Are You Strapped In?

July 28, 2022

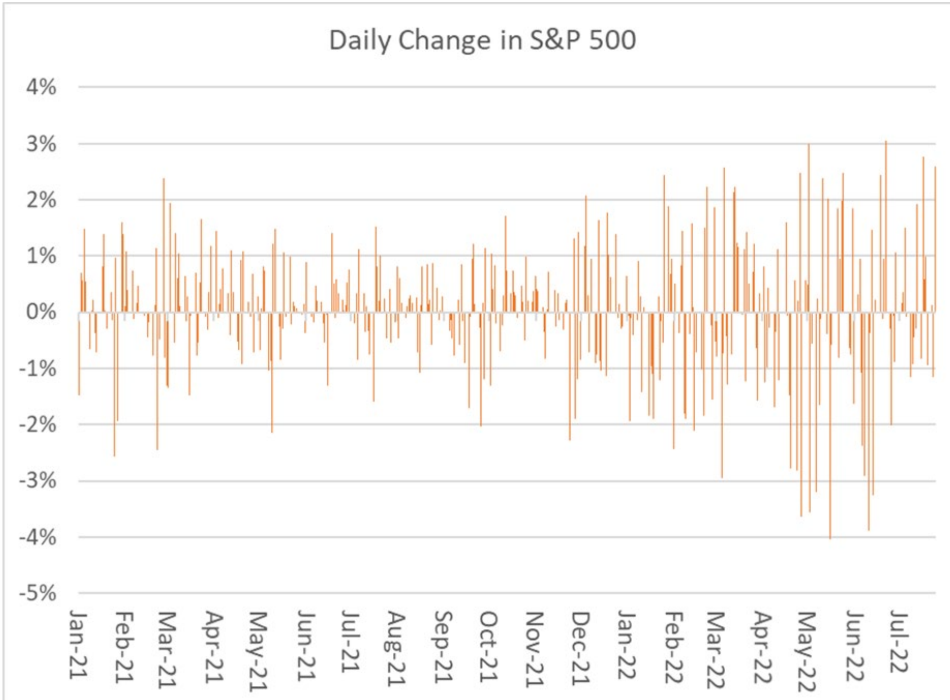
Stocks took off like a rocket ship on Wednesday with the S&P 500 up 2.6% and the Nasdaq up over 4%. What's interesting about yesterday's rally is that it followed a day on which the S&P 500 fell 1.3% and the Nasdaq fell 1.9%. What are we to make of all this volatility? How could sentiment change so quickly in a day?

Yes, the Fed meeting had something to do with yesterday's rally. During his press conference, Chairman Powell hinted, ever so subtly, that the Fed may slow the pace of interest rate hikes going forward. In fact, the hint was so subtle that many people, including me, missed it. I did hear Powell say that it's *possible* future interest rate hikes will not be as big. But I also heard him say that it's possible that more outsized hikes could still be needed. Perhaps more importantly, though, the Fed did acknowledge the downside risk of overly aggressive rate hikes. In doing so, he explained that there is a timing lag between interest-rate hikes and their impact on the economy. The implication was that it might be wise to go slower until we are able to glean more concrete evidence about the impact of all the rate hikes so far. In deference to the downside risk, Powell said that the size of future rate hikes will be data-dependent. This represented somewhat of a sea change from the more explicit guidance that preceded yesterday's Fed decision.

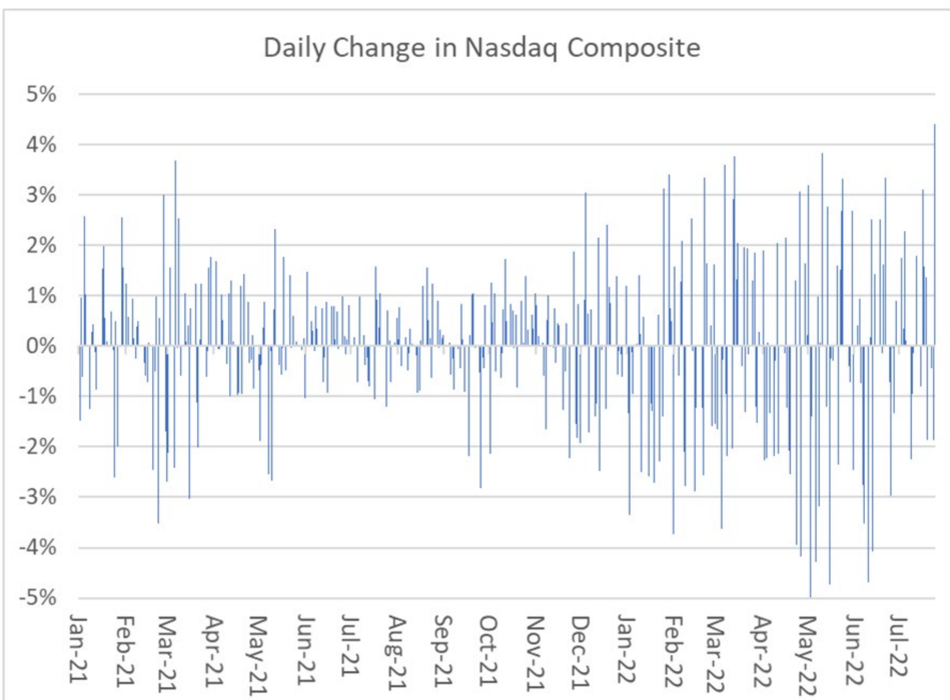
But I don't care what anyone tells you, nobody – not even the Fed – knows the answer to the one critical question that will determine the stock market's fate over the near- to intermediate-term: How high must interest rates go to bring down inflation to more tolerable levels? As long as this question remains unanswered, the volatility is likely to continue.

Another factor contributing to the sudden buying splurge yesterday was the strikingly high level of bearishness among investors in recent weeks. A recent survey of professional fund managers by Bank of America concluded that respondents haven't been this pessimistic about stocks since the throes of the Great Financial Crisis in 2008. The survey also concluded that cash levels among these investors are at their highest levels since 2001. These types of negative statistics are what the pros call "contrarian indicators" because they often signal buying opportunities. The rationale goes like this. Bearish stances cause investors to sell stocks and hold more cash. But there comes a point when the pessimism peaks and the selling is exhausted simply because the bearish folks have already done all their selling. When there is nobody left to sell and the incoming news is even modestly better-than-expected, big rallies can be triggered. That's what we saw yesterday, and it could have legs. But perhaps needless to say, it won't happen in a straight line.

So far in 2022 the S&P 500 has been either up or down by 1% or more on 49% of the total trading days (70 out of 142). For the Nasdaq, that figure is an eye-popping 69% (98 out of 142). Those figures for the full-year 2021 were just 22% and 31%, respectively. The charts below show the dramatic increase in volatility, which is one prediction that almost everyone got right. Volatility is spawned from uncertainty, and as long as the uncertainty continues, so will the volatility. So strap yourselves in, it could be a bumpy ride for a while.



Source: Bloomberg.



Source: Bloomberg.

We continue to favor quality above all else in this environment. Strong balance sheets, seasoned management teams, and highly predictable cash flow all serve as defensive barriers against continued volatility. We believe we are well positioned to endure and preserve opportunities for client portfolios.

Peace,

Michael

200 W Madison, 25th Floor
Chicago, IL 60606
(312) 962-3800
hightoweradvisors.com