PMI INSIGHTS

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HIGHER FOR LONGER.

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The S&P 500 Index (SPX) has been a decent contender on a year-to-date (YTD) basis (as at 09/26/23), returning 11.30% (price appreciation basis) on the hopes that the Fed will engineer a "soft landing" (i.e., bringing inflation back towards its 2.00% target while avoiding an outright recession). At current pricing (4,273.53), the SPX technicals (See **Exhibit 1**) highlight that the 52-week high of 4,607.07 (which is 7.8% higher) is the next important near-term target (to the upside) and will act as a major psychological resistance level to be overcome. However, given the asymmetrical risk profile (to the downside) and the market trading through its 50-day as well as 100-day moving average, some caution at the current level is warranted. All eyes will now be on the 200-day moving average around 4,194.59, as an important level that will need to hold to keep any current "bullish" narrative intact.

Exhibit 1

Source: Bloomberg/PMI

It should be noted that the "soft landing" view has led to multiple expansion wherein investors have become more optimistic that earnings will rebound next year and are willing to pay upfront for that expected growth.

Exhibit 2

Forward P/E Growth	Trailing EPS Growth
11.81%	-1.43%

Data as at 02/01/23 to 27/09/23

Exhibit 2 highlights this, as the market's YTD rally occurred with earnings slightly negative at -1.43%, thus demonstrating that the rise in "P" (market price) was happening absent "E" (earnings growth) and is based off investor optimism (i.e., multiple expansion) rather than improving corporate fundamentals.

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- Investment Management
- Pensions
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The Magnificent Seven

Approximately 88.19% of the SPX YTD performance occurred within the following seven stocks: AAPL, NVDA, MSFT, AMZN, META, TSLA, and GOOG. This is of concern as any sustainable or healthy market recovery should be predicated on broader sector participation as opposed to a narrow few that have benefited from momentum relating to the market's artificial intelligence (AI) exuberance.

Exhibit 3

Name	% Contribution to Index
NVIDIA Corp	18.60%
Apple Inc	17.58%
Microsoft Corp	15.25%
Meta Platforms Inc	10.99%
Amazon.com Corp	10.24%
Tesla Inc	8.90%
Alphabet inc	6.63%

Source: Bloomberg

Data as at 26/09/23

However, a look at the SPX Equal Weighted Index (SPW), which includes the same constituents as the capitalization weighted S&P 500 Index, but with each company in the equal weighted index allocated a fixed weight at each quarterly rebalance on a YTD basis returned -0.16%. That's some 11.46 % lower than the popular market capitalization benchmark version.

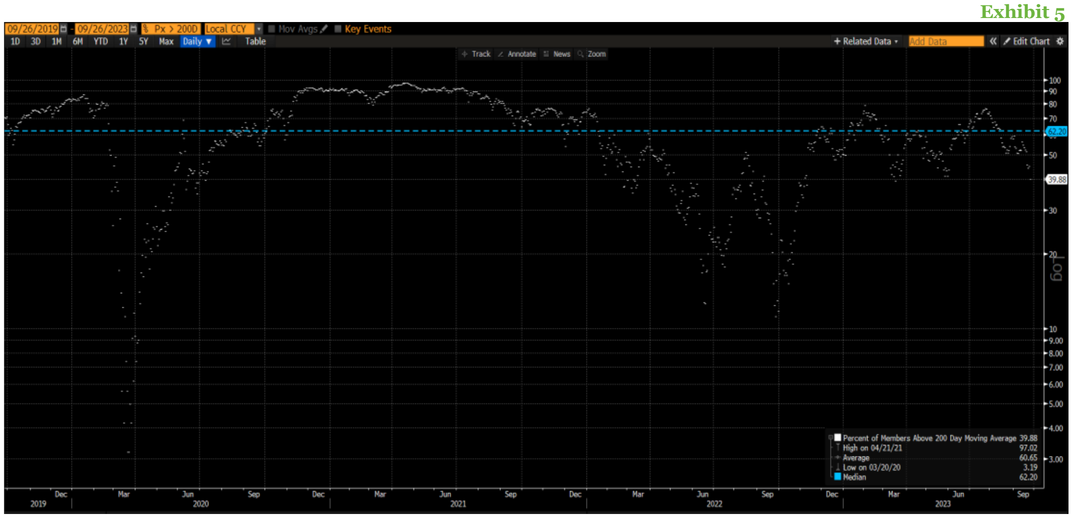
Interestingly, the BM7T Index (which is a proxy for the Magnificent 7 stocks (see **Exhibit 4**) after peaking on 7/18/23, has pulled back approximately -8.83% (taking it through both its 50-day and 100-day moving average) and may be in the early stages of breaking down. Its 08/18/23 low (which is currently -1.32% lower from current levels, see white horizontal line) needs to hold as a move below that level would be decidedly bearish action and will place the index officially in correction territory (-10.00% to -20.00%).

Exhibit 4

Source: Bloomberg/PMI

Exhibit 5

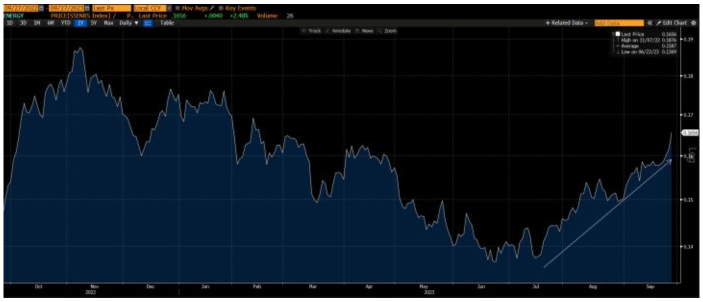
Market internals or breadth on the SPX have also been weakening as measured by the number of stocks trading above their 200-day moving average, which at 39.88% has been trending down and is well below its intermediate median of 62.20% (see **Exhibit 5).**



Source: Bloomberg/PMI

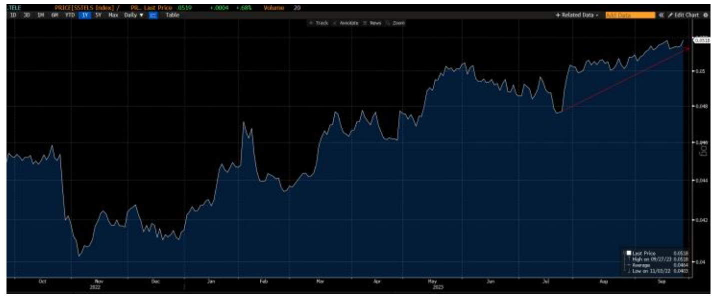
Since July, investors have been adopting more of a defensive tilt with a clearly defined rotation occurring into defensive sectors, e.g., Energy, Telecoms, Healthcare, and then Financials (cyclical rather than defensive). Staples, Utilities, and Industrials (for the month of September) have also benefitted from some recent rotation as well. However, Materials, Info Technology, Consumer Discretionary, and Real Estate, have been displaying weaknesses relative to the market. The following charts highlight the ratios of the sector prices (numerator) to the market price (denominator) with an upward trend, i.e., sector outperformance denoted by an increase in the ratio and underperformance by a decrease in the ratio.

Exhibit 6 – ENERGY



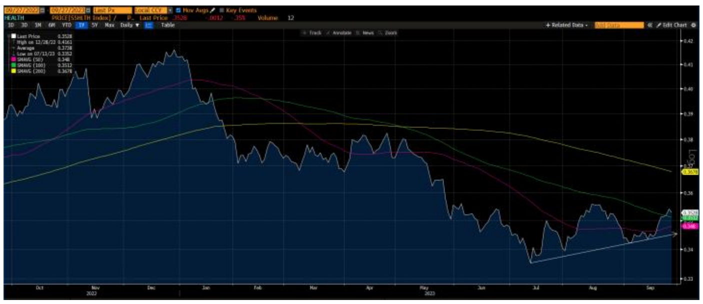
Source: Bloomberg/ PMI

Exhibit 7 – TELECOMMUNICATIONS



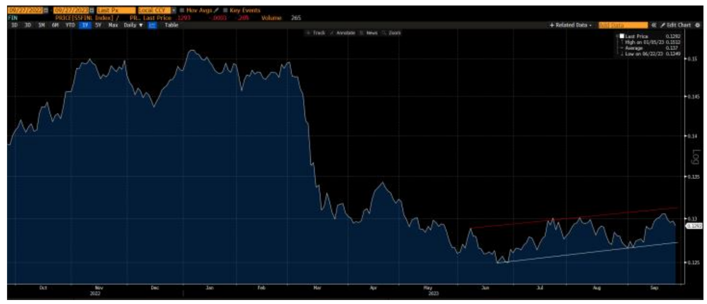
Source: Bloomberg/PMI

Exhibit 8 – HEALTHCARE



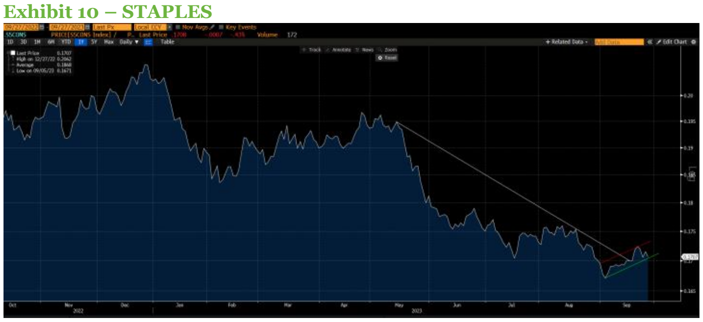
Source: Bloomberg/PMI

Exhibit 9 – FINANCIALS



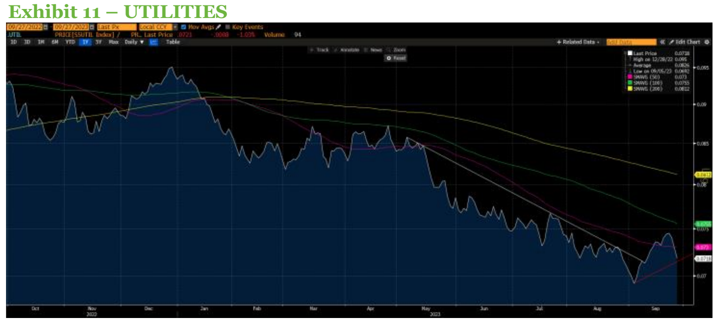
Source: Bloomberg/PMI

Exhibit 10 – STAPLES



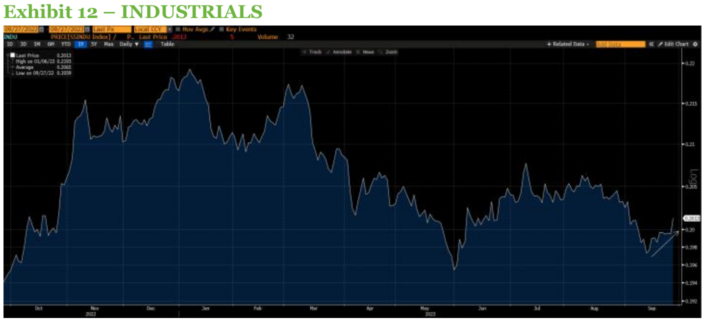
Source: Bloomberg/ PMI

Exhibit 11 – UTILITIES



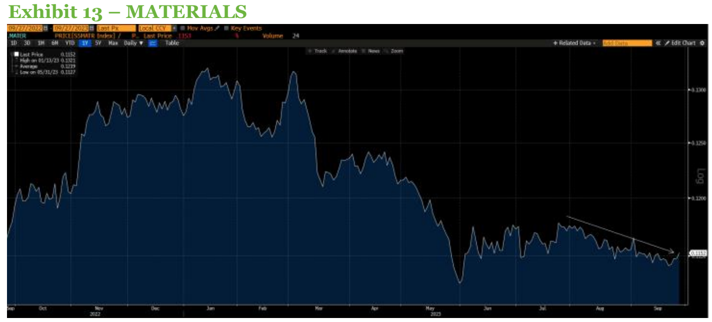
Source: Bloomberg/ PMI

Exhibit 12 – INDUSTRIALS



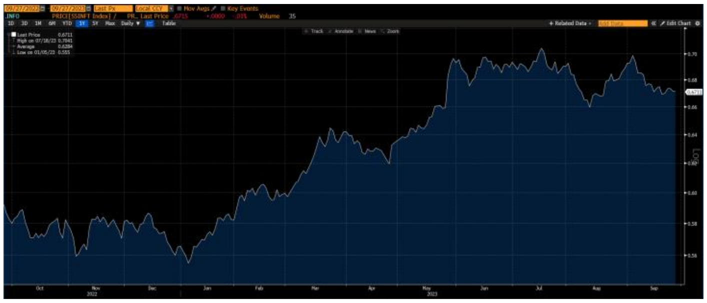
Source: Bloomberg/ PMI

Exhibit 13 – MATERIALS



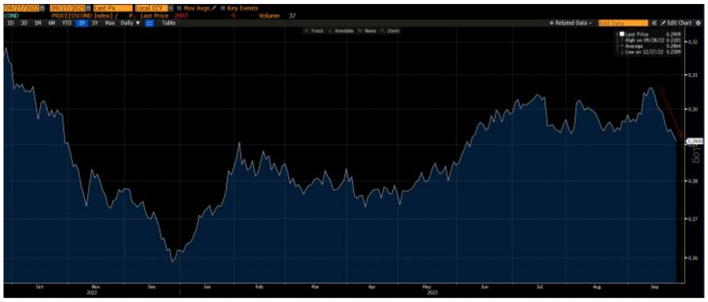
Source: Bloomberg/ PMI

Exhibit 14 – INFO TECHNOLOGY



Source: Bloomberg/ PMI

Exhibit 15 – CONSUMER DISCRETIONARY



Source: Bloomberg/ PMI

Exhibit 16 – REAL ESTATE

Source: Bloomberg/PMI

From a valuation perspective, **Exhibit 17** at right highlights the forward P/E multiples of the 11 sectors relative to their intermediate median P/E and the SPX Index forward multiple. Those sectors highlighted in "Yellow" can be considered as undervalued both relative to their intermediate median multiple as well as the market multiple. Those highlighted in "Green" can be considered as undervalued relative to the market but at a premium to their intermediate multiple. Those sectors highlighted in "Grey" are considered undervalued relative to their intermediate multiple but overvalued to the market. Lastly, the "Orange" is considered overvalued both relative to the intermediate multiple as well as the market multiple.

Exhibit 17

	Name	Forward P/E	Intermediate Median P/E	SPX Index Forward P/E
S5TELS Index	S&P 500 COMM SVC	18.1x	18.95x	19.70x
S5UTIL Index	S&P 500 UTILITIES INDEX	16.52x	19.67x	19.70x
S5COND Index	S&P 500 CONS DISCRET IDX	24.24x	28.11x	19.70x
S5CONS Index	S&P 500 CONS STAPLES IDX	19.65x	21.26x	19.70x
S5ENRS Index	S&P 500 ENERGY INDEX	11.85x	12.31x	19.70x
S5FINL INDEX	S&P 500 FINANCIALS INDEX	14.12x	13.82x	19.70x
S5HLTH Index	S&P 500 HEALTH CARE IDX	18.56x	17.44x	19.70x
S5REAL Index	S5REAL	32.89x	44.28x	19.70x
S5INFT Index	S&P 500 INFO TECH INDEX	28.02x	27.49x	19.70x
S5MATR Index	S&P 500 MATERIALS INDEX	17.66x	17.73x	19.70x
S5INDU Index	S&P 500 INDUSTRIALS IDX	18.79x	20.77x	19.70x

Source : Bloomberg/ PMI as at 09/26/23

Higher for Longer

The Sept 19th - 20th Federal Open Market Committee meeting was considered very "hawkish," with the committee reiterating a "higher for longer" narrative with the dot-plot signaling the possibility of another hike later this year to 5.75%. The new Summary of Economic Projections delivered was supportive of the soft-landing narrative.

Exhibit 18

Soft Landing Forecast			
	Currently	Fed 23 Forecast	Fed 24 Forecast
GDP	2.10%	2.10%	1.50%
Unemployment	3.70%	3.80%	4.10%
PCE Inflation	3.30%	3.30%	2.50%

Source: Bloomberg

The median projection for GDP growth jumped to 2.1% (from 1% in June). Unemployment is now expected to be 3.8% (down from 4.1% in June), while Headline PCE[1] inflation was revised up slightly to 3.3% (from 3.2% in June) and Core PCE Inflation down slightly to 3.7% (from 3.9% in June).

Simply stated, this should be good for the stock market as an expected acceleration in economic growth with lower unemployment should be good for corporate profitability.

[1] Personal Consumer Expenditure.

However, the Fed has a fine needle to thread against what certainly is an increasingly difficult backdrop of potentially both higher inflationary and recessionary risks. Areas of concern are higher oil prices (up around 34% in the last 3 months), the UAW[2] strike, yield curve inversion, Russia war, US government shutdown, a weak Chinese economy, and the resumption of student loan repayments, to name a few. This becomes more important given this year's multiple expansion-led rally, as any of the above could be a source of significant headwinds for future earnings.

Other implications from a higher for longer scenario are the effects it's currently having on Households and Consumers, as well as implications for Corporates grappling with an increased cost of capital.

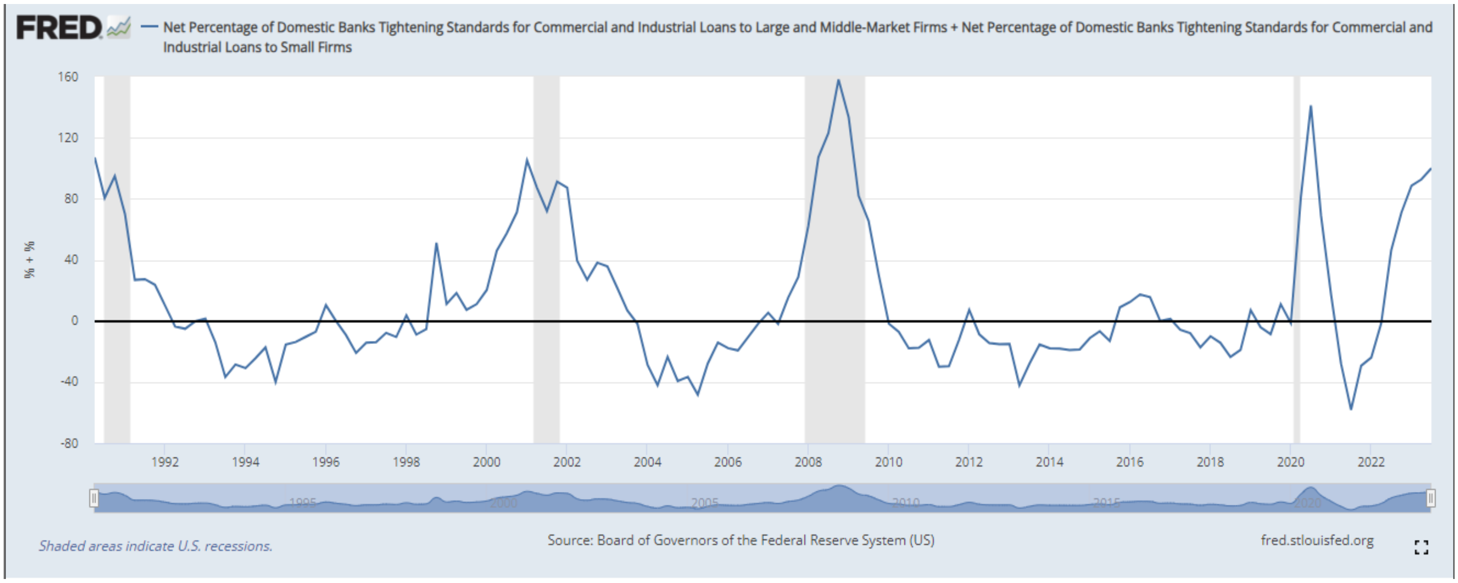
The labour market remains strong, with consumer spending (which contributes about 75% of GDP) proving resilient. However, of concern is the fact that consumer debt continues to make all-time highs, while personal savings, which showed some improvement throughout late 2022 into 2023, has once again turned down and is back at its 2008 level. (See **Exhibit 19**).

Exhibit 19

Source: Bloomberg/PMI

While corporate high-yield debt spreads do not reflect any real concern within the debt market from a default or economic risk standpoint, this too may come under pressure as bank lending criteria continues to head higher and debt refinancing occurs at higher rates. **Exhibit 20**, below, denotes that the tightening of bank lending standards continue to increase with further restrictive monetary policy. This carries risks towards exacerbating any projected slowdown in economic activity as companies look towards adding or refinancing existing debt at higher rates.

Exhibit 20



Source: Federal Reserve Bank of St. Louis

[2] United Auto Workers.

To date, companies have been more or less able to do a good job with managing their interest expense, many having taken the opportunity to refinance their debt at low fixed rates during the Covid pandemic. However, a significant proportion of debt is expected to come due in 2024 and 2025, which will have to be refinanced at higher rates. In a recent report, Fitch Ratings states that the U.S. Investment Grade remaining maturities for 2023 are at $110 billion, increasing to $330 billion in 2024 before peaking in 2025 with $403 billion coming due.

Did you know?.......

- **Bear market** - typically describes a sustained period where stocks are in a decline of -20% or greater. It is a market condition where falling prices are caused by economic decline, consumer pessimism, and negative investor sentiment.
- **Bull market** - A sustained period in the stock market where there is a 20% or more gain in the market's main equity indexes against a backdrop of high investor confidence and a strong economy.
- **Hard-Landing** - refers to a marked economic slowdown or downturn following a period of rapid growth leading to a recession.
- **Hawkish** - A hawkish stance is taken by central banks when trying to lower inflation through restrictive monetary policy. A hawkish approach is usually recommended when the rate of inflation is rising and there are signs it will keep rising relative to the central banks' inflation target.
- **Personal Consumer Expenditure (PCE)** - this index is used for analyzing inflation by measuring the monthly change in the price of a broad range of consumer goods and services.
- **Recession** - a slowdown in general economic activity that is recognized after two consecutive quarters of negative GDP growth.

A recent study by the Federal Reserve Bank of Boston cites findings that suggest that the pass through of the federal funds rate increases into firms' interest expense has been incomplete and delayed, with peak responses occurring about one year after policy rate increases. Thus, while the effects of the early Fed hikes may have fully passed into corporate interest expense ratios, the effects of most of the rate hikes have not fully kicked in. This, plus the shock of refinancing at higher levels may complicate any plans for a "soft landing" as corporate profits become impacted which can lead to decreased capital expenditures as well as increased lay-offs or outright defaults.

During this increasingly challenging macroeconomic backdrop, PMI continues to work alongside its clients focusing on effective risk management strategies towards ensuring their financial priorities will be met.

With the stock market appearing to be finally acquiescing to the reality of a "whatever it takes" Fed committed to bringing inflation back to its target rate, expect volatility to pick up from here into year-end as recession risks are very real and market breadth has been deteriorating. Long duration sectors such as technology (especially those companies in a loss-making position) could come under increased scrutiny as higher rates put downward pressure on valuations (Nasdaq Index down -10.58% at time of writing is within correction territory). In addition, the Magnificent 7 stocks (BM7T Index) which was a significant contributor to the market 's YTD returns is also flirting with official correction territory. Active stock picking with a focus on strong balance sheets and cashflows, within those defensive sectors trading at attractive valuations, should be prioritized at this time. We also recommend an overweight in cash.

On the fixed income side, an investment grade "barbell" strategy (with a focus towards the higher credit quality part of the spectrum) continues to look attractive wherein you capitalize on higher income on the shorter end (higher rates) with the possibility of capital gains on the longer end, as long-term yields eventually reflect a slowing economy alongside rate cuts now expected within the back end of 2024. For context, US 2-year Treasuries yield around 5.18%, while the 10-year is around 4.62%. PMI