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Equity Market Commentary

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The following views and perspectives are formed by the work of the Applied Equity Advisors team in managing assets for investors.

Some thoughts on recent market strength.

1. Last year, the best market prediction I heard came from a Chicago pal, Bob Curry, who said to me:

   The stock market is like a beach ball. It's been held under water for almost two years. When it's finally released, it won't just slowly float to the surface and that's it.

   What an accurate metaphor!

   Once the S&P 500 *finally* broke through the 4,796 two-year high, it took only 18 trading days to find 5,000.[1]

   The beachball didn't stop at the surface.

2. Now what? Here is more great feedback, sent to me from Gray Howard, down in Charlotte:

   While the market is certainly extended and it'd be healthy to see a pullback or some sideways consolidation, the S&P 500 is only about 6% higher from where it traded in January of 2022. Two years of going nowhere and then a breakout to new highs is hardly how major tops are formed.[2]

3. Not to mention, when a year commences with this much strength, historically it's a very good sign for the rest of the year.

[1] Bloomberg.

[2] Heck of a Run. February 28th, 2024.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

2024 is the 18th year since 1945 the market has been up 6% or more the first two months.

The average return from March until end of the year for the previous 17 times was **+11.9%** with only one instance where the market was down the rest of the year.[3]

4. Since the beginning of the year, the **2025** bottom-up consensus estimate for the S&P 500 has increased to **$277**.[4]

   Yet why should we be concerned with 2025 earnings in March of 2024?

   Leslie Delany and I frequently receive the question, "if you have cash waiting to invest, is now a good time?"

   In essence, investors are asking, "can I expect to make money from early March through the rest of the year?"

   That's why the 2025 estimate is crucial. On December 31st, 2024, the S&P 500 will price off the 2025 earnings outlook.

   The S&P 500 currently trades at 20.4x forward earnings, but only at 18.6x the 2025 estimate.[5]

   Therefore, if the estimate holds (as I said, it has already been revised upwards) and the P/E holds, there is the upside.

5. But will the P/E hold?

   P/Es are sentiment driven.

   Simply put, P/Es tend to go up if investors are moving directionally from fear to greed. Likewise, P/Es tend to go down if investors are moving from greed to fear.

   Monthly retail fund flows just turned positive in November, four months ago, after consistently selling into the rally off the October 2022 lows.[6]

   In my experience, it takes a year of a bull market for investors to realize the bear market is over. Just as they did in February 2021 off the March 2020 low.

   As per 2021, the capitulation back into the equity market lasted throughout 2021, driving the forward multiple to 22.4x for the S&P 500.[7]

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[3] Birinyi Associates, Inc.
[4] Factset as of March 1, 2024.
[5] Factset as of March 1, 2024.
[6] Investment Company Institute.
[7] Factset.

With it came significantly more speculation than we are seeing today. Margin debt soared; and does anyone remember SPACs?[8] What a bubble.

Could we get there again? The pundits will cite multiple reasons why this period is different.

However, I believe there is one thing the doubters can't question… investors' behavior is NOT different.

In the continuum of "bull markets are born on pessimism (2023), grow on skepticism, mature on optimism, and die on euphoria", I still think we are in the <u>skepticism</u> stage. [9]

6. It's not just retail investors that are <u>gradually</u> warming to the rally. As Birinyi points out:

   Wall Street strategists, after starting the year with an average year end forecast of 4,767, which would have been an ever so slight decline in 2024, have, reluctantly (and we suspect under pressure), started raising their forecasts. Typically, this is a negative, except when the average strategists' forecast continues to equate to a decline in the S&P 500. In January their forecast (4,867) was for a 0.5% decline to year end, while their most recent collective wisdom (4,897) is their most pessimistic yet.[10]

   Wall Street likewise remains in the skeptical stage.

7. As I wrote last month, there is an old Wall Street axiom: *Reversion to the mean is the iron rule of the financial markets*.

   The S&P averages a 5% pullback about three times a year.

   We have not experienced one since last October. We are due.

   The market also experiences a 10%+ correction about once a year.[11]

   I think that comes later in this year.

   Election year volatility tends to pick up as we get closer to the conventions in the summer.[12]

8. Another reversion to the mean that has already begun corrects 2023's concentration of performance of the magnificent 7 versus the rest of the market and last year's resultant poor performance of active management.

   As an active manager, it's virtually impossible to be overweight all 7 stocks.[13]

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[8] Fundstrat, March 2024.
[9] Sir John Templeton.
[10] Birinyi Associates, Inc.
[11] Bank of America Global Research, March 2024.
[12] Bank of America Global Research, March 2024.
[13] Maximum position limits and overly concentration rules guard against this.

Yet the magnificent 7's performance YTD has started to bifurcate. Some good, some so-so and some bad.

The result? Good potential for a far better year for active management, as picking and choosing winners is a more viable strategy than simply owning all of them.

That has certainly been the case for Applied Equity Advisors YTD.

9. Finally, the rumblings of "this is the year for non-US investing" seem to be perking up again.

To allocate to an international manager means taking money away from the US.

Over the last 30 years, MSCI EAFE (non-US) has returned 5.5% annually with an average annual intra-year correction of -17.5%.

The S&P 500 has returned 10.4% with an average annual intra-year correction of -14.7%.[14]

Does roughly 50% of the return with increased volatility sound good to you?

At some point, that non-US recommendation will work.

I'm not smart enough to know when, nor apparently are those who have been recommending that strategy.

To be clear, we think there are wonderful company-specific opportunities around the world.

Two of our largest relative positions in Global Concentrated and Global Core are European companies.

But then I wouldn't bet against our US stocks in those two strategies either.

Andrew

[14] Strategas, February 2024.

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