CETERA® INVESTMENT MANAGEMENT

COMMENTARY

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Bear Market Rally or New Bull Market?

- Stocks are rallying off their June bear market lows.
- Valuations are rising, but less than 50% of S&P 500 stocks are above their 200-day averages.
- Inflation and the Fed remain investors' focus, so volatility will continue.

After losing nearly 20% the first half of the year, the S&P 500 is up over 13% since June 30. Pessimism turned to optimism, as inflation is showing signs of easing and thus the Federal Reserve may not have to raise interest rates as much as previously expected. Higher interest rates are a headwind for economic growth and corporate earnings.

The big question on investors' minds is whether this recent rebound in stock prices will be sustainable or just a bear market rally. Stocks do not go straight up nor straight down, so some fear this rally will not be sustained, and stocks will eventually continue their downward trend. Answering this question is difficult, but we can look for clues in equity market fundamentals, technicals, and even the bond market.

Fundamentals such as corporate earnings have largely beaten expectations this earnings season. The S&P 500 price-to-earnings (P/E) ratio peaked over 24X forward earnings in September 2020 when investors bid up stocks on fiscal stimulus news. Since that peak, the P/E ratio has been falling and dipped under 15.5 in June of this year. This is important because this is near the 20-year average. Currently, this ratio is above 18 and starting to raise concerns that the stocks could be getting overpriced again. While no longer cheap perhaps, these valuations are still lower than February 2020 pre-pandemic level.

The potential that we are past peak inflation could help slow the pace of Fed hikes and increase future earnings estimates. The big fundamental point to watch is the magnitude of Fed rate hikes. Investors are grappling with whether the Fed will raise rates 0.50% or 0.75% at its next meeting on September 21. If the Fed feels the need to remain aggressive, this could hurt stock prices. If the Fed is confident that inflation is headed in the right direction, stock markets could continue their ascent higher. The good news is that we will also get a plethora of important economic data and Fed thoughts before the next meeting.

Looking at technicals, technicians like to watch the 200-day moving average on the S&P 500. If the S&P 500 can remain above that average for a sustainable period, it suggests a legitimate rally. If it cannot, it could be a sign of just a bear market rally. The S&P 500

hasn't closed above that threshold since April 7 but is currently less than 1% below the 200-day moving average. If we look at stock market breadth, over 90% of stocks in the S&P 500 are above their 50-day moving average and only 46% are above their 200-day average, so there could be room for more upside as companies push above these longer averages.

If we focus on the bond market, we can get some more insights. Bond investors also think we are past peak inflation and are bidding up bond prices, sending bond yields lower. The 2-year Treasury yield can be an indicator of where bond investors think the Fed Funds rate will be in a year from now. This yield is currently 3.25% and off its peak of close to 3.50%. The current Fed Funds target range is 2.25% to 2.50% with Fed Funds Futures probabilities points to either another 0.50% or 0.75% hike in September. This would put the Fed Funds rate close to what the bond market is currently expecting. Although, bond investors may be expecting more rate hikes and subsequent rate cuts next year.

We are at an important fork in the road in terms of market direction. We have had a nice rally on optimism around peak inflation and the notion that investors have already priced in an economic slowdown. Important economic data and Fed direction will help discern how much longer the rally can be sustained. Furthermore, the stronger dollar, quantitative tightening, and the not yet felt effect of already instituted rate hikes on the economy may also keep Fed rate hikes in check on a go forward-basis.

Regardless of what transpires next, we do believe market volatility will be elevated as investors grapple with it and react to the day-to-day deluge of economic data, including inflation readings, and geopolitical risks. In this environment, please continue to work with your financial advisor to make sure you are properly diversified to help mitigate market volatility and your portfolio is aligned with your long-term investment objectives.

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