Asas Capital
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WEEKLY NEWSLETTER

June 9th, 2023

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Musings

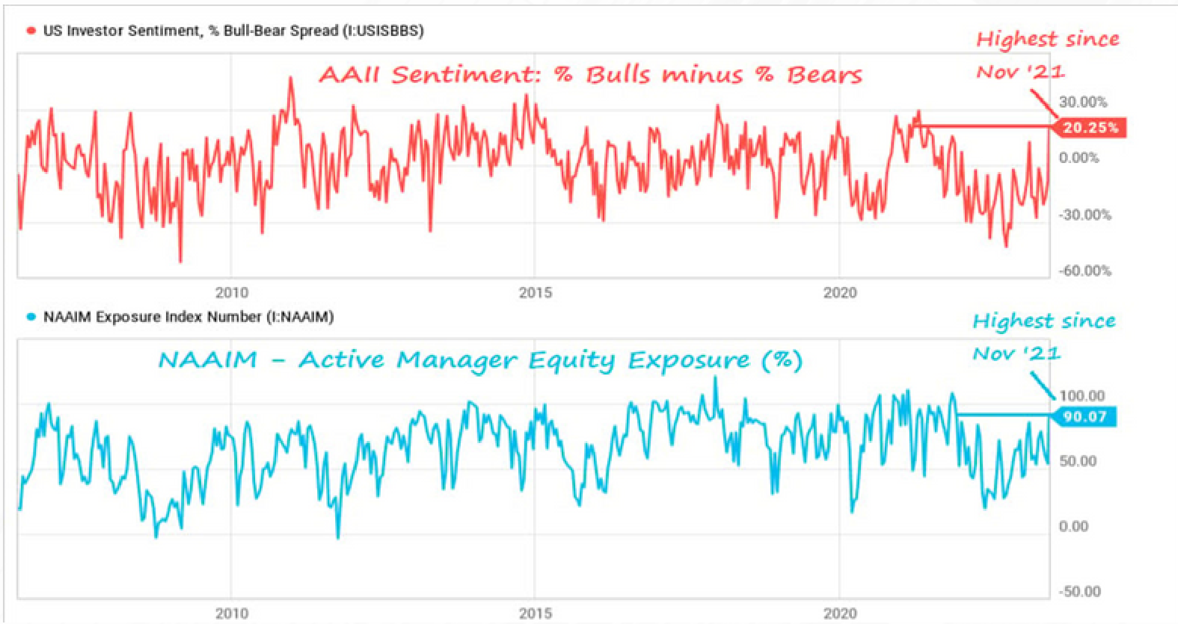
"In investing, what is comfortable is rarely profitable."

-Sir Robert Arnott

Last week in the markets

A few interesting things happened in the U.S. stock markets last week.

The S&P 500 closed more than 20% off its October lows on June 8th. At 248 trading days, the recent run back to a bull market was the longest bear run for the S&P since 1948. In doing so, it reached the **4,300 level that many analysts had seen as a potential target for this up move.**

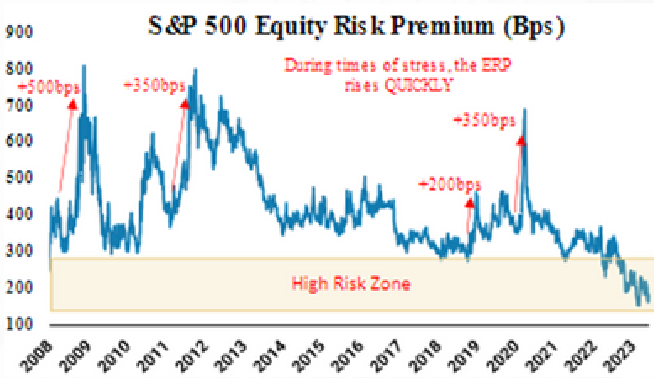


The breadth of the market also increased sharply. We have mentioned in our earlier newsletters how narrow the market breadth has been so far, with **only 7 stocks accounting for almost the entire gains of the S&P 500 in 2023.** That changed very sharply last week, with a broad-based rally that saw 10 of the 11 S&P 500 sectors push higher. Reasons included short covering of oversold positions, though it appears that at least that reason for the move has been exhausted now.

Market sentiment overall seems supportive of a move higher.

Meanwhile, **$VIX has moved down to 13.83, its lowest weekly close since February 7, 2020.** With the debt ceiling suspended, bank failure fears subsiding, the Fed expected to pause, and recession forecasts pushed out, the wall of worry that has persisted for over a year seems to have been torn down. Historically, there doesn't seem to be compelling evidence that such a high level of complacency is followed by poor stock market performance.

What is ERP? excess return that investing in the stock market provides over a risk-free rate. Currently, the equity return is higher due to the higher risk-free rate and not ERP. More than 100% of the reset on P/Es last year was a function of higher 10-year Treasury yields. It may be difficult to get bullish on stocks more broadly until this "reset" is more accurately reflected in the ERP.



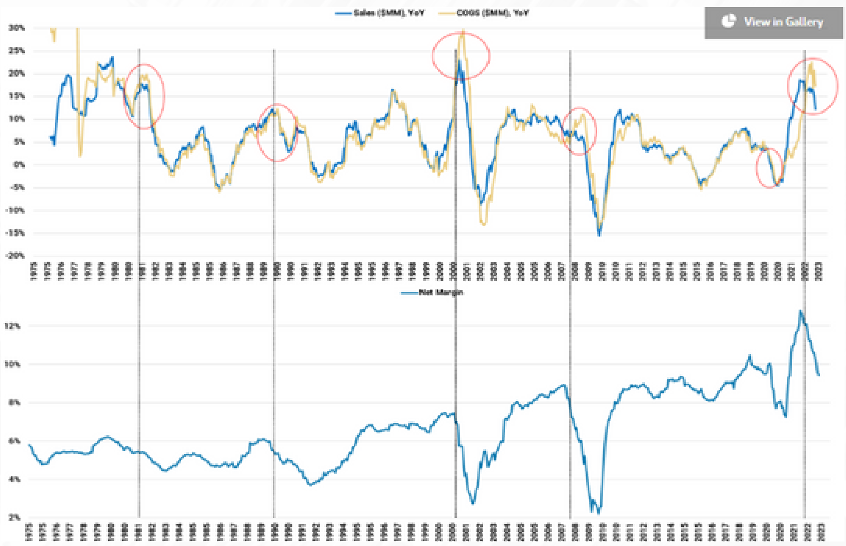
Source: Bloomberg, Morgan Stanley Research

The chart shows that ERP is at its lowest which was not even the case in global financial crisis.

The natural question is – where do we go from here?

Over the long term, stock prices follow corporate earnings. As the economy slows, earnings will eventually follow the same path. The cessation of the liquidity boost from pandemic-era Government support, the impact of rise in interest rates on the cost and availability of credit, the increase in unemployment rate that the Federal Reserve is targeting, the lingering negative wealth effect from the correction in financial assets in 2022 – all point to a slowdown in consumption. As such, it is hard to avoid the conclusion that markets are headed lower over the medium term.

That said, there have been many instances of stock markets rallying for several weeks or months within the context of an overall bear move.



Source: Morgan Stanley

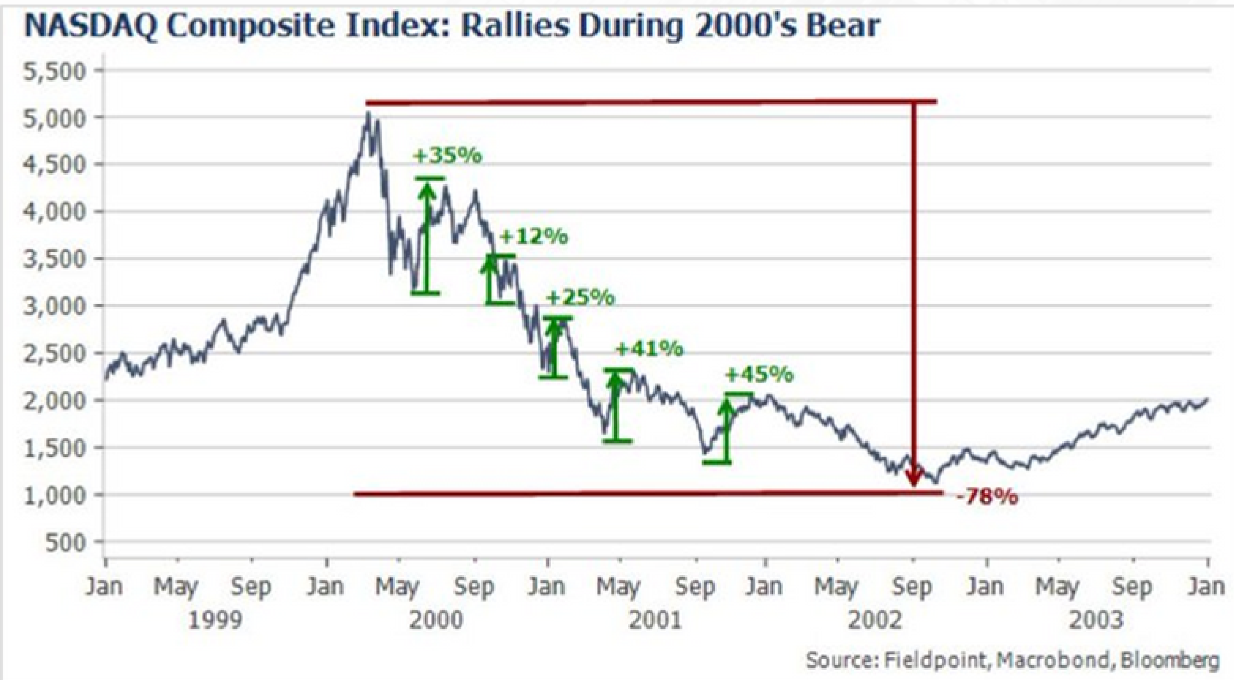
The chart above clearly shows a compression in net margins as the cost of sales is growing higher than top – line growth due to dilution in pricing power.

One must also factor in that even though the U.S Government borrowed $ 359 billion on the same day as the Fiscal Responsibility Act was signed (oh, the irony!), the market barely moved a muscle. The dry powder available, especially with money market funds, was able to absorb the liquidity withdrawal without trouble.

In investing as in life, you often don't get the cards that you like, but trade the cards you get. As such, we bow for now to the momentum of the market and open ourselves up to the possibility of further upside from these levels in the near term. Given the low levels of volatility, we prefer to play the long side using option strategies.

A huge week is setting up on the macroeconomic front, with the Federal Reserve and the European Central Bank both scheduled to decide on interest rates and update monetary policy amid persistent inflation. The consensus view is that the ECB will lift interest rates by a quarter point and the Federal Reserve will stand pat.

Chart of the week



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