to target was echoed by multiple senior Fed officials including Minneapolis Fed President Neel Kashkari, San Francisco Fed President Mary Daly, Cleveland Fed President Loretta Mester, and St. Louis Fed President James Bullard.

Powell's comments at the July FOMC press conference were quickly reflected by the market, with Fed Funds futures now pricing in a 3.25% rate at the end of 2022 and the first rate cut in early 2023. The 2-year Treasury Note yield has increased very slightly to 3.1% since the Fed meeting while the 10-Year Treasury Note yield has declined to under 2.7%. As a result of these moves, the Treasury yield curve, as proxied by the 2s10s spread, has declined further and is now inverted by 37 basis points, suggesting growth is slowing sharply.

U.S. Treasury Yield Curve Near Historically Wide Inversion

U.S. 2s10s Yield Spread, %



Source: Bloomberg

There are positive factors that should help ease inflation in the coming months including improving base effects, lower gas prices, commodity prices that are well off their peaks, and slowing economic growth; however, there are also negative factors that may frustrate policymakers and markets and keep inflation higher than the Fed's target. These include the lagged impact of near record-high housing costs, historically tight global energy markets, still-tight labor markets, and heightened geopolitical tensions. While we believe inflation will be more of an issue than it has been for the last few decades, there is no way to *accurately* predict how all of these variables will converge—we're all data dependent now!

According to the Cleveland Fed's Inflation Nowcast, July inflation is expected to come in at 8.8% year-over-year and August inflation, which will be reported a week before the September Fed meeting, is expected to remain at 8.8%. According to the same Nowcast, core inflation is expected to accelerate from 6.1% year-over-year in July to 6.4% in August. If the Fed does indeed pivot with inflation at these levels, it will be a first.

Despite the challenging macroeconomic backdrop, valuations for longer-duration risky assets remain elevated as evidenced by the price-to-sales ratio of the technology-heavy NASDAQ 100 Index. While valuations have improved substantially, they remain high relative to any other period in history with the exception of the Tech Bubble.

Technology Valuations Remain High Relative to Pre-Pandemic

NASDAQ 100 12-Month Forward Price-to-Sales Ratio

Source: Bloomberg

Summary and Positioning

The Fed's move to data dependency has the potential to increase volatility for interest rates and asset markets. While the July FOMC press conference and recent market developments suggest the Fed may be nearing the end of the current hiking cycle, inflation remains a long way away from the Fed's target of 2% and may stay elevated for some time particularly because of the lagged effects of the heavily-weighted shelter component of CPI.

As it relates to positioning, we are extending duration out of cash and cash proxies into the 2–3-year part of the Treasury curve. Within fixed income and credit, we are implementing a targeted investment grade credit position in the 3-4-year part of the curve. In equities, we are maintaining tilts to quality and value while staying modestly underweight risk. We also are maintaining allocations to energy and energy infrastructure assets and precious metals as hedges against persistent negative real interest rates.

If inflation eases more than we expect, overall asset markets should do well and our portfolios will likely not fully participate to the upside. If inflation remains stubbornly above 2% and the Fed remains data dependent, they will be forced to continue to tighten monetary policy, which could drive longer-duration risky assets materially lower and our relatively conservative positioning will help. Finally, if inflation stays stubbornly high yet the Fed pivots anyway, stocks may do well, but we believe precious metals and our underweight to duration will make up for the underweight to equities.

In short, we believe patience and some caution are still warranted.

Sincerely,

The SpringTide Investment Team

Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

Citations

1. n/a

Disclosures

The material shown is for informational purposes only. Any opinions expressed are current only as of the time made and are subject to change without notice. This report may include estimates, projections or other forward-looking statements; however, forward-looking statements are subject to numerous assumptions, risks, and uncertainties, and actual results may differ materially from those anticipated in forward-looking statements. As a practical matter, no entity is able to accurately and consistently predict future market activities.

Additionally, please be aware that past performance is not a guide to the future performance of any investment, and that the performance results and historical information provided displayed herein may have been adversely or favorably impacted by events and economic conditions that will not prevail in the future. Therefore, it should not be inferred that these results are indicative of the future performance of any strategy, index, fund, manager or group of managers.

The graphs and tables making up this report have been based on unaudited, third-party data and performance information provided to us by one or more commercial databases. While we believe this information to be reliable, SpringTide Partners bears no responsibility whatsoever for any errors or omissions. Index benchmarks contained in this report are provided so that performance can be compared with the performance of well-known and widely recognized indices. Index results assume the re-investment of all dividends and interest. Moreover, the information provided is not intended to be, and should not be construed as, investment, legal or tax advice. Nothing contained herein should be construed as a recommendation or advice to purchase or sell any security, investment, or portfolio allocation. This presentation is not meant as a general guide to investing, or as a source of any specific investment recommendations, and makes no implied or express recommendations concerning the manner in which any client's accounts should or would be handled, as appropriate investment decisions depend upon the client's specific investment objectives.

Terms of Use

This report is intended solely for the use of its recipient. There is a fee associated with the access to this report and the information and materials presented herein. Re-distribution or republication of this report and its contents are prohibited. SpringTide Partners, LLC is a registered investment adviser with the Securities and Exchange Commission; registration does not imply a certain level of skill or training. For more detail, including information about SpringTide's business practices and conflicts identified, please refer to SpringTide Partners' Form ADV Part 2a and Form CRS at: https://www.springtide-partners.com/disclosures

Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

Asset Class Definitions

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Interm-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Interm-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.