Daily Market Note: August 16th 2023 by Larry Cheung, CFA

Sector Rotation Intensifies Away from Big Tech and Into Defensive Areas as Yields Push Higher

Forward-looking Conclusions of this note:

- Macro: Yields across the long-end of the Yield Curve (10, 20, 30Y) all continue to drift higher. This is causing discount rates in DCF models to move higher, repricing future cash flows to lower values (lower stock prices).
- U.S. Stock-Specific: No change in views on U.S. Stock Selection. As now demonstrated, Put Selling is dramatically outperforming Direct Share ownership. There will be a time when Direct Shares + Call Options will work better. But I'm not sure we are there yet.
- Bonds: Bonds continue to selloff, and yields continue to rise. But the impact on our TLT Options position has so far been reasonably contained. Direct Shares on TLT would have been a lot more challenging.
- China: China is a crowded trade among short-sellers. If I see further weakness, I think sporadic gap-ups in the 2-4% range for the sector will start to emerge over the coming 3-5 weeks. No change in views from last note.

Daily Market Note & Context

The market narrative continues to center around higher long-term yields that, if they go much higher, I expect a more pronounced selloff to emerge. So far, we are witnessing a slow-grind distribution in tech stocks (a slow bleed out). Volatility has been remarkably contained given that many Big Tech stocks are entering a –10% correction territory (with a few exceptions).

At this point, the S&P 500 earnings season is mostly finished (84% reported) and year-over-year earnings decline are in the –5% neighborhood. The forward P/E for the index is now around 19.2X compared to the 5Y average of 18.6X and 17.4X. I continue to think that today's valuation does need to compress a bit back to longer-term averages before there is an evidence-based rationale for adding stocks for long-term asset allocation. For tactical trading, the index Forward P/E is not as relevant, but long-term Investors should definitely pay attention to this valuation metric.

Investors ideally should be watching candles developed on the Weekly Chart while Traders should be watching how the Hourly Chart is developing in the context of the Daily and Weekly Chart. Using Hourly Timeframes, my work suggests that we should soon see a modest 1-3% counter-trend bounce in Tech stock-specific names across FAAMG and Semis in the context of eventual selling pressure to push prices lower after the bounce has occurred. I don't see any tech bounce being durable until the 10Y Yield stabilizes and halts its advance.

Holistically, here's how I now view the relationship between the 10Y and the Nasdaq-100 QQQ based on their recent correlation.

- If 10Y Yield (now 4.3%) makes its way back to 4.2%, I see QQQ reclaiming 370
- If 10Y Yield (now 4.3%) breaks above 4.4%, QQQ is most likely seeing 355 or lower.
- If 10Y Yield breaks above 4.5%, QQQ may revisit 345 Neckline or lower.

Despite the 10Y Yield making advancements, I am not changing my stance on TLT being good value at the Strike Level mentioned in previous letters. The U.S. is not in a position to keep inflation-adjusted rates this high without doing lasting damage to the real economy. High yields will eventually cause higher unemployment, yet high unemployment will eventually pressure down the yields.

If the 10Y Yield makes a parabolic spike, I may use Micro-Treasury Futures to take a trading position on Yields to bet on tactical mean-reversion lower. Will discuss later if it comes to it. More to come.