WHY DECLINING MARKET BREADTH IS A FALSE FEAR

SEPTEMBER 2023

KEY POINTS

- While many see the recently falling market breadth as a negative, rapidly falling market breadth hasn't foretold bear markets, and in fact, often proceeds very positive equity returns.
- While we agree Artificial Intelligence (AI) is a bit overhyped, the "bounce effect"—the tendency for the downturn's worst-performing equities to perform best as the market recovers—likely explains much of what pundits deem "AI froth". Information Technology was among the worst performing sectors in the 2022 bear and therefore was poised for a sharp rebound in the recovery which followed.
- Many of the leading growth names commonly referred to as "Magnificent Seven" in the press, have still not fully recovered from their 2022 downturn. Furthermore, different breadth indicators show US equities outside the "Magnificent Seven" have broadly performed better than most think.

INTRODUCTION

The new bull market that we believe started in October 2022 has featured a classic "wall of worry"—a barrage of investor fears that tamps down on sentiment as equities climb higher. Global equities have rallied despite investor fears over aggressive rate hikes, inflation and recession expectations. Additionally, despite the economic and political tailwinds behind this bull market, many pundits argue the current market environment is fundamentally unstable. They say that this year's narrow market breadth—commonly defined as the percentage of equities beating the broader market—makes the rally weak, set to fall again when Tech stops leading. We believe this is a false fear and is a brick in the "wall of worry", creating space for this new bull market to continue.

THE 2023 MARKET RALLY & BREADTH FALL

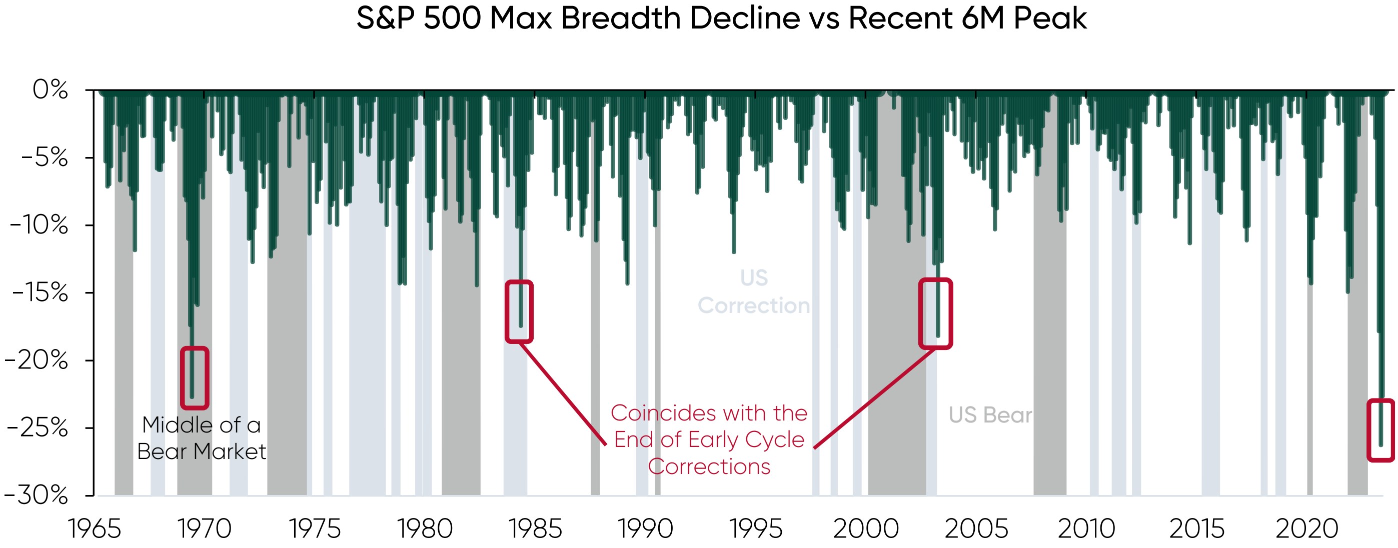
While US equities strongly recovered in 2023, the traditional measure of market breadth (% of outperforming stocks over the prior 12 months) rapidly narrowed in the year's first half. Market breadth peaked at January's end as over 62% of S&P 500 equities beat the index over the prior year. However, by May's close, just 32% did. That is this breadth measure's fastest plunge since reliable data started in 1965.[i] Historically speaking, traditional low market breadth is a late cycle indicator—leading investors to believe this rally is unsustainable. However, there is more to this drop in breadth than most investors understand. Falling market breadth we believe is a false fear and many of the fears surrounding this market rally seem misguided.

COMBATING INVESTORS' FALSE FEARS

FALSE FEAR: FALLING MARKET BREADTH IS A NEGATIVE FOR MARKETS

Pundits during this rally have insisted that the market has looked narrow, hollow and fragile—arguing that the falling market breadth seen in the first half of the year is a bearish indicator. However, falling market breadth isn't inherently bearish. As shown in Exhibit 1, this year's fall in market breadth was the steepest fall in history. However, history suggests falls of this magnitude precede strong performance. Of the three other breadth periods approaching 2023's record size: one in 1969 came mid-bear market and soon before a 32-month bull market erupted, delivering 74% gains. The others came during early bull market corrections: one in 1984 and one in 2003. Average +12M, +18M and +24M S&P 500 returns following these periods of large drops in breadth were 7.0%, 15.0% and 30.8% respectively.

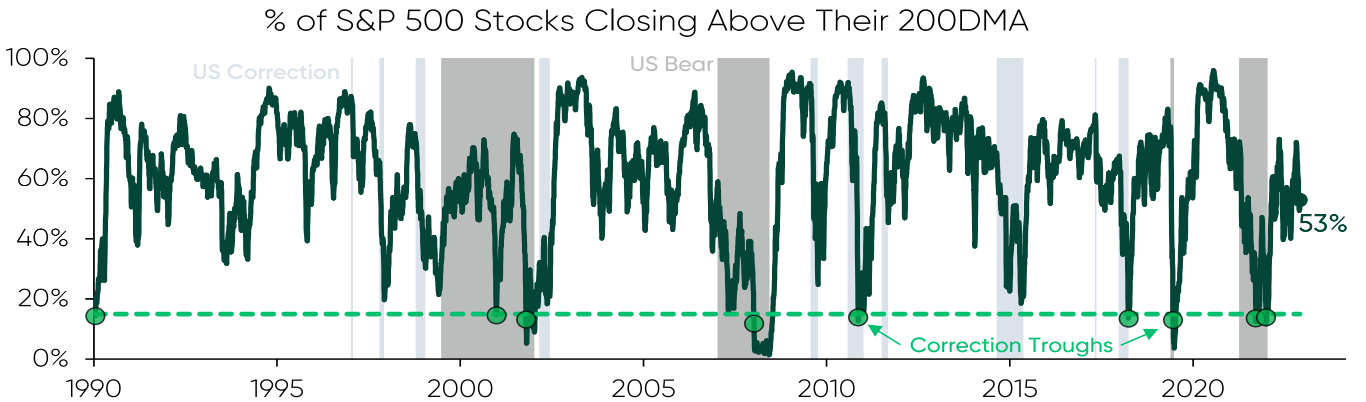
Exhibit 1: Sharp Decline in the % of Stocks Outperforming the Market



Source: Clarifi—Trailing 12M S&P 500 breadth (% outperforming), monthly through 31/5/2023. Drawdowns measured from the max declines during a rolling 6M period vs front month.

Another common way of measuring breadth is by looking at how many equities close above their 200-day average price. In June and September of 2022, this number fell below 15% for the S&P 500—only the eighth and ninth times since 1990. Again, however, this drop in breadth historically proceeds booms, not busts. Exhibit 2 shows that S&P 500 returns following the seven deep troughs before 2022 were higher 86% of the time in the next 3 to 24 months. In fact, after 24 months, US equities on average were 33.4% higher.

Exhibit 2: % of S&P 500 Stocks Closing Above Their 200 Day Moving Average

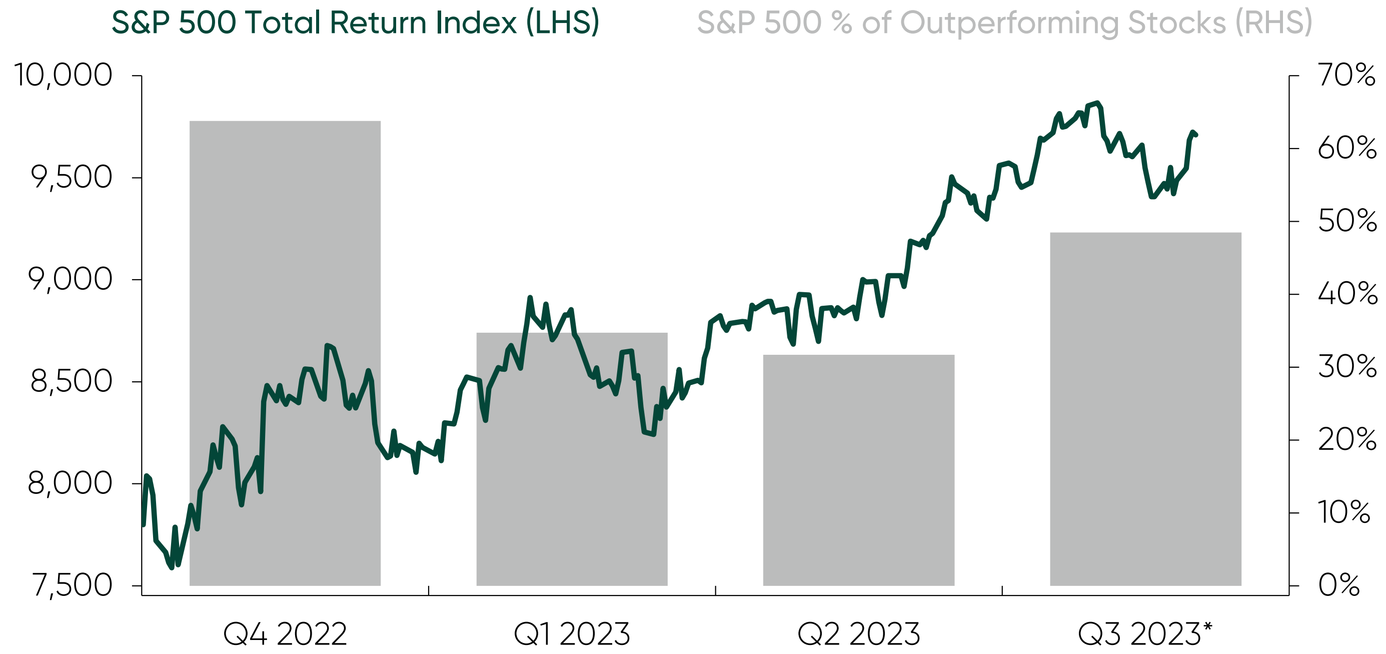


Returns After the % of S&P 500 Stocks Above Their 200DMA Dips < 15%					
Date	+3M	+6M	+12M	+18M	+24M
16/10/1990	5.8%	29.7%	31.4%	39.2%	37.7%
26/09/2001	14.1%	13.1%	-15.1%	-13.6%	-1.0%
18/07/2002	0.3%	2.3%	12.7%	29.3%	24.9%
07/10/2008	-9.0%	-18.1%	6.2%	18.7%	16.2%
10/08/2011	10.6%	19.8%	25.4%	35.4%	50.9%
26/12/2018	14.2%	18.1%	31.3%	21.9%	50.1%
13/03/2020	12.2%	23.2%	45.5%	64.8%	55.1%
Average	6.9%	12.6%	19.6%	28.0%	33.4%
% Freq. Positive	86%	86%	86%	86%	86%

Source: FactSet. Daily % of S&P 500 constituents above their 200 day moving average from 1/10/1990-31/8/2023. Current periods beginning in 17/6/2022 and 27/9/2022 are not included in the summary statistics.

Additionally, a low-breadth boom now is quite logical. In a slow growth environment with widespread recession fears, few stocks can inevitably grow. Investors fearing risk crave the reliability of assured growth and will pay up for it since that is now so scarce. So investors flock to large, high-quality growth-like equities and market breadth shrinks. However, as pessimism falls and these false fears begin to diminish, breadth should begin to rise again and we expect the bull market will continue its climb. This has been the case thus far in 2023, with breadth narrowing in the first half of the year but rising so far in the second half—all while equities have continued their strong run, illustrating that markets can move higher in both narrowing and widening breadth environments. (Exhibit 3)

Exhibit 3: Equities Have Largely Ignored Market Breadth



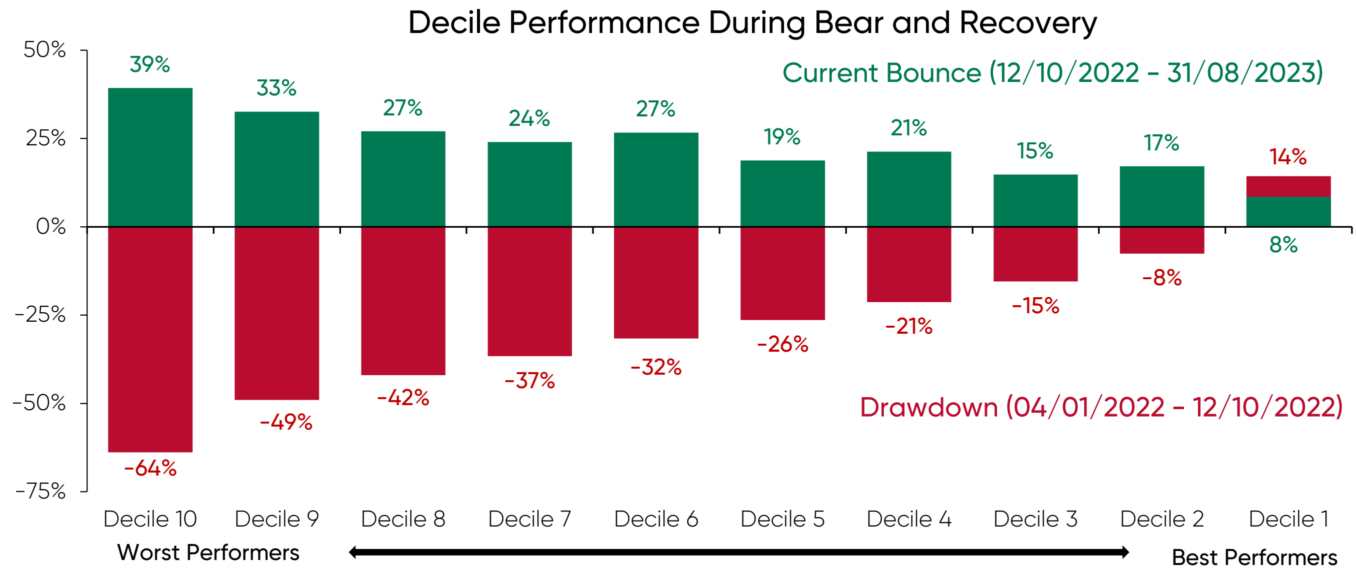
**Data shown from 1/7/2023-31/8/2023. Source: FactSet, as of 31/8/2023 in USD. Shows S&P 500 quarterly % of stocks outperforming the index by count and S&P 500 Total Return Index with daily data.*

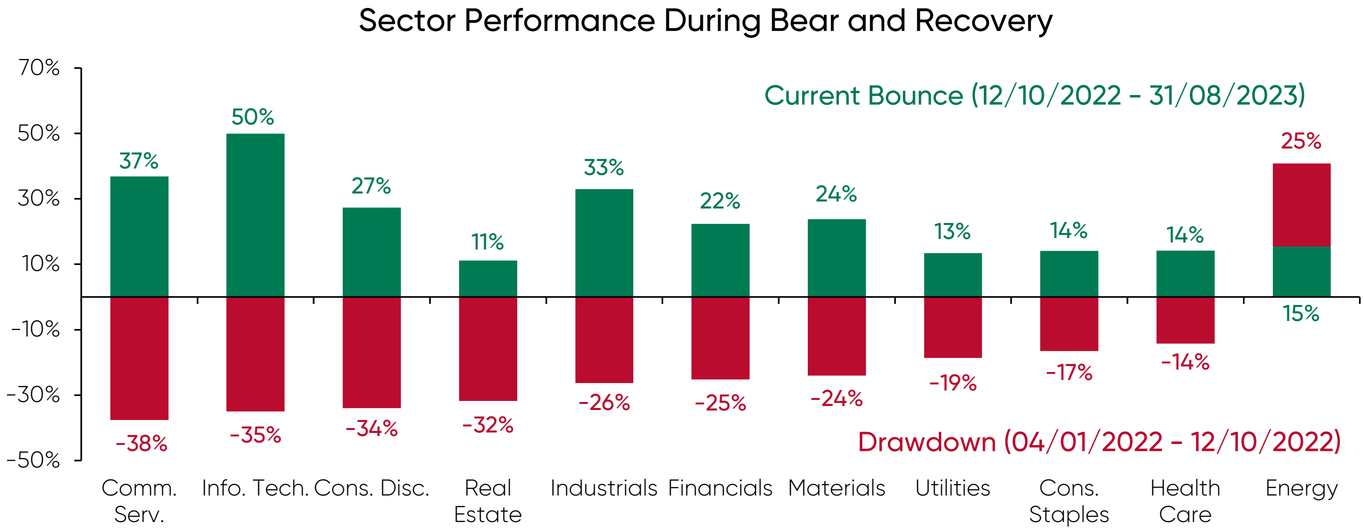
FALSE FEAR: AI ENTHUSIASM IS THE PRIMARY REASON FOR TECH'S UPTURN

Another reason many pundits say the rally cannot continue is the recent emphasis on Artificial Intelligence. AI has been a hot topic of late, and many believe enthusiasm over AI has led the Information Technology sector higher—leading many to believe equities sharp rise will reverse when reality proves AI to be frothy. While we agree AI is likely a bit overhyped, pundits are missing a key point: there are other factors involved that matter more to Technology's bounce this year than AI.

In order to understand why large, growth-oriented companies are leading this year, we need to consider what happened during the 2022 drawdown. A phenomenon we often discuss is called the "Bounce Effect": the tendency for the downturn's worst-performing categories of equities to perform best as the market initially recovers. This has happened following a majority of bear markets historically and has played out well since this bull market began last October. Despite strong fundamentals, large growth equities—predominantly found in sectors such as Information Technology and Communication Services—fell hard in 2022's bear market, but in the recovery they are rebounding strongly. (Exhibit 4)

Exhibit 4: The Bounce Effect





Top Chart Source: FactSet. MSCI World Price Returns from 04/01/2022-12/10/2022 and 12/10/2022-31/8/2023. Deciles are bucketed by performance in drawdown. Bottom Chart Source: FactSet. MSCI World Sector Total Returns from 04/01/2022-12/10/2022 and 12/10/2022-31/8/2023. Data in USD.

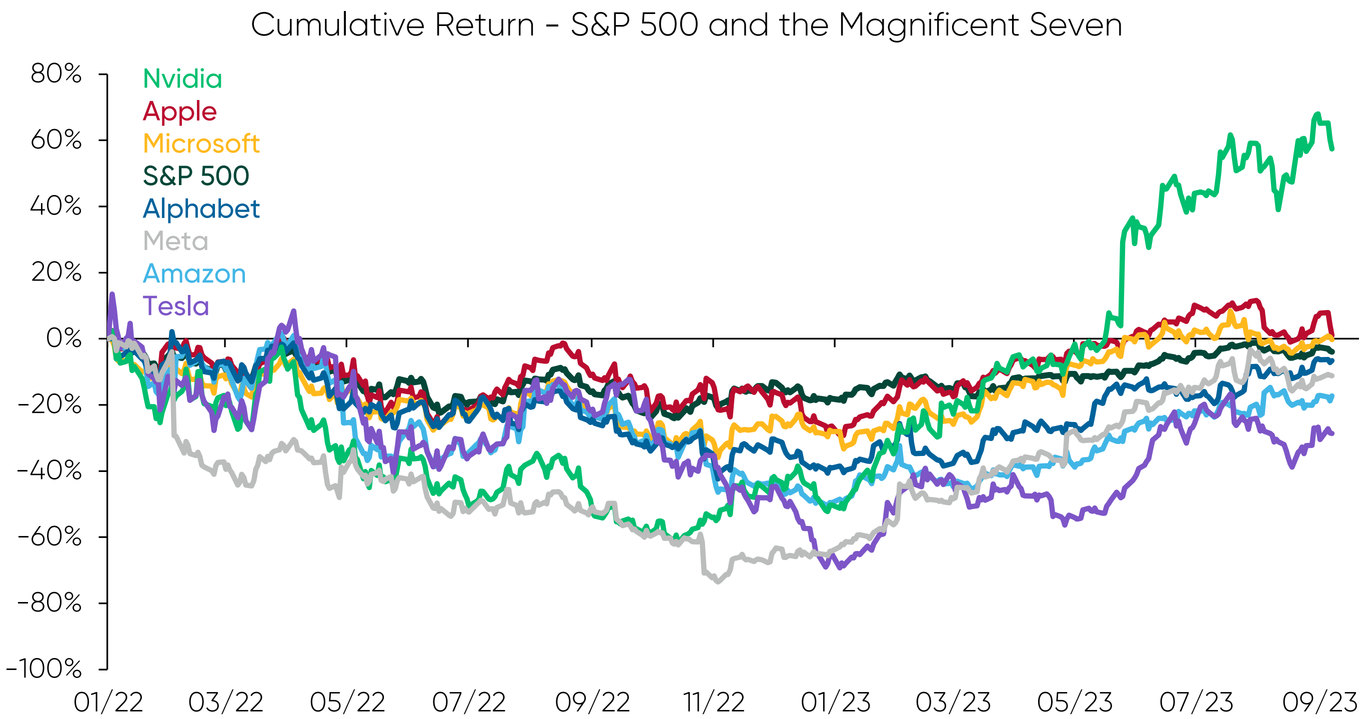
Beyond this, slow overall economic growth favours Tech and growth generally, given their better ability to deliver sales growth in that environment. Many economists continue forecasting recession or at best, sluggish growth. That fuels fears of a low-growth world hampering companies dependent on booming demand—like smaller, value firms. Therefore, investors want to own companies capable of churning out earnings in a slower global economy. These are true growth equities. Their rise is a simple, logical result of tight supply and high demand. Hence, we think concerns over Tech's rise this year is a false fear. And false fears are bullish—bricks in the wall of worry.

FALSE FEAR: THE MARKET RALLY ISN'T SUSTAINABLE AND HAS BEEN DRIVEN BY A FEW NAMES

Similar to breadth fears already discussed, pundits have touted the "Magnificent Seven" stocks (Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia and Tesla) as the primary driver of this year's market bounce. The argument many pundits make is that the concentration of these equities is the primary driver for the strong equity returns this year—which is not sustainable given these stocks are now overvalued and therefore have little room to run. Similar to other investor concerns on breadth, this fear is a bit misunderstood and misses a lot of context.

First, while these names have strongly rebounded this year and helped drive markets up, as previously discussed: what falls the most in the drawdown tends to bounce the most in the initial recovery. Almost all of these names meaningfully underperformed during the drawdown (except Apple) and therefore were poised to strongly bounce in the initial recovery. Second, while the "Magnificent Seven" have performed well this year, they likely haven't performed as well as many may lead you to believe. Exhibit 5 shows that while the "Magnificent Seven" have rebounded, only three of the seven have outperformed the S&P 500 since the beginning of 2022 and only Nvidia has meaningfully reached new highs. More specifically said, excluding Nvidia, all of these stocks have either significantly underperformed or performed in-line with the S&P 500 since the start of 2022. This is a far cry from the narrative that all of these equities have drastically outperformed, are overvalued and have little room to run.

Exhibit 5: The Not So Magnificent Seven



Source: FactSet, as of 31/8/2023 in USD. Shows stock returns and S&P 500 Total Returns from 1/1/2022-31/8/2023 with daily data.

Furthermore, traditional market breadth typically overshadows the actual amount of equities outperforming in a given index due to the cap-weighted nature of these indexes. This is the case in a US index like the S&P 500 with a few heavily weighted names. There are a few ways to illustrate this. First, as shown in Exhibit 2, at the end of August, 53% of S&P 500 stocks closed above their 200 day moving average—at a healthy level and up significantly from their 2022 lows. Second, we can strip out the cap-weighting effects and examine how many stocks outperform the S&P 500 Equal Weighted index. Year-to-date through the end of August, 47% of stocks have outperformed the S&P 500 Equal Weighted index–which is in line with historic averages and even higher than several of the past few years[ii].

CONCLUSION

As headlines continue to provide reasons this bull market cannot continue, we believe many of these are false fears. Falling market breadth historically has proceeded strong equity returns and the many overarching arguments surrounding breadth and AI enthusiasm miss a lot of important context. Market breadth is yet another illustration of what Ken Fisher calls "the pessimism of disbelief"—the idea that in new bull markets people will continue dismissing the rally and seek reasons to be bearish or reasons the rally cannot continue. Today's economic data, while not stellar across the board, keep beating expectations and this bull market has continued its run despite a mound of investor worries: from inflation to earnings to low market breadth. This is encouraging, and this "pessimism of disbelief" likely gives equities plenty of room to run going forward.

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[i] Source: Clarifi, as of 9/6/2023. S&P 500 breadth, defined as the percentage of constituents leading the index over the past 12 months.
[ii] Source: FactSet. Data based on the S&P 500 Equal Weighted Index from 01/01/2023 – 31/08/2023. Data in USD. Historic averages based on last 20 years of calendar year data.

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