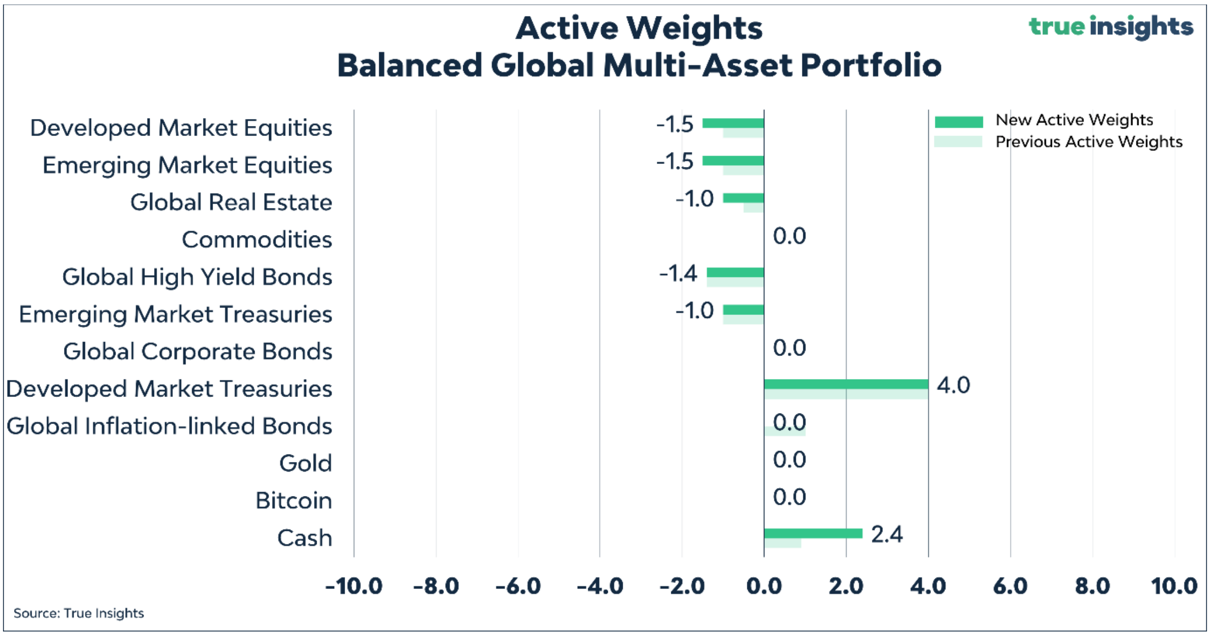
We tactically lower the weight of equities as Sentiment looks stretched and Macro continues to deteriorate

Change in Portfolio Weights August 18, 2022

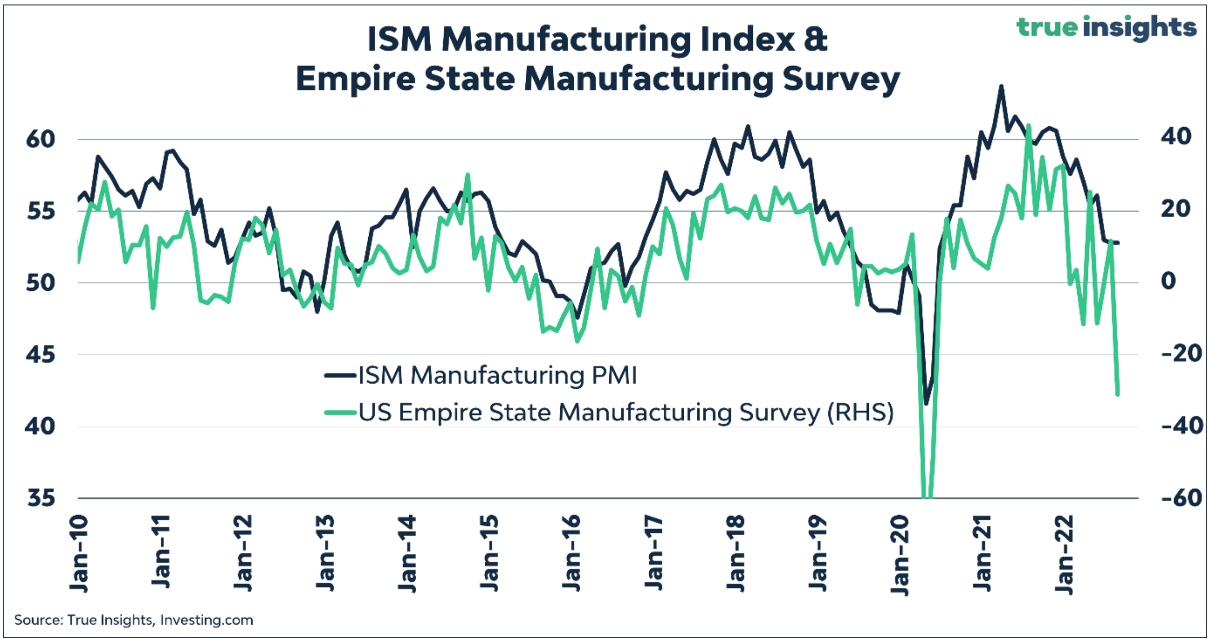
The battle between Macro and Sentiment continues. But with some Sentiment indicators looking stretched and Macro continuing its journey south, there is a tactical trade opportunity by shorting equities.



Macro

ISM Manufacturing heading lower

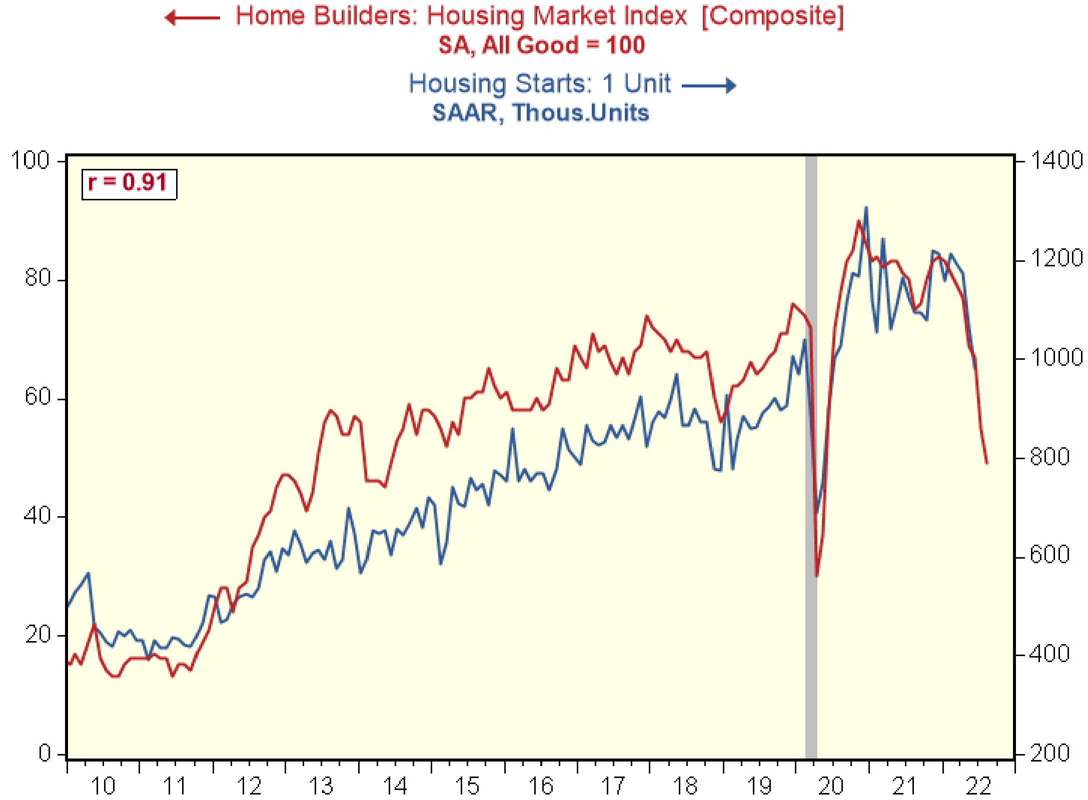
The evidence that the ISM Manufacturing will drop below 50 in the not-so-distant future is growing. On top of the Prices Paid Index – which leads the overall ISM Manufacturing Index by roughly 12 months – the New Orders vs. Inventories Index, and our OECD Leading Indicator Diffusion Index – showing that all economies in our OECD universe are slowing – the latest Empire State Manufacturing PMI doesn't bode well for the ISM Manufacturing either.



The Empire State Manufacturing PMI fell to -31.3, a miss of 35 points(!) compared to expectations. The only time the Empire State PMI 'disappointed' more was in the early stages of Covid. As a reminder, historically, a falling ISM Manufacturing Index was followed by below-average or negative returns on the S&P 500 Index.

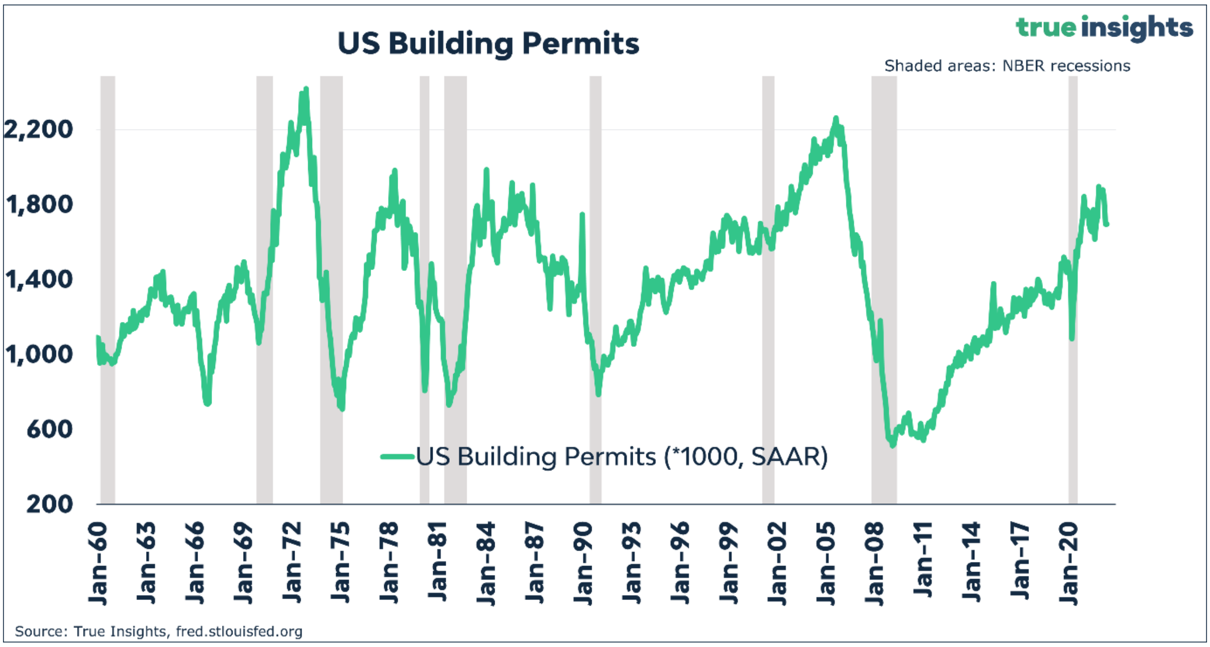
US Housing activity dwindling fast

The NAHB Housing Market Index tumbled to 49 in August, meaning US homebuilders are now net negative (50 = neutral.) This is the lowest level since 2014, Covid excluded, and suggests a significant slowing of housing activity.



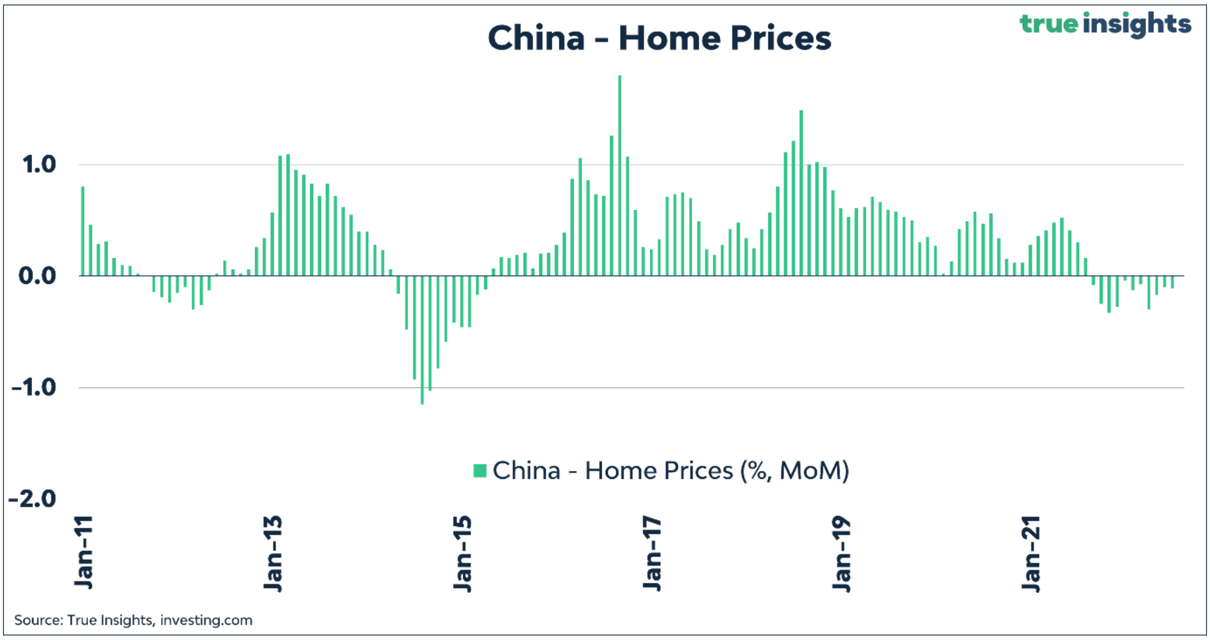
Sources: NAHB, CENSUS/Haver

There is a strong correlation between the NAHB Housing Market Index and housing starts, but also (new) home sales and building permits. And building permits consistently peaked in the run-up to a US recession.



In addition, the US housing market is a leading indicator of overall economic activity and the labor market.

China: more real estate issues.
As we highlighted in our Daily Insight, China had to cut rates to try and stabilize its economy. The Chinese real estate sector continues to collapse, taking consumer confidence, spending, and investments down in its fall.

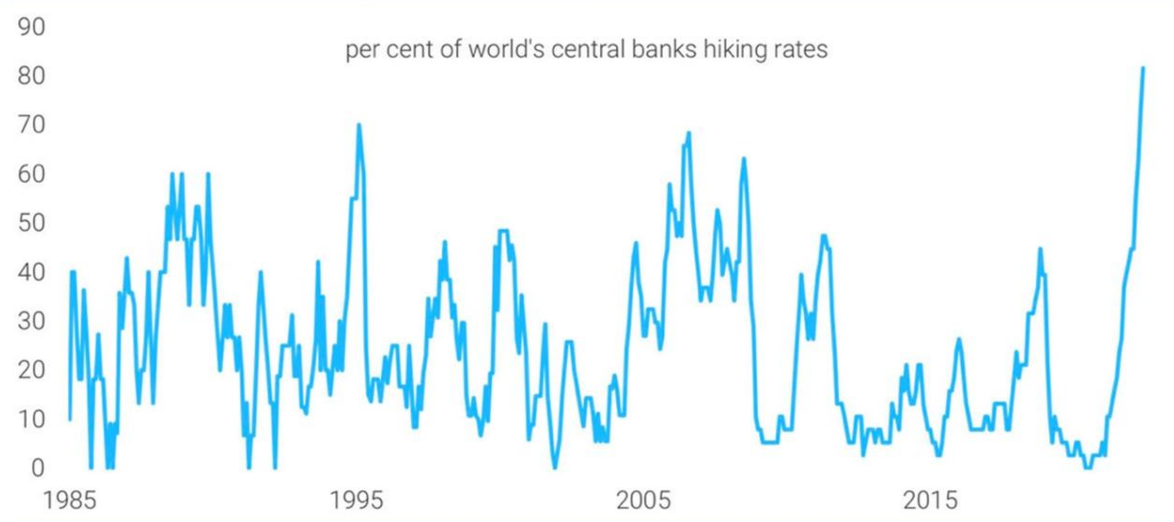


Without an immediate pivot from the Federal Reserve – which equity markets are pricing – the risks of a Yuan depreciation are rising. The euro and yen have shown in recent months what monetary policy divergence can do to currencies. Historically, the relationship between the Yuan and equity markets has been negative. Lower equity markets often accompany a weaker Yuan.

Monetary tightening remains abundant

Equity markets have extrapolated the words of Jay Powell into oblivion. But underlying inflation data reveal there can't be a pivot, at least not in the near term. In addition, sticky price pressures linger, implying the Federal Reserve must remain aggressive to get ahead of the curve. The same applies to many other central banks. As a result, the global economy is experiencing the broadest tightening cycle in history even though it is already slowing. This significantly reduces the odds of a 'soft landing.'

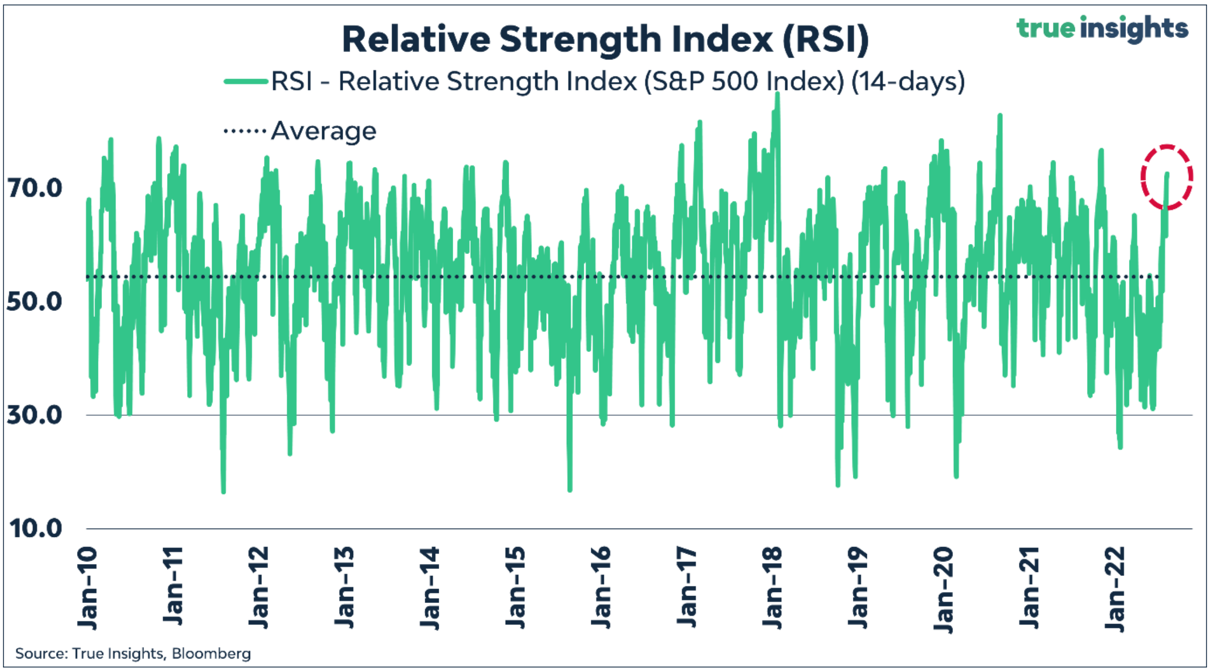
Chart 1: Broadest tightening cycle in history



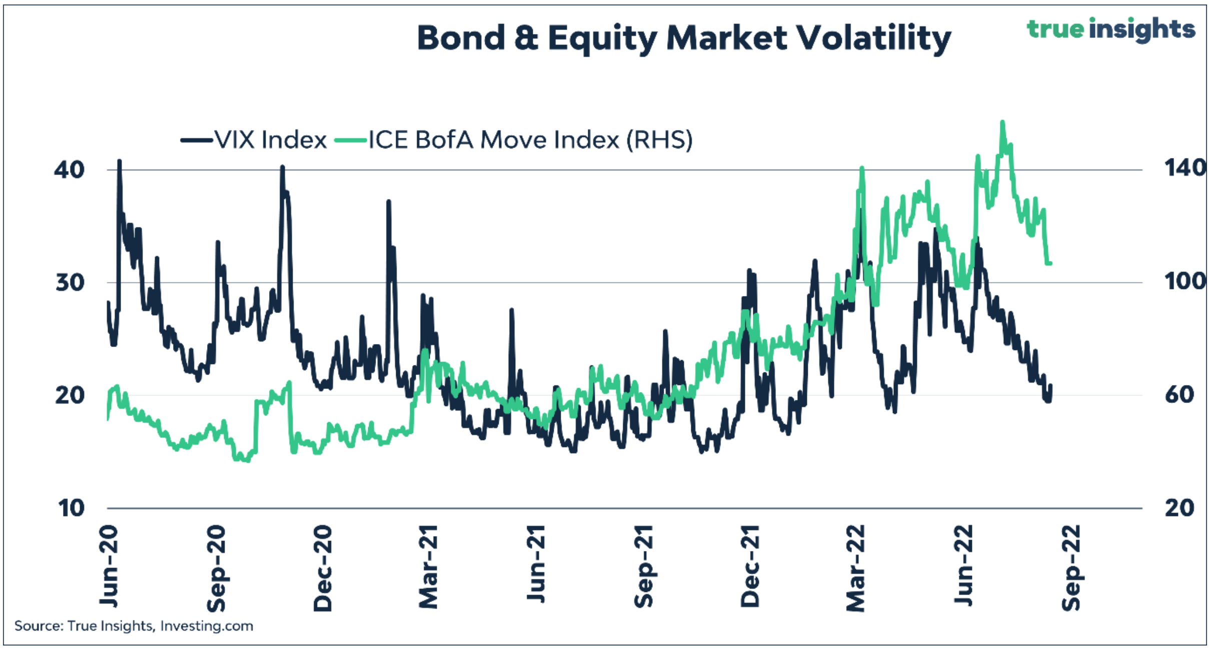
Sources: BIS, TS Lombard estimates.

Sentiment

US equities are now overbought, with the Relative Strength Index (RSI) rising above 70. Historically, markets have moved lower most of the time after this happened. Also, the percentage of companies in the S&P 500 Index trading with an RSI above 70 has risen sharply.

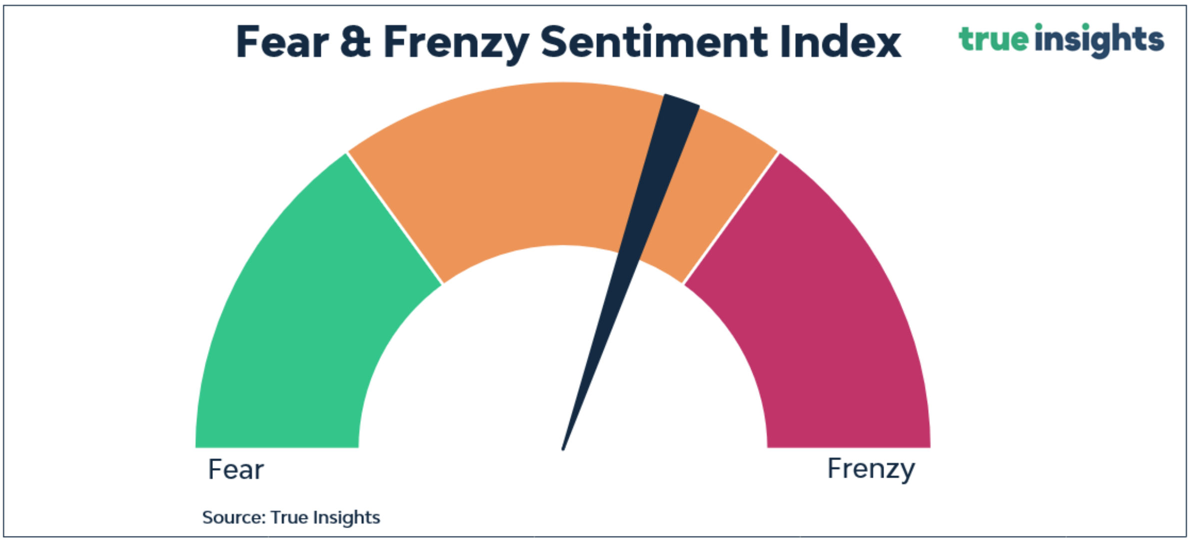


In addition, equity market volatility is much lower relative to the volatility of other asset classes. With growth, inflation, and earnings uncertainty abundant, equity market volatility is likely too low instead of bond and FX volatility being too high.



We also look at the steepness of the VIX futures curve. The gap between the 6-month and 1-month VIX future has widened significantly as short-term volatility fell, consistent with our cross-asset volatility charts above. This also points to equity market complacency.

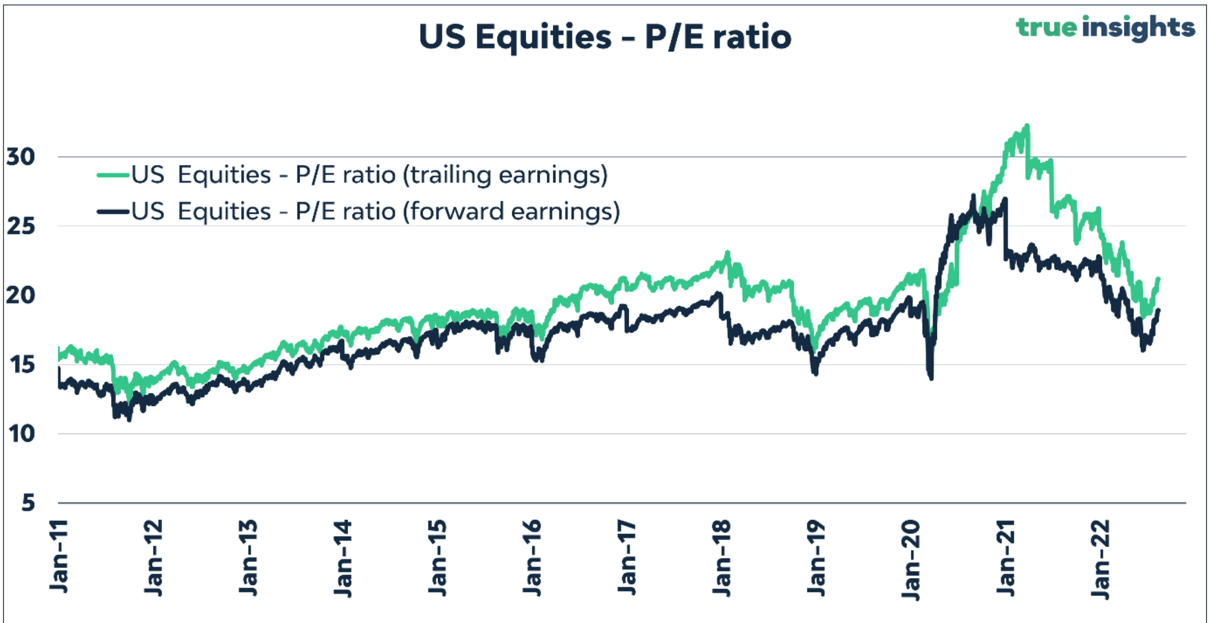
Our Fear & Frenzy Sentiment Index leans towards Frenzy, but is not there yet. One reason for this is investor positioning, which has become bearish in recent weeks.



The risk here – and what makes the battle with Macro – is that equities have started a new bull market. Some closely-watched indicators, like the % of companies trading above their 50-day moving average, suggest this may be the case.

Valuation

The S&P 500 Index is up 18% from its low on June 16, while earnings-per-share have risen less than 2% since then. It's no surprise that equity market valuation has shot up during the last two months.



Source: True Insights, Bloomberg

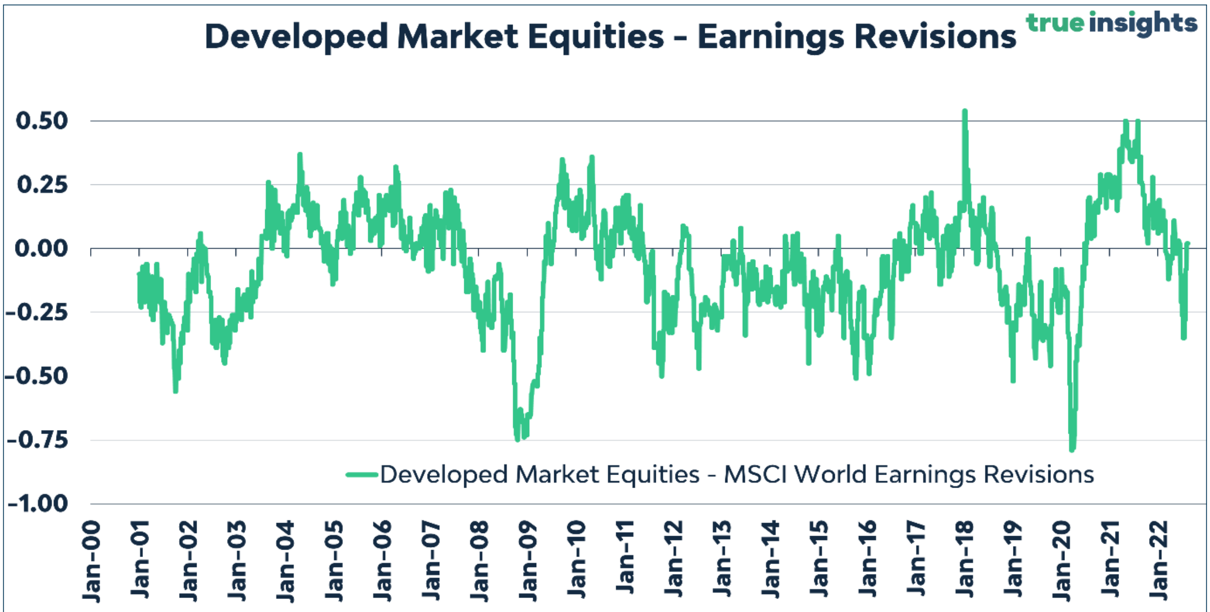
As a result, the realized P/E ratio has climbed to a lofty 21, and the forward P/E ratio is up to 19. Implied earnings growth stands at 12%. This contrasts sharply with history. Every time the US economy experienced a severe slowdown or recession, earnings-per-share and sales-per-share growth turned negative.

2023 EPS scenario

		Cons. Estimate	GS baseline	GS recession
		$244	***$234***	***$200***
vs. cons. 2022		(+7%)	(+2%)	(-12%)
		Est. at YE 2022 assuming halfway revision		
		$244	***$239***	***$222***
Forward P/E	**19x**	4650	4550	4200
	18x	4400	4300	4000
Current	**17x**	4150	4050	3800
	16x	3900	3850	3550
	15x	3650	3600	3350
	14x	3400	3350	3100
Mar. '20	**13x**	3150	3100	2900

Source: Factset, Goldman Sachs Global Investment Research

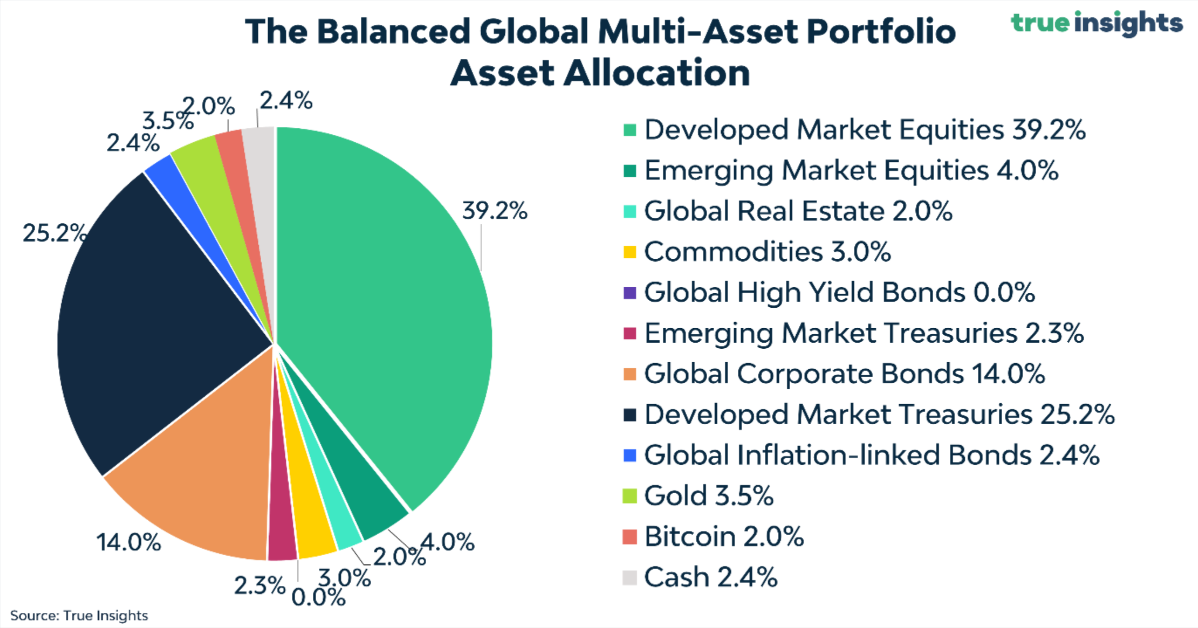
The table above offers guidance on where the S&P 500 Index should be for different combinations of earnings and valuation. A forward P/E ratio of 17 combined with zero earnings growth implies an S&P 500 Index of just under 4,000 points, or 7% downside. If US equity valuation drops to 15.3 – hitting one standard deviation below the 10-year average forward P/E-ratio –and earnings-per-share fall 10%, the S&P 500 Index would have to drop to around 3,400, implying 20% downside. For the S&P 500 Index to have upside from a Valuation perspective, earnings must continue to grow, and P/E ratios cannot fall.



Source: True Insights, Bloomberg

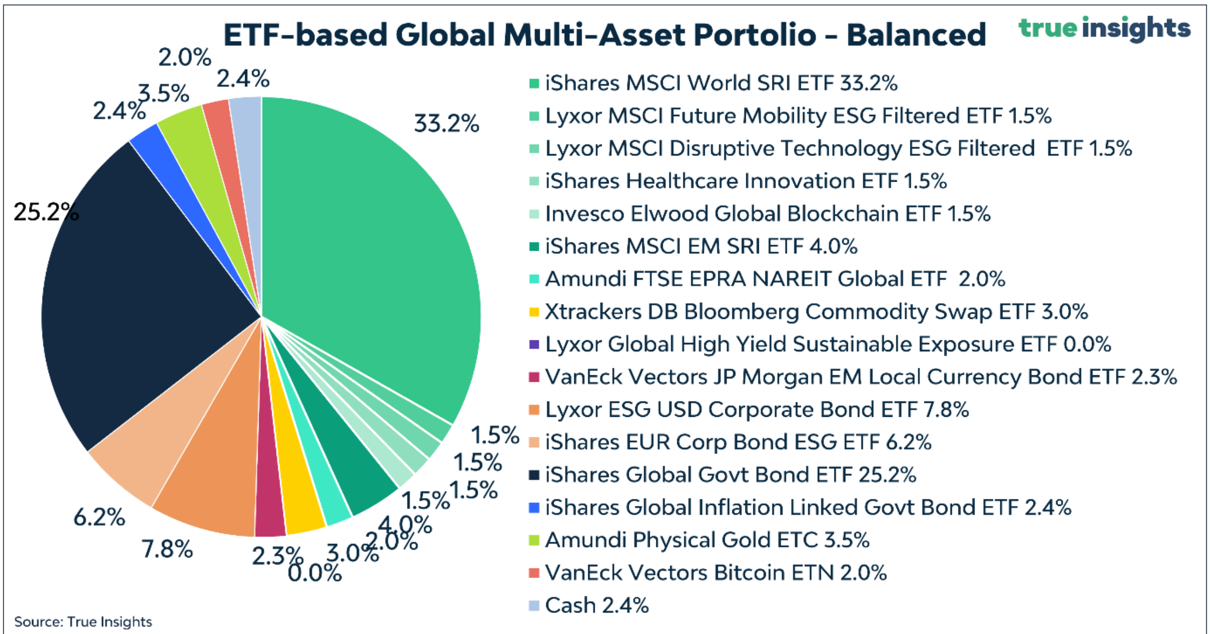
Finally, earnings revisions turned positive again recently. This is striking given the economic environment, and it must be related to the positive market sentiment in recent weeks. We don’t think this will hold.

New Asset Allocation



We lower the weight of Developed and Emerging Market Equities and Global Real Estate, each by 0.5 percentage points. This brings the cumulative underweight in these three asset classes to 4.0 percentage points. We increase the weight of cash as this is a tactical trade on top of our medium-term underweight in risky assets.

New ETF-based Global Multi-Asset Portfolio



We lower the weight of the iShares MSCI World SRI ETF, iShares MSCI EM SRI ETF, and Amundi FTSE EPRA NAREIT Global ETF each by 0.5 percentage points. We raise the weight of cash.

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