TD Wealth

The Downside Up

Market Insights

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Wealth Investment Office

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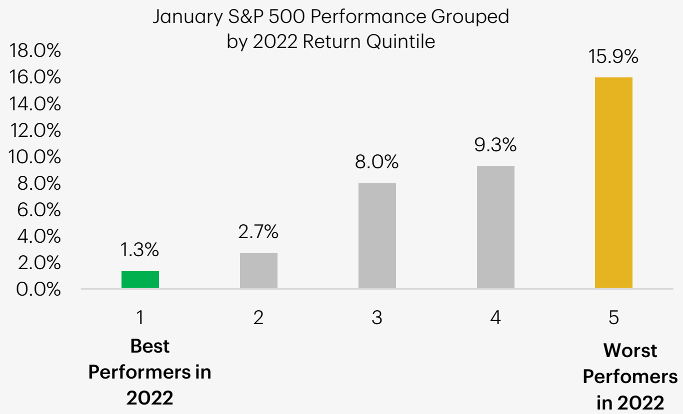
In the popular Netflix series *Stranger Things*, scientists discover a hostile alternate dimension called **The Upside Down**, which brings chaos to the everyday lives of residents in the town of Hawkins, Indiana. We've recently experienced a form of chaos ourselves — the anomalous price behaviour in equity markets so far this year, in which the best performing stocks of 2022 became the weakest performers to start this year, while the worst performing stocks of 2022 have been some of the strongest performers in the first two months of 2023 (Figure 1).

As shown in Figure 2, so-called "quality" stocks (with strong balance sheets, high-quality earnings, etc.) have lagged in this market rally, underperforming the broad market. On a sectoral basis, technology has been one of the best performing sectors year-to-date, whereas health care and consumer staples have been the bottom-performing sectors in 2023.

This highlights that the rally has not been supported by broad based participation and is more speculative in nature. We believe equity markets will remain volatile, with risk to the downside given the ongoing challenges in macroeconomic data.

Figure 1: Upside down or downside up?



Source: FactSet as of January 31, 2023.

Figure 2: Quality stocks have lagged the average recently

Source: Bloomberg Finance L.P., TD Wealth as of February 23, 2023.

Is there economic support for a renewed bull market?

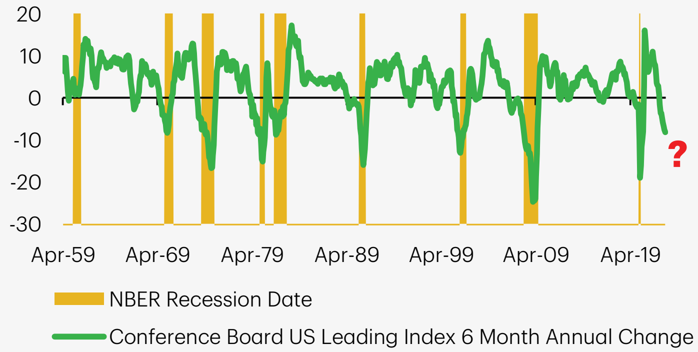
When we look at the macroeconomic indicators necessary to support a new bull market, we find the data mixed at best, and more likely pointing to a recession on the horizon.

For instance, Figure 3 shows the U.S. Conference Board Leading Index (green line) plotted against official U.S. National Bureau of Economic Research (NBER) recession periods (gold-shaded regions). Over the past 60 years, every time the Conference Board Leading Index declined by a similar magnitude over the prior six months, the U.S. experienced an official recession. In its most recent update, in February 2023, the Conference Board noted that a recession warning had been triggered.

Another strong recession indicator, the OECD Leading Composite Index, is trending lower (Figure 4) and dipping towards the 98 level, which is associated with recessions.

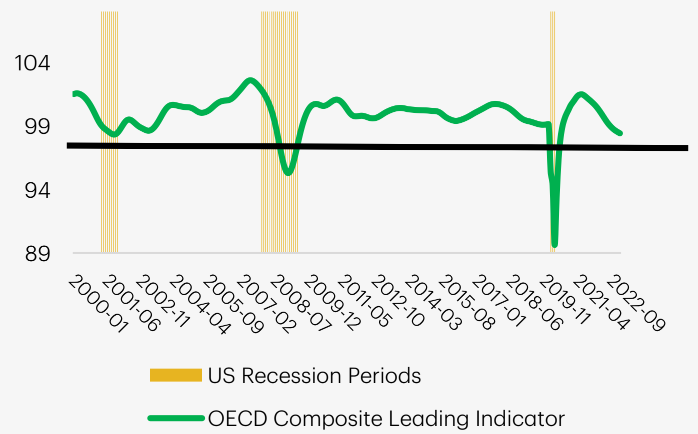
In addition to these leading economic indicators, we also see a strong recession signal from the bond market. An inverted yield curve (in this case, when the yield on the two-year U.S. Treasury exceeds the yield on the 10-year Treasury) has a near perfect track record in signalling a recession over the following nine to 18 months. The current negative yield spread is at its lowest since the early 1980s (Figure 5).

Figure 3: Conference Board leading indicators point to a high probability of recession



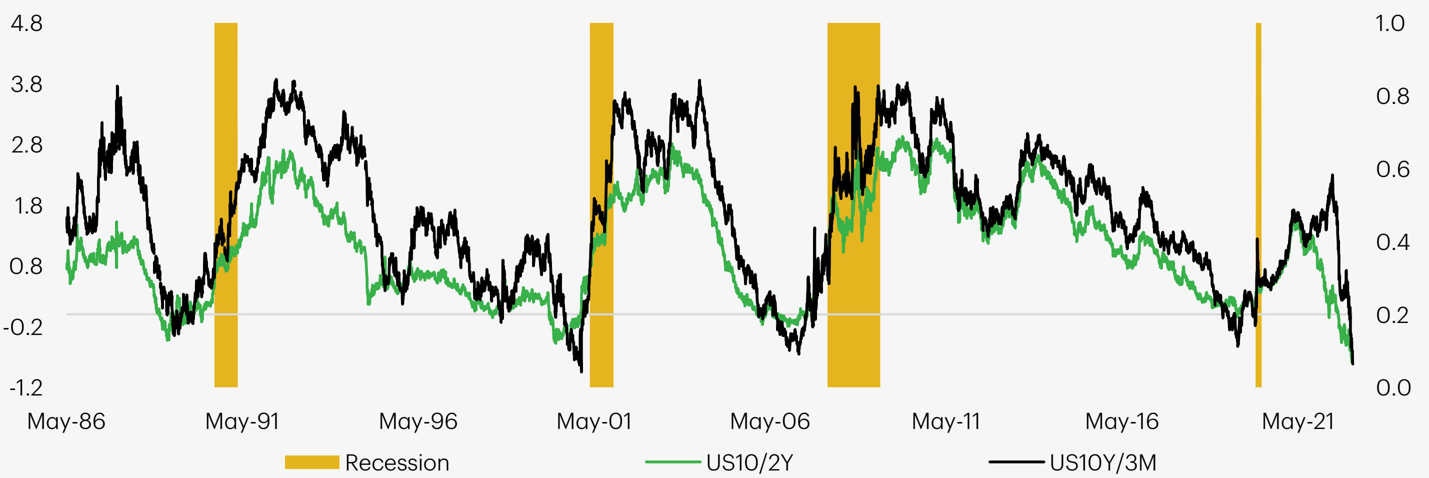
Source: Bloomberg Finance L.P., TD Wealth as of February 17, 2023.

Figure 4: The OECD CLI has signalled the prior three recessions on dips below 98



Source: OECD, TD Wealth as of January 31, 2023

Figure 5: Yield curve inversion has almost always been followed by recession



Source: Bloomberg Finance L.P., TD Wealth as of February 23, 2023

Economic activity drives stock market performance

The importance of examining the macroeconomic data in determining bull and bear market cycles is illustrated in Figure 6, which shows the relationship between economic growth and stock-market direction.

Turning to how the economic slowdown is playing out in corporate earnings, Figure 7 shows the downward path of analyst earnings revisions over the 2022 and 2023 periods. Since equity indices are valued by the earnings that are projected, a downward path for earnings projections should lead a lower index level in the absence of a sentiment-driven multiples expansion.

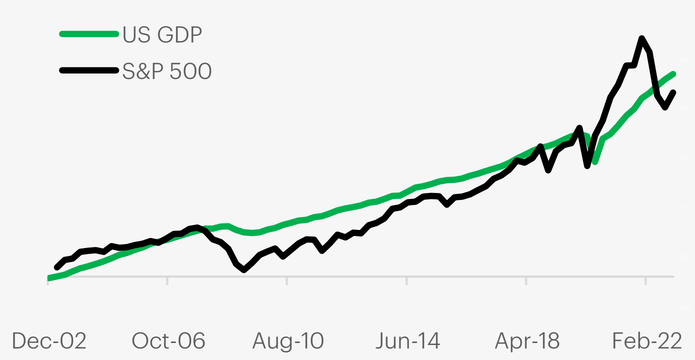
While sentiment and the movement in the price/earnings multiple will drive stock market performance in the short term, over the medium and long term, stock performance is determined by earnings growth (Figure 8).

Conclusion: Rally seems unsustainable

The noise in the equity market is in large part being driven by a big economic question: Are we headed into a recession? Will it be a hard or soft landing, or have we avoided a recession altogether? The jury is out on all three, but what we know for sure is that we are in a late-stage economy and this is the foundation of our thinking and our allocations.

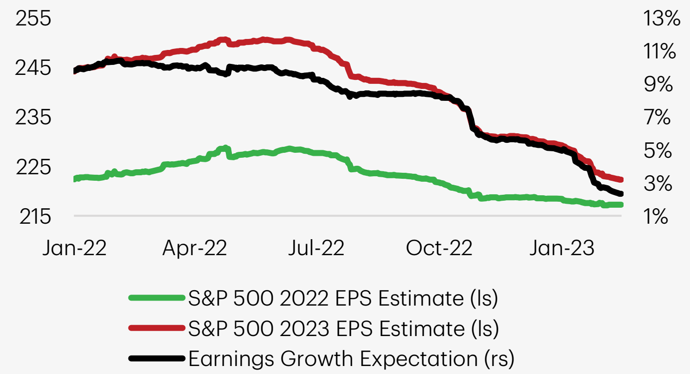
Our current directional theme is based on the idea of keeping grounded, which is why we titled our Portfolio Strategy Quarterly, Right Here. Right Now. Environments like this create a lot of noise which can lead to short term movements which can lead to longer term losses if one is not careful. Looking at the sharp rally in equity markets year to date, and considering the economic data ahead of us, it would seem the **Downside Up** anomaly is not sustainable. The key to success during periods like this is to stick to one's discipline, which in this case means owning an equity portfolio based on economic growth, not sentiment or cyclical volatility.

Figure 6: Economic growth drives corporate earnings which drives stock prices by recession



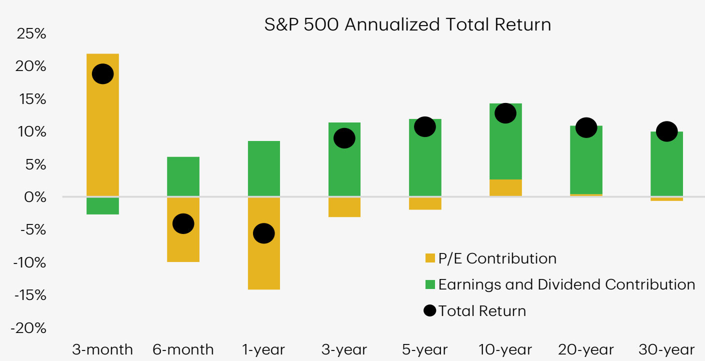
Source: St. Louis Federal Reserve, FactSet, TD Wealth as of January 31, 2023.

Figure 7: S&P 500 earnings estimates for 2023 continue to fall



Source: Bloomberg Finance L.P., TD Wealth as of February 23, 2023

Figure 8: Corporate earnings drive stock market performance over the long term



Source: Bloomberg Finance L.P. as of February 15, 2023

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