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

10/05/2023 | FRÉDÉRIC LEROUX

Investors seem to be unfazed by the threats hanging over the economy and financial markets – equity indices have been marching steadily upwards for months. Yet there's an explanation for this apparent paradox.

What a turnaround! Although the mood among investors was particularly bleak last summer, the past few months have seen handsome gains in stock markets in advanced economies. Between end-September 2022 and end-April 2023, the S&P 500 rose 16% and the Euro Stoxx 50 added 31%[1]. **Is this rally atypical? And what lessons does it hold about what to expect in the coming months?**

The sharp rebound came after a period of unprecedented monetary tightening[2], whose effects were compounded by the war in Ukraine's initial impact on energy prices. But the scale of the rebound – which erased all of last year's losses in European equity indices – can be explained neither by the upcoming end to monetary tightening, 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[3] started to fall in October.

The US banking crisis has further increased the likelihood of a recession in the country

While the above factors are undeniably positive, a number of threats remain, including recurring ones – like geopolitical tensions with China, the US public debt ceiling[4], and the stretched valuations of US stocks – and now the energy equation. Also, we shouldn't forget the lagging effects of the 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 a deep recession would make current debt levels unsustainable – a fact central banks are keenly aware of**. And secondly, lower inflation should lead to higher real household incomes[5], enabling consumers to absorb part of the economic shock.

It's actually not so unusual to see this kind of economic climate have no impact on financial markets. It reflects a paradox in which market movements are guided more by investors' extreme positioning than by macroeconomic and geopolitical news.

The 2022–2023 monetary tightening and worries associated with the war in Ukraine prompted a massive selloff, leaving investors with a very pessimistic positioning in equities – too pessimistic relative to the 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."

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 put an abrupt halt to the paradoxical market rally that began in 2019.

(1) Source: Bloomberg, April 2023. (2) **Monetary tightening**: When central banks aim to slow an overheating economy – which can drive up inflation –through a combination of higher interest rates and reduced liquidity injections into the market. (3) **Core inflation**: A seasonally-adjusted measure of inflation that excludes prices subject to government control (electricity, gas, tobacco, etc.) and prices that tend to be volatile (petroleum products, fresh foods, etc.). (4) **US debt ceiling**: The maximum amount of debt that can be incurred by the US Treasury; often leads to a budgetary impasse and can be raised only by an act of Congress. (5) **Higher real incomes**: An increase in household income after factoring in inflation.

MARKETING COMMUNICATION

The banking crisis could usher in the long-awaited fall in prices and bring a cure for the economic slowdown: monetary easing

What should we therefore 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.

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 rallying despite the menacing fundamentals could very well continue for as long as a deep recession is avoided.

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