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The Brevity Series – Technical Trading

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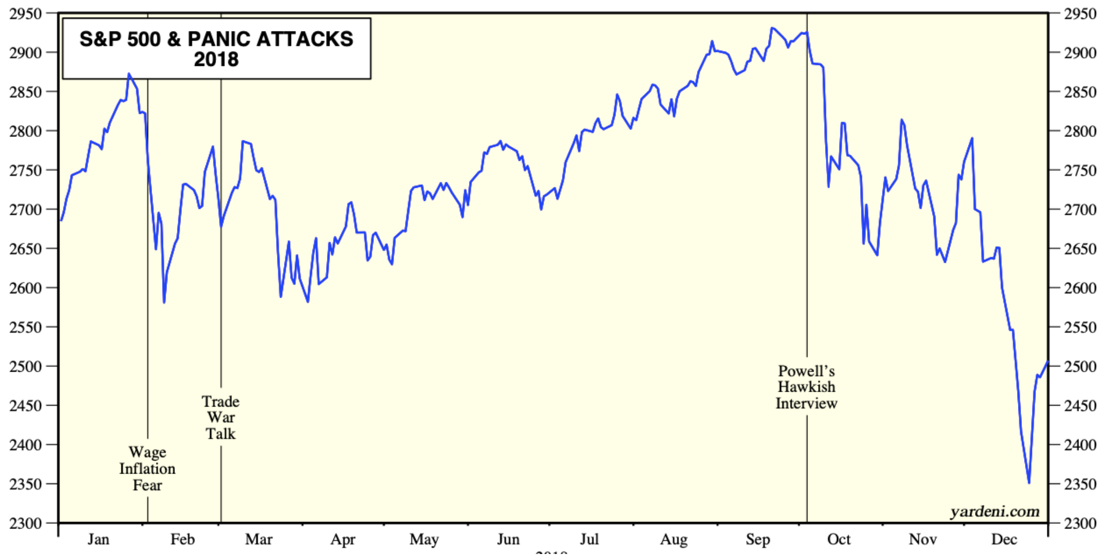
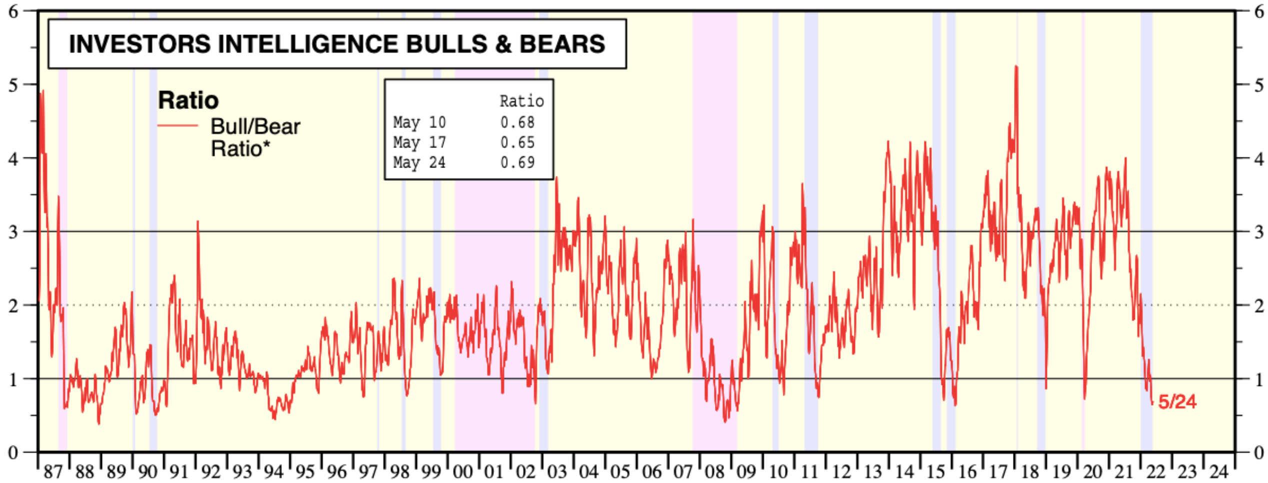
Stock markets continue to be driven by technical factors, not fundamentals. On Friday, May 20th, the S&P 500 dipped into bear market territory on an intraday basis, then roared back to close above the critical -20% level. It made another run at bear market territory on Tuesday, May 24th, and once again it failed to close below the -20% threshold.

We recently commented that the definition of a bear market was arbitrary and simplistic. We should have also pointed out that arbitrary and simplistic doesn't mean unimportant. If enough investors/traders are focused on a market level, its importance becomes self-fulfilling, despite being arbitrary. That's happened twice in recent days. It also happened during the 2018 Taper Tantrum. In December of 2018, markets dipped below -20% intraday but couldn't hold the bear market threshold into the market close, recovering and closing down -19.9%. In 2018, the rejection of a bear market turned out to be a market bottom.



With a modest level of confidence, we think that may have been what happened on Friday, May 20th. The S&P 500 failed to hold below the critical down -20% level. Many technicians have pointed to the recent twice-failed bear market sell-off and intraday rebound as a “double bottom". Market Technicians view the *double bottom pattern* as a charting pattern that reverses bearish trends and negative momentum.

Technicals are a curious thing. Although we think building an investment process purely on technical signals is borderline malpractice, we must also acknowledge that technical signals play a significant role in short-term market movements, especially during rapidly trading high volatility periods. The only technical signal we officially recognize in our equity framework is the Bull/Bear Ratio. We’ve mentioned this ratio before. We consider this signal a valuable timing aid when increasing or decreasing equity exposure. It measures investor sentiment and is a contrary indicator. When investors are overly pessimistic, it has historically been an excellent long-term buying opportunity. Although this signal’s forecasting ability is not as strong when investors are overly optimistic, it’s also done a decent job of identifying overbought markets. Overbought conditions tend to last longer than oversold conditions, so it's more valuable in identifying entry points than exit points.

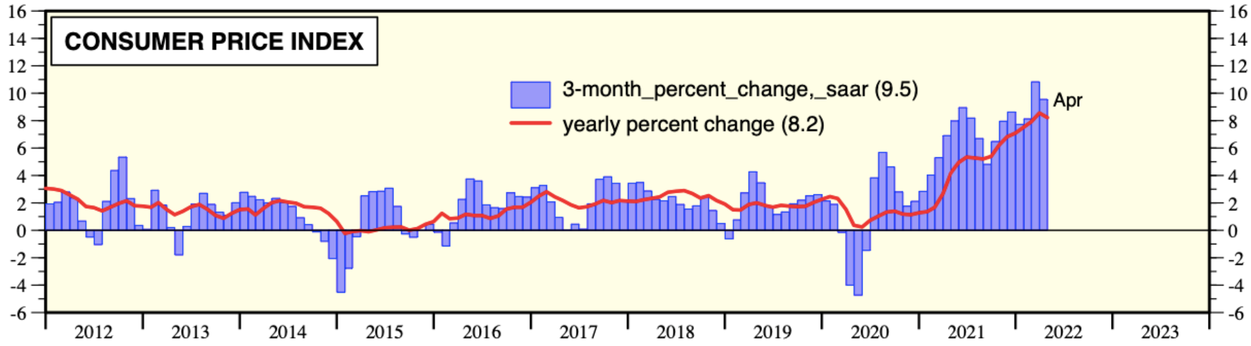


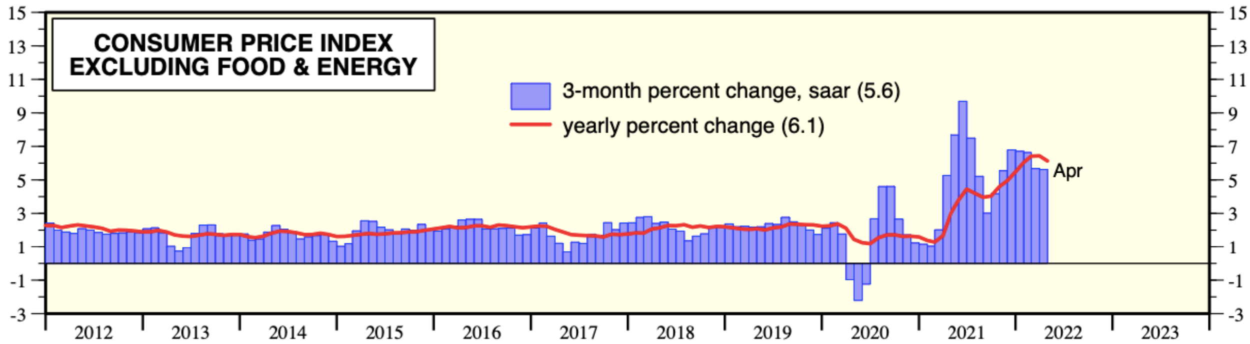
Historically, when the Investors Intelligence Bull/Bear Ratio has dropped below 1 it has signaled a good buying opportunity for long-term investors. This most recently happened in March of 2020. A week ago at market depths, this ratio dropped to .68 (Blue shaded areas are corrections and purple shaded areas are bear markets.)

Typically, reversal patterns of major sell-offs are highlighted by an initial stock market snapback followed by lower volatility. Lower volatility is a result of stock market pricing shifting back to fundamental valuations and away from technical trading.

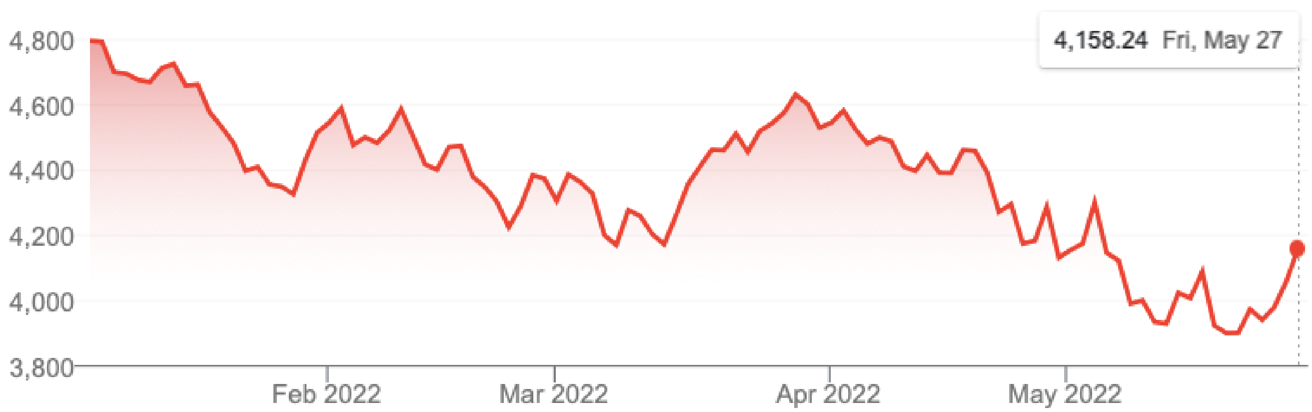
At the start of 2022, stock market multiples were priced for perfection. After the Russian invasion of Ukraine and subsequent market sell-off, we termed 2022 as the "lost year". We saw higher energy prices and supply chain disruptions costing investors a year's worth of stock market returns. An unexpectedly hawkish Fed then further disrupted a stock market that was priced for perfection.

We remain in the camp that economic conditions are far from perfect, but also not dire. It is likely inflation has peaked and will continue to moderate throughout this year and into 2023. The Fed should be able to get inflation under control without crushing the economy. We expect inflation to drop back to 5% by the end of this year and trend between 3%-4% during 2023. When highly volatile food and energy prices (admittedly important components in our everyday lives) are removed from the CPI, we are already seeing inflation moderating.

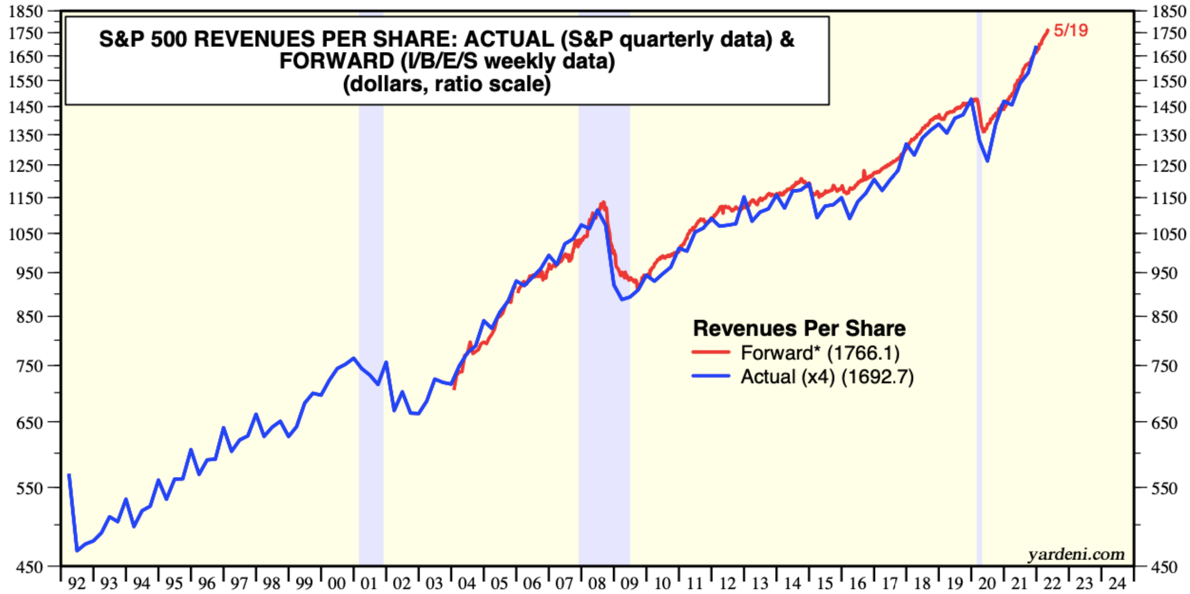


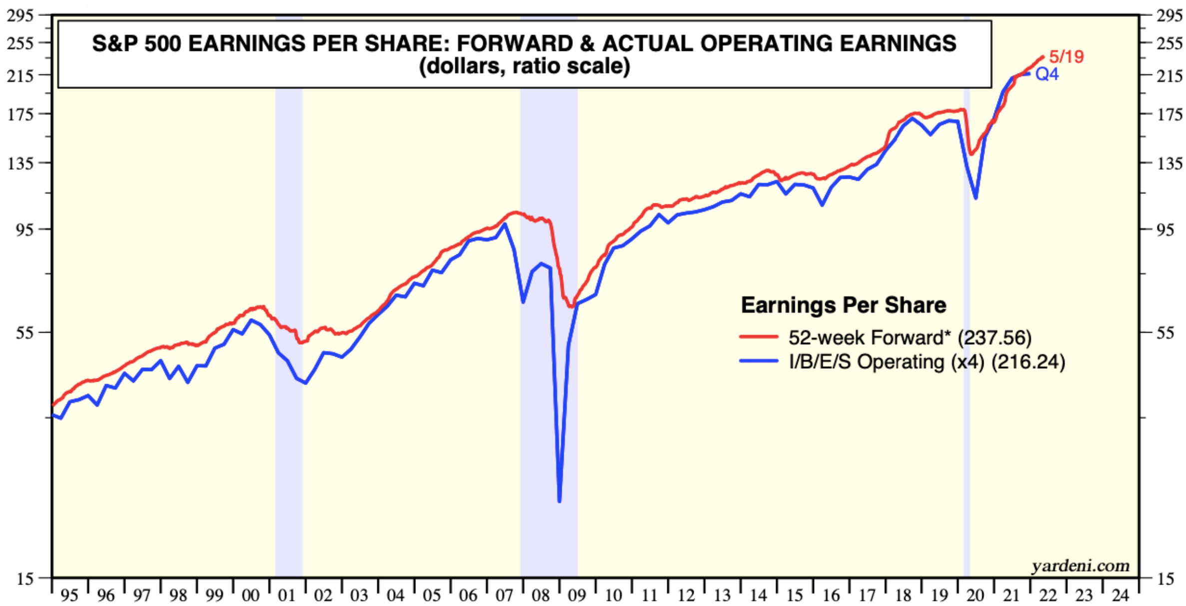


We also see it as prudent to change our "lost year" terminology into "lost year and a half". It's not nearly as catchy, but likely more accurate. Our hope that stock markets can claw their way back to even for 2022 is becoming less realistic. We now expect it will take until mid-2023 for stock markets to achieve new highs. After dipping nearly -20%, the S&P 500 has bounced 7% and is now -13%YTD as of Friday's close.



Even with industry analysts continually increasing their revenue per share and earnings per share forecasts, 13% is a lot of ground to make up. We expect a full recovery will take a little longer than we originally anticipated.





In the meantime, we continue to remain overweight Large Cap Value stocks. With the recent recovery in markets, this trade is now modestly in the money. A further recovery in markets will likely lead to a pullback on this overweight. We are also looking to increase our material underweight to duration if 10-Year yields once again approach the 3% level. In general, Fixed Income (bonds) are becoming a much more attractive asset class as yields rise, credit spreads widen, and inflation moderates. More on that next time.

We hope everyone had a wonderful Memorial Day Weekend,

The Mommaerts Mahaney Team

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J. Matthew Tuccini, CFP®: Matt has over 17 years of experience working in the financial services industry with vast experience in retirement planning, tax strategies, and financial planning.

Robert Kea, CFA: Bob has over 30 years of experience in portfolio management. He was a founding member and Co-Head on Putnam's Asset Allocation Group, which managed $12Bn in both retail and institutional assets.

Jason Rolling, Financial Advisor: Jason has been in the financial services industry for the past 15 years. His financial experience includes retail banking, consumer & commercial lending, bank management at the local, regional and SVP level, wealth management, and financial planning.

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