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INVESTMENT ADAGES TO EXPLAIN EQUITY MARKETS TODAY AND NOT WORRY (TOO MUCH) ABOUT THE FUTURE

10/05/2023 | FRÉDÉRIC LEROUX

Recent quarters were great ones for stock markets in advanced economies. Between end-September 2022 and end-April 2023, the S&P 500 gained 16%[1] and the Euro Stoxx 50 rose 31%[1]. That's a nice surprise considering the sentiment among investors and savers last summer. Should we consider this to be a "normal" rally, or does it instead reflect atypical market behaviour? And does it give us a valuable indication of what we can expect beyond the next few months?

This sharp rebound came after a period when markets were largely weighed down by monetary tightening of an unprecedented extent, compounded by the war in Ukraine's initial effects on energy prices. But still! The scale of the rebound – which erased all of last year's losses in European markets – can be explained neither by the upcoming and widely expected end to monetary tightening ahead of a fairly long pause by central banks, nor by the economy's gradual return to normal several months after the war in Ukraine broke out, nor even by the fact that US core inflation finally peaked last October.

> *An economic climate that poses serious challenges yet without impacting financial markets is not uncommon.*

While the above three factors are undeniably positive, a number of threats and unresolved issues remain, including recurring ones – like geopolitical tensions with China, the US public debt ceiling, and the stretched valuations of US stocks – and more specific ones, like the energy equation. Also, we shouldn't forget the lagging effects of unprecedented monetary tightening. Isn't the US banking crisis a case in point?

This crisis has put a squeeze on lending and further increased the probability of a US recession. **However, we believe any such recession will be relatively moderate, since the high amount of debt in the system means a deep recession could make that debt unsustainable – a fact central banks are keenly aware of**. And secondly, lower inflation could lead to higher real household incomes, enabling consumers to absorb at least part of the economic shock.

An economic climate that poses serious challenges yet without impacting financial markets is not uncommon. At most it reflects a paradox in which market movements are guided more by investors' extreme positioning than by what one would expect from the steady flow of macroeconomic and geopolitical news.

The 2022–2023 monetary tightening and worries associated with the war in Ukraine prompted a selloff that left investors with a very pessimistic positioning in equities – too pessimistic relative to the (even downbeat) news surrounding those two major developments. Owing to this underweighting in equities, the market is now poised to rise, in keeping with the adage: "A bull market climbs a wall of worry."

(1) Source: Bloomberg 28/04/2023

Or in other words, a situation where investors' positioning is too negative for the perception at a given point in time, driving a rally in equities. Those who come late to the party are forced to "buy the dips" if they don't want to miss out on the bull run. The wall of worry is thus climbed and latecomers are required to buy the dips until investors' positioning is no longer overly conservative or until a genuine shock – preferably exogenous – comes along, as we saw in early 2020 when the pandemic hit, putting an abrupt halt to the paradoxical market rally that began in 2019.

> *"The US banking crisis and the resulting squeeze on lending have increased the likelihood of a recession in the country."*

Given all the above, what should we expect to see in the coming months, which stand to be typical of the end of a cycle where stock markets are torn between hopes of a pause in monetary tightening and worries of an economic slowdown? **Investors' positioning today is considerably less pessimistic than it was last summer, but there are still some big diversified and alternative asset managers that are largely underinvested in equities. This could drive a further rise in stock markets.**

But beyond that, and in light of the threats still hanging over the economy and financial markets, these asset managers will need to adopt the mantra: "bad news is good news", meaning that bad news for the economy is good news for the stock market. We saw this in the previous decade when persistently sluggish economic growth ensured that monetary policy would remain accommodative and liquidity injections would continue to support valuations.

Among the concerns mentioned earlier, the US banking crisis is one candidate for bad news that can be turned into good news. This crisis could reduce lending activity and force the US Federal Reserve to inject large amounts of liquidity into the system, bringing what the markets are expecting (an economic slowdown that pulls down prices) along with a cure for the economic slowdown: monetary easing. **The current paradox in which stock markets are marching upwards despite the menacing fundamentals could very well continue for as long as a deep recession is avoided.**

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