Daily Market Note: October 4th 2023 by Larry Cheung, CFA

Focused Traders & Investors waste no time tactically buying yesterday's plunge at key levels and exits planned. We were among them.

<u>Forward-looking Conclusions of this note:</u>

- Macro: Discussed yesterday was our view that markets would find an intermittent bounce. How long this bounce sticks, I do not know. All I could surmise was that a bounce was coming, and it showed up today.
- Stock-Specific: The number of opportunities that look attractive to me on a stock-specific level is growing.
- Bonds: The higher for longer narrative is a mirage that will fool many people in 2024, in my view. I will be positioning accordingly. Simple as that. Rates can go higher, but all higher levels from here are Temporary (with a Capital T).
- China: Certain Chinese EV names look attractive to me. I'm entering Li, XPEV, and BYD.
- Rest of World: I like the European Luxury theme from yesterday at these levels. Dipping my toes in now.

<u>Daily Market Note & Context</u>

Macroeconomic data points are famously difficult to truly take at face value – for example, yesterday's JOLTS jobs report indicated that openings are plentiful and today's ADP report shows that private hiring is slowing. So, which to believe? These reports are contradictory to each other. The most important data point here that I took away was that large corporations (defined by 500+ employees) shed 83,000 jobs whereas small/mid-sized firms picked up the slack to result in a net add of hiring of 87,000 jobs.

While America's labor force is built on SMBs (small-medium businesses), the statistics show that the vast majority of consumer spending is held up by higher income folks who work at large companies. Large companies that have achieved scale are able to pay their workforce at higher wages to attract stronger talent. Now that we have large companies shedding jobs, with more to come, I can not back down on the view that the U.S. is about to enter a slowdown that will be demonstrated by:

- Lower housing prices (albeit this decline may be modestly contained to –5-10%)
- Higher unemployment (to potentially 4.5% by mid 2024)
- And deflationary pressures to emerge in some sectors – such as Autos.

I would characterize the economic environment we are currently in as Stagflation. Slow growth. Pesky inflation. And OK labor market. However, as can be seen by the immediate and forceful impact of higher long term treasury rates, the Fed's hawkish commentary (which will end up being a policy mistake that puts a lot of people out of work) has instantly had the following impact:

- Devastation of the Vanguard Real Estate ETF VNQ. I trust the VNQ's equity levels as a prelude for what's to come for the real estate market. Residential will not be spared, contrary to what the current high home price levels may suggest
- Immediate selling of Financials – we can now see the great importance of limit sell orders upon a defined profit target the last time I talked about Banks, as Treasury yields spiking as wreaked havoc on Goldman Sachs (GS), Morgan Stanley, Bank of America, and other financial firms that are perceived to have large bond market exposure. Financials have been nearly impossible to profit from an investment perspective. Trading, though, is different.

Traders that have taken long-term 10Y treasury rates to current extreme levels north of 4.8% are putting immense pressure on the broader macro structures upon which most companies are built (using debt to finance growth). This is why RSP ETF, which I believe will underperform SPY & QQQ, has continued to lag cash-rich companies from the FAAMG stocks. I expect this trend to continue, regardless of whether yields come down or not. The toll from higher rates will make its way into guidance for most S&P 500 companies in this reporting season. The good news for us is that much of SPY/SPX is controlled by the Magnificent 7, and I don't believe FAAMG will be that impacted by higher rates.

For equity investors, we are entering a 6-9 month period where I expect companies to once again announce layoffs and job cuts. While this means pain for main street folks, public companies where Wall Street is their boss will do everything they can to protect their EBITDA margins and EPS outlook. This is a cycle I have seen over and over again. The ADP report today with large corporations shedding jobs is a whisper that companies are going to protect their bottom line.

If restructuring and further layoffs are on the table, then I wouldn't be overly nervous as a longer-term equity investor. Pain on main street typically leads to gains on Wall Street.

Today's bounce is justified and expected. However, stocks are likely to be choppy until the 10Y Yield spends at least 3-5 sessions under 4.7%. Once that happens, the focus will shift onto earnings season. Traders can lift trailing stops to prevent erratic fades from relinquishing yesterday's profitable entries in SPY/QQQ.