Farro Capital

Market Insights

10th August 2023

"Things are seldom what they seem, skim milk masquerades as cream." —W. S. Gilbert

Seems like the adage "anything that can go wrong will go wrong" has been turned upside down by Mr. Market. Despite rising interest rates YTD, US equity market has continued to climb a wall of worry. Central banks' data dependence, declining inflation, high nominal GDP growth, EPS recovery & AI frenzy – what more could go right!

Given this uncanny backdrop, in our latest market insights, we try to uncover what Mr. Market – "wisdom of crowds[1]" – might be up to as we cover the most pressing topics on investors' minds & give a sense about portfolio positioning.

- What are the key takeaways from YTD price action.
- What is US equity market signaling.
- What is the driver of US economic surprises.

Year-to-date price action.

While on the surface it's been a classic risk-on in S&P 500 from multiple expansion with growth and cyclicals outperforming (Table 1), under the hood there are three takeaways from equities and cross-asset behavior:

- Improvement in S&P 500 breadth and value factor since June 2023.
- Tightening in USD High Yield credit spread towards 2019 level when FED pivoted and cut rates.
- Rise in short-term and long-term USD yields without a material drop in inflation break-evens (B.E.)[2].

Table 1: YTD returns and valuation re-rating.

	Total Return			Best P/E		
Index	**1Q23**	**2Q23**	**YTD**	**Dec-22**	**Aug-23**	**Re-rating**
S&P 500 Index	**7.5**	**8.7**	**18.8**	**17.6**	**20.9**	**18%**
S&P 500 Ex Tech & Comm	**0.6**	**4.9**	**8.1**	**16.6**	**18.5**	**12%**
S&P 500 Technology	21.8	17.2	40.7	22.5	30.1	33%
S&P 500 Communication	20.5	13.1	44.3	14.5	18.8	30%
S&P 500 Discretionary	16.0	14.6	36.6	23.3	26.6	14%
S&P 500 Materials	4.3	3.3	9.4	13.8	18.8	36%
S&P 500 Industrials	3.5	6.5	12.5	20.5	20.3	-1%
S&P 500 Staples	0.8	0.5	2.8	22.1	21.0	-5%
S&P 500 Utilities	-3.2	-2.5	-7.9	19.7	17.2	-12%
S&P 500 Health Care	-4.3	3.0	-0.6	17.1	19.1	12%
S&P 500 Energy	-4.7	-0.9	0.8	8.2	11.9	46%
S&P 500 Financials	-5.6	5.3	4.4	13.7	14.6	7%

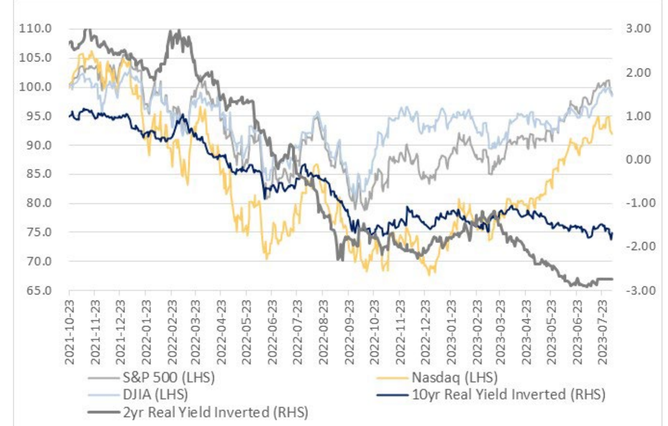
Source: Bloomberg. BEst P/E: Bloomberg estimated P/E.

To put these in overall scheme of things, last year the speed and magnitude of the rise in interest rates shook equity & credit markets and drove US inflation break-evens towards ~2%. This year, equity & credit markets have snapped back, and inflation break-evens have not collapsed even as interest rates have risen. It's not only Mega-caps that have taken S&P higher but also S&P Ex-Tech & Comm Index that crossed its Aug-22 & Jan-23 levels.

The gist is that short term and long-term real yields are higher now vis-à-vis Oct 2022 and Jan 2023, but equity and credit markets have marched on unfazed (Chart 1).

[1]The wisdom of the crowd theory proposes that the collective opinion of a diverse independent group of individuals is more accurate than that of a single expert. [2]Bond market expectation of future inflation.

Chart 1: US Equity indices rebased vs US 2yr and 10yr real yield.



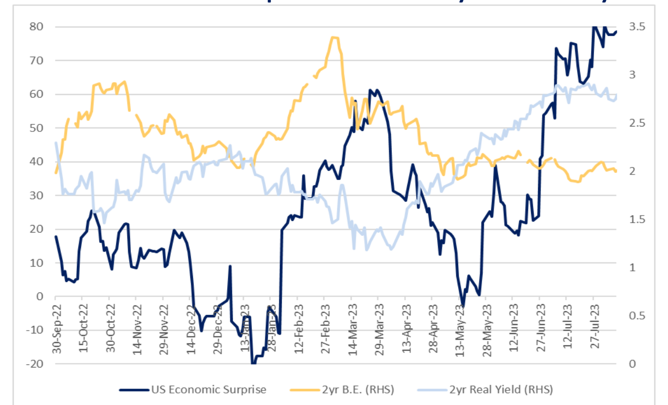
Source: Bloomberg

What is equity market signaling?

Nobody has a crystal ball, but our reading is that unlike Jan 2023 rally, which was based on hopes of a "soft-landing", April 2023-July 2023 rally has been goldilocks of "no-landing" now, else a "soft landing" later – a heads I win, Tails I win proposition! Why does it seem so?

- First, cross-asset behavior; equity rally until Jan 2023 coincided with slowdown in growth and fall in real yields – a behavior more consistent with a soft landing. On the other hand, the rally since April 2023 has transpired amidst improving growth along with rising real yields but stable inflation break-evens – a behavior commensurate more with a no landing (Chart 2).

Chart 2: US Economic surprise Index vs US 2yr B.E. & Real yield.



Source: Bloomberg. Citi US Economic Surprise Index: A +ve number means actual economic data better than estimates and -ve vice versa.

- Second, the Federal reserve; given a data dependent FED, which on the margin now seems to be less worried about inflation risks and easing financial conditions, the equity market may be eyeing that the FED is more likely than not to budge from its tightening rhetoric should growth collapse.

- Third, historical context; there is increasing chatter that 2023 is looking like a repeat of 2019 when the FED achieved some sort of a soft landing.

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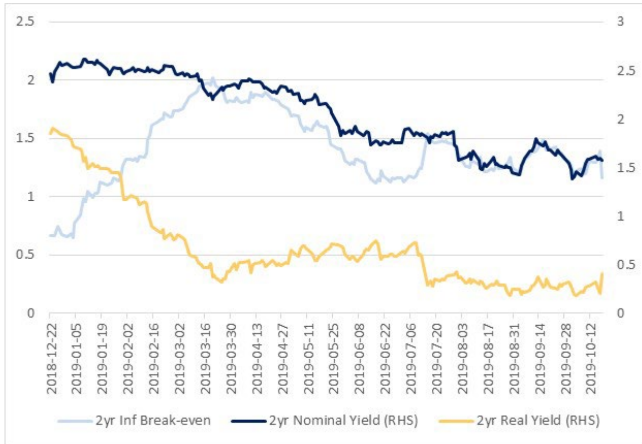
On surface, yes, but under the hood, no. The 2019 rally coincided with a downward shift in yield curve and drop in real yields along with recovery in inflation break-evens from their nader (Chart 3) as FED signaled policy pivot whereas the rally since April-2023 has happened without any such backdrop (Chart 4).

Chart 3: Dec 2018 to Oct 2019.



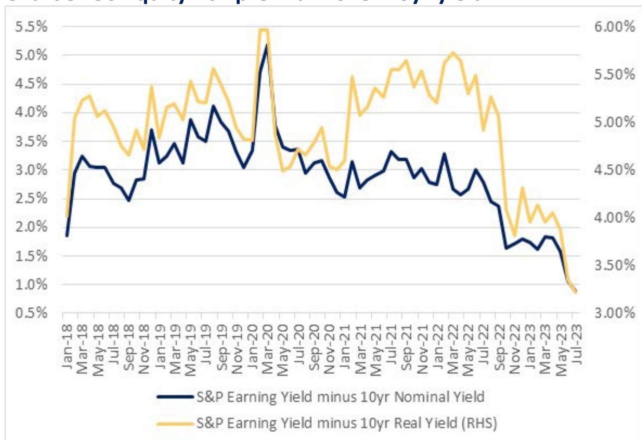
Source: Bloomberg

Chart 4: Oct 2022 to Aug 2023.

Source: Bloomberg

In summary, unlike in 2019, US equity risk premium has collapsed in 2023 to extremely lows levels, which in our view could be reconciled more so with an idea of economic expansion now, else a soft landing later than anything else (Chart 5).

Chart 5: US Equity risk premium over 10yr yield.



Source: Bloomberg. S&P 500 E/P minus 10-year US bond yield i.e., risk premium has collapsed unless compensated by growth.

Assuming that the notion of an eventual FED pivot is true, the question remains what has been driving economic expansion in the US despite the level of interest rates not seen in the last 20 years.

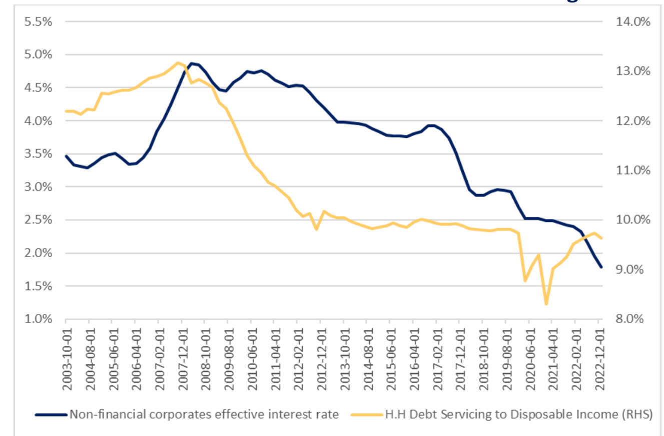
Wasn't the sky supposed to fall on a debt laden economic system that the Perma bears touted could not take high interest rates?

The driver of US economic surprises.

In the last 2 year or so, we have seen a huge value transfer happening within the US economy via two channels:

- First, value transfer from financial to private sector: It's no secret that US households' and corporates' balance sheets remain healthy from a debt servicing standpoint; by refinancing their debt at record low fixed interest rates, these two economic agents acted even more financially rational than the financial sector itself. To frame it differently, there is a large unrealized gain sitting on liabilities of household and corporate sectors, mirror image of which is the large unrealized loss sitting on assets of financial sector.

Chart 6: Interest rate channel broken for the time being.



Source: FRED

- Second, value transfer from public to private sector: It's also not news that the US government ran wartime-like deficits from March 2020 to Oct 2021 to make transfer payment to households and businesses with the support from the Federal reserve. However, what has come as a surprise to many is the rise in fiscal deficit from Oct 2022 to June 2023 i.e., $852bn more than the same period last year. To frame it in historical context, there have not been many instances when the unemployment rate was this low (3.5%) and fiscal deficit rose by this much (doubled).

In short, the key driver of recent economic surprises has been the US government balance sheet, which has ballooned to ~120% of US GDP with the support of Federal reserve balance sheet.

The natural question then is whether this is a free lunch from the government to its people or will there be a cost attached to it? Nobody knows the future, only time will tell. However, rating agency "Fitch" has downgraded US credit rating from AAA to AA+.

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Conclusion.

We understand that history has more often sided with optimists than pessimists and it's possible that:

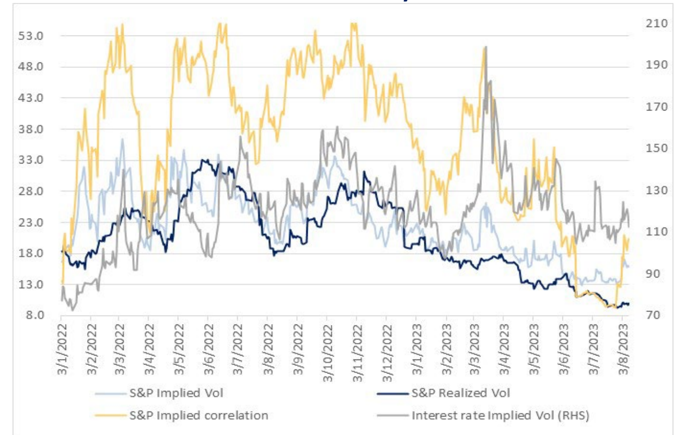
- The goldilocks of "no-landing" with disinflation now, else a FED engineered "soft-landing" later comes to pass.
- Government balance sheet transfer turns out to be irrelevant given the GEMM – geo-political, economic, and military might – status that US garners and the superior productivity – capital, labor, total factor – of US private sector that its entrepreneurs exhibit.
- Even if inflation resurges, FED remains patient and behind the curve, and lets disinflation process work slowly through base-effect.

On the other hand, US equities are pricing in exactly the above with:

- US equity earning yield versus bond yield at 20yr low.
- US equity P/E versus rest of the world at 20yr premium.
- Big-tech resurgence toward their peak multiple over optimism of a new Tech growth cycle.

To sum up, things can go either way and there is a case to be made that the cheapest asset class right now is volatility (Chart 7) with protection against mild-to-moderate selloffs i.e., 12mn 80%-100% strike puts on SPX around its 5th percentile since 2008.

Chart 7: S&P and Interest rate volatility.



Source: Bloomberg

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