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Episode 10

2024 MARKET OUTLOOK: MACRO MEETS TECHNICAL

Tom Herrick: Hello, this is Tom Herrick, Chief Market Strategist for Cary Street Partners. I'm here today with our business partner, Katie Stockton. She's the Founder and Lead Principal with Fairlead Strategies. We're going to review the 2024 Market Outlook from Cary Street Partners, which is essentially four high-level recommendations. We're constructive on equities, particularly within growth stocks. Also within equities we're very constructive on small caps, smaller companies relative to larger companies. Additionally, we think there will be continued downward pressure on yields this year so we're constructive on bonds. And within bonds we also like mortgage-backed securities. So with those four high-level macro viewpoints, we'll welcome Katie Stockton. Katie, how are you today?

Katie Stockton: Good Tom. Happy New Year.

Tom Herrick: Thank you for joining us today and for our audience benefit, Katie has had a long career on Wall Street. She founded Fairlead in 2018, and prior to that she worked at BTIG, MKM, amongst other firms. She's also a contributor on CNBC, has a very strong national media profile. We work together, Fairlead is an institutional research house and money manager. How have you found running your own firm, Katie, versus working on those large Wall Street firms?

Katie Stockton: Well, you know, it's funny you say 2018, Tom and it feels to me like it's still a startup. So I think it's just the roller coaster that everybody kind of warned me before I started my own business. Where one day will be amazing and you're sort of on top of the world, feel like you've got this amazing growth ahead, and the next day, you know, feels like a pullback in the markets, right? Where you just feel like everything's going wrong. We thankfully now have a great team. We have five of us in total at Fairlead Strategies. And that means we have people that are sort of experts in different parts of the business. So with my good team, everything is made possible. There is a lot of the administrative stuff that comes with what we do, but we're proud of what we're putting out in terms of research, product and of course with the ETF that we manage.

Tom Herrick: It's been a great relationship for us. I'm going to take just a minute here and talk about our discipline or process at Cary Street in how it collaborates with Fairlead on the technical side. The top-down discipline that I develop is essentially evolving to high-level viewpoints with macro inputs, which is very common on Wall Street. And macro inputs, we're talking big, large economic type inputs. And then we add somewhat differently, not as commonly, we add this technical perspective, which is where Fairlead comes in, and their expertise to reinforce that outlook. And the reason for that is, macro inputs can be, I'll use the word messy, they lack precision I guess is a good way to put it. Whereas the technical toolkit that Katie works with, that adds a lot more precision to the entire process. The macro input for this year going forward, this is not anything particularly unique, is still the inflation picture. Disinflation now, and we've been good on inflation for three years, both on the way up and the way down. And the reason this input is so important is because that inflation data eventually works its way into the Fed, first stomping on the brakes last year, taking their foot off the brake. Maybe this year taking their foot all the way off the brake, lower rates. It feeds into rates, feeds into yields and most importantly, it feeds into what we talk about risk asset prices, stocks and bonds, in particular. That's the macro input at the 100,000-foot level.

What I'm going to do with Katie is walk through the recommendations for 2024. I do want to mention very quickly, you know, it's January 16th today, 2024. We first published this November 27th, so some of this has happened already. A little bit of it has. It's still pertinent, timely information, but there has been a bit of a lag between when we originally published this outlook. So for 2024 Cary Street's, essentially we're constructive on equities. We have a balanced growth value perspective but we want to emphasize it's very important to keep that growth allocation. Those growth stocks were the big performers last year. And this recommendation is actually a repeat from 2023. It's really important last year because those were the sectors that performed – technology, communications, consumer discretionary. And we want to make sure we have ample exposure to them because they're potent performers in a disinflationary environment. Katie, you

were right on sector and exposure last year, owning those three predominantly for most of the year. I'd love to hear what your thinking is on sectors and maybe other participants, they are as well.

Katie Stockton: Yeah for sure, Tom. We are also bullish on equities and that would be relevant certainly for this year. But I like when things are supportive, of course, from a macro perspective. We've seen long term momentum shift to the upside behind all of the major indices. And with the move that we saw in late Q4, we saw a lot of breakouts. So you were right to be bullish in November, certainly. And I think you're still right to be bullish because you have these breakouts and breakouts tend to foster additional upside momentum. They of course remove resistance levels from the charts. And we are expecting the S&P 500 to break out to a new high here in the first quarter. And that of course provides a positive technical catalyst. So we agree with you on that front. And we think it will be an easier market to take advantage of. I think it's right to leverage the improved market breath, which again, really manifested itself mostly in Q4 of last year. We saw inklings of it a bit earlier than that. But the real breadth improvement came in that quarter where we actually saw the advance decline line for the S&P 500 reach a new high. So we're excited about that because that means more sectors, more stocks should participate. And of course, that would mean that it's not a so mega-cap centric type of environment as it was last year, which is why I think it was a difficult year for most people. If you didn't have that exposure concentrated in the way that a lot of the indices and popular ETFs do, well, then you'd naturally underperformed these benchmarks. So it was a challenging year in that regard. We saw, of course, the outperformance from those mega-cap heavy sectors. Now we've actually seen it kick in more from a small and mid-cap perspective. So our rotational work still supports technology, consumer discretionary, communication services, but now it's shifting also in favor of other sectors. Financials and industrials would be good examples. And secondarily perhaps real estate. We've seen relative performance improve in those sectors in a meaningful way. And it suggests that they will be perhaps a source of upside leadership, at least here in the coming months or so. So it's nice to see that expansion and the market breadth on the sector front. Health care would be one that we haven't really yet seen kick in, but we have some indications of a loss of downside momentum in relative terms. And being a heavyweight in the S&P 500, we'd also really love to see that relative performance improve for health care. I think there's a lot of promise there, and the way it manifests itself in the growth value ratios is that with growth and value, it's been more of a struggle very recently for growth. We've seen corrective phases in growth versus value, but we agree on being overweight growth still longer term because we saw meaningful turnarounds last year in those ratios. And I say ratios because we're looking at both a large cap comparison and also a small cap comparison. So I feel that this corrective phase that you've seen and growth of late, might actually be an opportunity to build that relative exposure.

Tom Herrick: And the growth stock conversation, I often find myself going back to sort of those macro inputs. The reason they stunk in '22 was the same reason they were stars last year, and probably relatively good performers this year as well. It all goes back to yields. And when yields are escalating, you know, those are long duration securities. They have long business plans. They're not cyclical companies. They're big potent performers when yields come down and are miserable when yields go up like '22. This is why timing is everything. Your mention of health care is particularly interesting because it always seems to me when we're in these markets that are really sort of solid bull markets with less volatility, I always feel like health care is a big participant in that kind of market, and that's been absent for quite a while now, I think. So that's interesting. But to be clear, you're not there yet with health care, you're just seeing some early signs of life?

Katie Stockton: I would say we're hopeful. That's exactly right. And this one, I mean, financials have a big footprint too. So that was another key shift that we saw and they've come into their earnings season a little bit, I say they came into it a little hot, right? After a nearly ten week consistent up move. That's why this earnings season is a bit of a challenge, giving us some consolidation. But it's consolidation that we think will be something that we can take advantage of and that will refresh the uptrend and perhaps make it a bit more sustainable in its steep slope.

Tom Herrick: This is actually perfect going into outlook recommendation number two, which is small caps. And that's something we're very high on. We published a piece back in September. There's been an enormous performance dispersion between large and small companies in the equity marketplace. And long term we're talking a half a decade, a decade or more. That valuation differential between large and small is just huge. If you do any kind of basic regression analysis, you would look at large caps and think they should return mid-single digits, maybe high single digits over the next ten years, and small caps could be double that. In the technical work, now that's a very long in term, very imprecise comment that I just made. So what do you see in a current market that either reinforces or doesn't reinforce that small cap viewpoint?

Katie Stockton: I almost think of small caps as generally higher beta, and they would tend to thrive there in more of a risk-on type of environment. So on the surface last year would have been perceived as risk-on, it really wasn't that for much of the year really until year-end, because we had such narrow leadership from those mega caps and you just didn't have the small caps participating really in a

meaningful way at all. So that's where that spread becomes wider and wider and then ultimately gets to a compelling place. I think from a fundamental perspective, and we do believe that last year's best performers are often not the next year's best performers. Right? There's that kind of rotation, and that happens in relative strength, certainly from a large mid-cap versus small cap perspective. So we think offset there is a very good promise for relative strength to continue to improve behind small caps, as it did during that year-end up move. And we say that because the ratio has what looks like an actual long term bullish reversal, when we look at something like the Russell 2000 Index divided by the S&P 500 Index, you'll see some meaningful shift potentially underway there. It's a little bit early to call it decisive, but I think it's very promising. And then also here in the near term you tend to get something called the January effect, which benefits small caps, which sometimes are subject to I'd call it undue tax law selling. And if any year was a candidate for that, I certainly think 2023 was that. Meaning that they get basically oversold by the tax-loss harvesting season. And with that, the relief rally tends to be really very impressive in relative strength terms. So short term we're interested, long term I think there's a lot of promise for it. And when you look at the small cap benchmarks in absolute terms, you can see a lot of breakouts there too. So these are not breakouts to new all time highs like we have, say in the Dow Industrials or the Nasdaq 100, but rather breakouts from really prolonged trading ranges. You could call the trading ranges basing phases and in some cases, but to us, a breakout is one of the most compelling things that we can identify from a technical perspective as a catalyst to add exposure. And while the relative strength is improving, we also have that positive catalyst in absolute terms.

Tom Herrick: I want to pivot now to yields and bonds here a little bit. Kudos to you for a great call last year on yields. We reverse this long downtrend we had post GFC to basically at this point I guess it was early '22 where we finally reversed that downtrend, which if you just go with that simple thinking, it's like oh yields are going higher. Well they did go higher. But nothing moves on a straight line. There's nothing linear in this business. And within these large trends and you know now we see yields more in an uptrend not a downtrend, really more normalized is another way of thinking about it. But you get, within that, you get periods where things are stretched way too far one way or the other, and you get reversals. And I think it's just important to comment that these things can last a long time. I mean, when you're on a long trend of, say, five years or ten years, you can have a two-year period where you have a counter trend or sideways movement or things of that nature. So why we do think we're in an uptrend, we think things got overstretched when we got up there in that 5% range. And most importantly, we're at the end of a rate hike campaign. So we're at the end of this cycle. So everybody gets comfy in those 5% plus money markets right now. That is, the odds of that changing are very high over the next year, year and a half. And by changing, going lower again, not to zero where they came from but number like three would be pretty typical. It's time to lock in some of these rates is the point from a fundamental macro perspective. When you look at the technicals on the ten-year Treasury, where do you see us right now? Because we have come a long way in terms of price in yield just since October. Which always makes me a little uncomfortable when I'm saying we're going to have more downward pressure right after we've had a ton of downward pressure. How do you see that dynamic right now?

Katie Stockton: The volatility has just been really remarkable in the world of treasuries. And yet maybe it's something we just need to become accustomed to here. What we have seen is with that secular shift higher, which we really are on board with, we can draw a multi-decade downtrend channel that was reversed just a couple of years ago. And with that reversal, we are making the assumption that yields will work their way higher in the coming decade, perhaps. So higher highs and higher lows. But as you mentioned that acceleration to 5%, I mean that was a really steep up move for Treasury yields and clearly wasn't sustainable. Now down back around 4% already and in a pretty short matter of time. So with that corrective phase, what we've seen in our long term indicators behind ten year Treasury yields is a pretty notable shift in momentum, as you could imagine. So with that corrective phase we have now on our monthly charts, I would call it sort of a sell signal in terms of momentum behind yields. So the indicator that I'm referencing flipped positive behind yields in late 2020 and just in the last two months flipped negative, meaning that yields should come in in a corrective phase. And we say corrective because again, we believe that there's also been a secular shift. But within that context you can have counter trend moves of one, two years in duration. Certainly happened on the way down. And so we see no reason why it shouldn't happen, especially after such a steep up move. So we're expecting yields, while they're bouncing in here short term, and we expect a little bit more of the same in the coming weeks. We do expect them ultimately to make downward progress towards that three and a quarter, if not lower sort of area for the ten year. And with that, we do expect bond prices to continue to turn the corner. I think in the same way that we feel a meaningful peak is in place for ten-year Treasury yields, of course, we think a meaningful low is in place for Treasury bond prices. And this goes really across the fixed income spectrum. So there is very good potential there. And I think that you're right, Tom, in that the 5% money market is probably not going to be as conveniently available as it was in recent history. So it does make the case to evaluate some of these fixed income opportunities.

Tom Herrick: How low could the ten-year go? I get this question a lot, mostly because of the volatility we've seen recently. How low could you go on the ten-year and still maintain an uptrend? You know, longer term. Is there a number or range?

Katie Stockton: So that first three and a quarter, it's about 322 to 325 for the ten-year yields. That's our sort of first threshold. You could go into the mid twos and still maintain the uptrend when we're referencing something that we use as support which would be the Fibonacci retracement level. So it could go lower and obviously that still would be a higher low versus 2020. Right? So to maintain that series of higher lows really anything can happen. Right? But from a Fibonacci perspective, using those support levels that we like to drive, I think mid twos could still be doable without reversing what we think is that secular shift higher.

Tom Herrick: Yeah, that gives me comfort, mostly from a room perspective. I don't know where the low is in this cycle. I don't know if we go from four to three and a quarter or three. Seems like those are more realistic numbers, but I never would have thought we'd reach five last year either. So having a lot of room left to travel and still maintain that uptrend, I think is for the purpose of context, important for people to understand and think about. Also, within fixed income, our final recommendation for the year or high-level recommendation, is mortgage-backed securities, mortgage backed bonds. Essentially, they have an implied government guarantee so they're thought of a lot as treasuries. We find them to be very attractive because the yields are very high relative to the Treasury yields. Often at this point in the cycle, it wouldn't be grade tone mortgage backs because normally you'd get a lot of prepayment. Keep in mind people prepay mortgages as rates go lower. But so much of America is locked in at sub 4% mortgage rates right now. I mean, you really gotta dynamite those people out of giving up a 3.5% mortgage rate. I mean, there's people in the twos. They're going to hang on to those things as much as possible, which means you won't get that prepayment effect that you normally would get if mortgage rates go, say, from 7 to 5% or 7 to 5 and a half or something like that. That's why they look attractive to us. I'd be interested in what your perspective is on the MBS sector as well. I don't know if the signals are as defined there as some of these other things that are bigger, more liquid markets.

Katie Stockton: Yeah, I mean, they really are actually because, well, when there's a positive correlation, of course, even with Treasury bonds there. So we have the same shift in momentum. So behind any kind of MBS benchmark, you see that momentum not only as having alleviated on the downside, but now having improved enough to generate long term sort of momentum buy signals. So that's in place, suggesting that the recent low back in Q4 was a major low. And then also we have a counter trend indicator. It's one of the DeMark indicators for those that track technicals. And we looked at it just almost, you know, it’s not normal for us to apply our technical indicators to macro data, but at times we'll do it just to see what's happening. And we applied it to mortgage rates. And there was actually a sell signal, a pretty major sell signal, from these indicators. And then of course, if you kind of flip that over and look at the MBS benchmarks, you'll see the reverse. I would liken it to sort of an oversold buy signal. That has implications in particular for about the next seven months. So we do believe that this counter trend move follows a significant low and that there is upside potential for, let's say, the next seven to maybe 12 months. Based on what we're seeing, we don't really have a good level of confidence in it happening beyond that because we don't have the indicators to show us that yet. But if you could imagine that with upside follow through or more of a basing phase, that it can certainly serve as the foundation for more.

Tom Herrick: Thank you for commenting on all of our viewpoints. Is there anything beyond what we've talked about that looks interesting to you?

Katie Stockton: Well, I mean, I hate to go there, but first of all, I think with crypto, technical analysis is one of the best ways to understand it right now as an investment or as a trade.

Tom Herrick: I don't know how you can invest in it without technical analysis, honestly.

Katie Stockton: And that’s a good way to put it right. So for those that are interested in it, longer term, we have seen a very meaningful shift in our long term momentum gauges and a series of breakouts. The first was a base breakout following a bear market cycle for crypto, and we've seen a subsequent breakout beyond that. So the levels that we can project to, they warrant a bullish bias for crypto. What we saw recently with the Spot Bitcoin ETF approval is that with the pullback that ensued on the back of that sort of a sell the news event, if you will, from a short-term perspective, ether gained relative strength in a really meaningful way. So we feel that maybe the big potential here in the coming months within the crypto world would be an ether as opposed to Bitcoin. So that's something to think about. We had them as the most stellar out performers last year among asset classes, so perhaps they won't be that this year. But I would welcome a more orderly uptrend from crypto as indication that it's a maturing investment class.

Tom Herrick: The only interest I have had in crypto is I feel like there's sort of this nascent correlation to, I don't know, the speculative juices in the market to bullishness factor. Are you starting to see that? Is there enough data out there that's actually showing up, that's a good sign of bullish sentiment, if you want to call it that, or turning sentiment?

Katie Stockton: Yeah I would think that. And we at times will reference crypto for that risk appetite and almost more on a short-term basis where we'll check in the morning if Bitcoin's up 4% and the S&P futures are down a percent or something. It shows some kind of divergence that makes you think, right? So we do see it as sort of a risk-on type of asset class. And we'd be hard pressed to see a bull market cycle in crypto without also seeing generally bullish action from equities. But the correlation that we used to have between Bitcoin and the Nasdaq 100, as one example, has really dissipated so that it's not quite as relevant as it was. Maybe that will shift back. Maybe it's sort of a cyclical relationship, but, we do see upside potential in crypto. And certainly with potential reward comes a lot of risk, perhaps. But from a technical perspective, we can always assign, you know, stop losses and have other ways to manage risk.

Tom Herrick: Well, thank you so much for taking the time to do this again, Katie Stockton from Fairlead Strategies. Their website is FairleadStrategies.com.

Katie Stockton: Thank you, Tom.

Tom Herrick: I'm Tom Herrick, Chief Market Strategist for Cary Street Partners. We have a website too, CaryStreetPartners.com. We welcome any audience input on this podcast and interest in the future. And with that, everybody have a great 2024.

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