

# Advisory Blog

Timely insights on the issues that matter most to advisors and their clients

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## EV Forward: Equity Sentiment Indicators Scream "Buy!"

By: EV Forward | May 3, 2022

**Boston** - Entry point valuations tend to have their best predictive power for equity returns over a five-to-seven year horizon. We believe forecasting market returns over shorter time horizons is largely a fool's errand, given the large number of competing variables at play in a complex system like the stock market. However, various contrarian sentiment indicators could serve as shorter-term buy signals when they reach extreme readings.

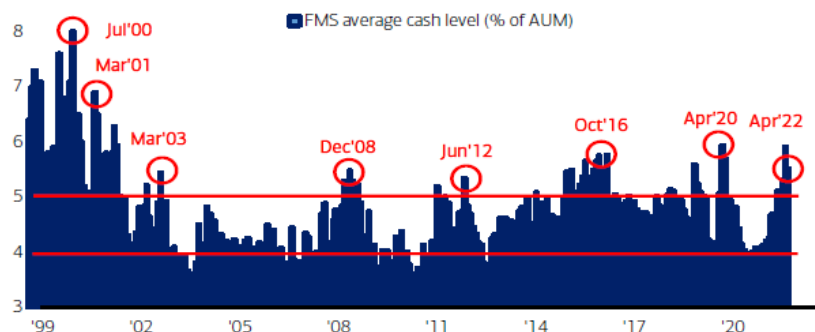
### Watching investor sentiment, fund manager cash and the fear gauge

One sentiment indicator, American Association of Individual Investors (AAII) Survey, recently reached such a reading. As background, this weekly survey asks U.S. retail investors if they are bullish, bearish or neutral on the S&P 500 Index over the ensuing six months. Market observers typically report the series by tossing out the "neutral" responses and taking a net bulls-minus-bears figure. We have found that it provides a reliable contrarian signal, but the efficacy comes entirely from the "bull" side of the equation.

Two weeks ago, the percentage of AAIL survey respondents who self-identified as bullish fell to 15.9% — a 30-year low. In our view, that is a table-pounding buy signal.

Another key contrarian indicator is the monthly BofA Global Fund Manager Survey (FMS). One recurring data point is the level of cash that professional fund managers are carrying in their portfolios. When the level of self-reported cash is above 5%, as in the FMS dated April 12, it can be a sign of excessive caution — signaling a buy for equities.

**Chart 13: FMS cash levels down to 5.5% in April**  
FMS average cash balance, %



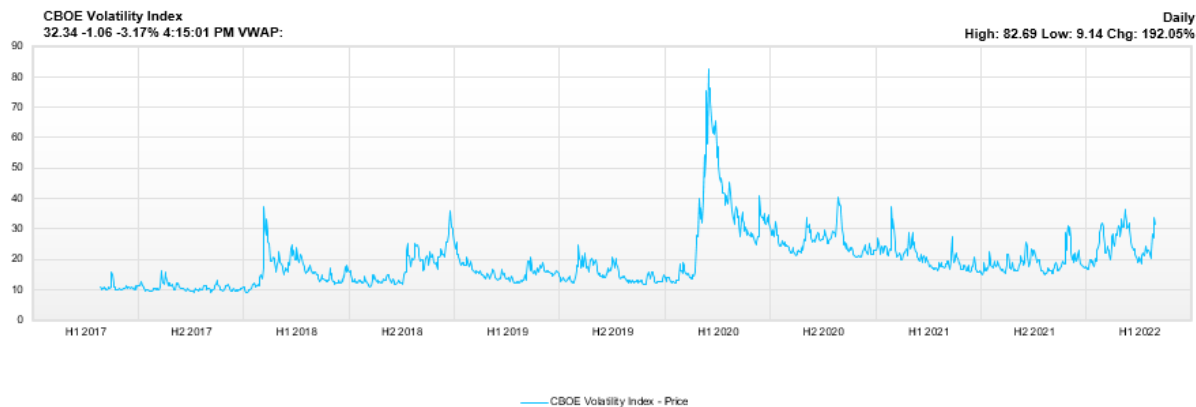
The third contrarian indicator worth

Source: BofA Global Fund Manager Survey

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highlighting is the Chicago Board Options Exchange (CBOE) Volatility Index, or VIX, which measures the implied volatility of options on the S&P 500. As a rule of thumb, we view 15% to 17% as the normal level of volatility for U.S. equities, with a reading in the low teens suggesting investor complacency and a reading above 20 indicating excessive fear and uncertainty. The recent reading over 31 suggests adding risk to portfolios.

VIX fear gauge in excessive territory



Source: CBOE and FactSet as of April 27, 2022.

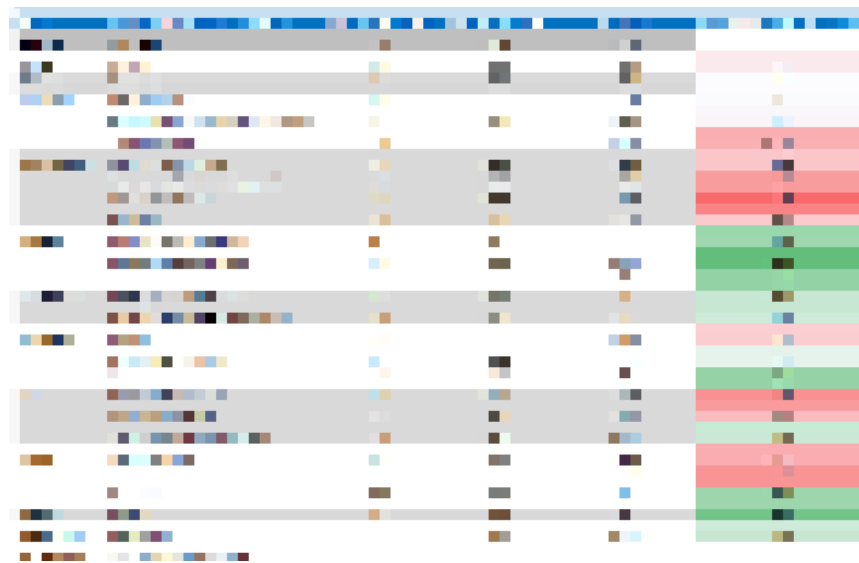
As always, there are counter arguments to the bullish conclusions that we can draw from these three indicators. Two research firms, Ned Davis and Strategas, are both dismissive of the AAI results in particular, pointing out that other measures of sentiment —such as put/call ratios — are sending a neutral signal.

Defensives are expensive

The forward price-earnings (P/E) ratio<sup>1</sup> on the S&P 500 has fallen from 21.4 to 18.1 times — a 25% de-rating over the past five months. Interestingly, not all sectors and industry groups have seen valuations fall.

The valuation levels of the defensive consumer staples and utilities sectors have both risen on absolute terms. Meanwhile, P/E ratios in the growth and cyclical parts of the market have collapsed: Transports, consumer services, semiconductors and media & entertainment have experienced de-ratings of 26% to 40% —with the cumulative effect of pushing certain defensive industries from market discounts to market premiums, and certain growth and cyclical groups from premiums to discounts.

Relative sector valuations have shifted significantly since November



Source: Morgan Stanley Investment Research and FactSet as of April 22, 2022.

Of course, we have to be careful when comparing one P/E ratio to another. With two prices and two earnings estimates, there are four variables at play, and the earnings estimates may be unreliable. If stale earnings estimates need to be cut across a number of industry groups, for example, then valuation levels may not be what meets the eye.

It seems unlikely that the long-term earnings prospects of defensive sectors have risen meaningfully in recent months. All

else equal, the rise in the risk-free rate should have led to a rise in the discount rate, and a corresponding fall in the P/E ratio. Since P/E ratios have risen instead, it seems reasonable to conclude that risk premia have collapsed in these industry groups and that defensives are now expensive.

### Testing the market narrative on inflation and interest rates

Investors like to engage in explanatory narratives. Here's my take on the story the market is telling itself:

Inflation has become a problem. We can debate whether it is a function of loose monetary policy, profligate fiscal spending, pandemic-induced supply chain disruption, Russia/Ukraine, oil price shocks, corporate greed, untethered consumer price expectations or some combination of these. But there is no debating that inflation is now a problem and risks becoming sticky and permanent.

The Federal Reserve sees this and has quickly navigated to an ultra-hawkish posture, talking about a series of 50-basis-point rate hikes — perhaps even 75 bps — along with Quantitative Tightening (QT). We know from history that the Fed tends to make a policy mistake by tightening until something in the system breaks, typically leading to recession. Neither higher rates nor recessions are good for stocks.

It is worth thinking through scenarios where this narrative might be derailed. Suppose inflation turns out to be transitory after all. The Consumer Price Index (CPI) reading of 8.5% could end up being at or near a peak. What if something happens to bring more oil supply onto the market — from Iran, Libya, OPEC members with spare capacity such as Saudi Arabia or UAE, even U.S. onshore production? Or some sort of truce in Ukraine that relaxes sanctions on Russia?

Let's also assume the pandemic continues to evolve into an endemic, allowing the global supply chain to right itself in the coming months. Moreover, suppose that the Treasury market concludes that the year-to-date doubling of long-term interest rates is sufficient. With falling oil prices and supply chain relief, the Fed may not need to be so hawkish, and long rates could partially reverse back towards 2.0%.

What would stocks do under this scenario? They would go up a lot. And the leadership of the market would likely move back to growth-oriented tech, biotech and consumer discretionary stocks, and away from commodities.

**Bottom line:** Now is one of those rare times when those of us who are contrarians get to play the role of bull. Sentiment is poor, defensives are expensive and, eventually, the one-way narrative on inflation and rates will change. We believe it may be time to add risk to equity portfolios.

1. Price-Earnings Ratio (P/E) is a valuation ratio of a company's current share price compared to its earnings per share.

S&P 500® Index is an unmanaged index of large-cap stocks commonly used as a measure of U.S. stock market performance.

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EV Forward

> Rising inflation, less accommodative central bank policies and heightened geopolitical risks have created significant market volatility in 2022. In this series, our investment teams offer their views on the opportunities and risks present for their strategies. As always, our goal is to seek fundamental value that helps build client wealth over the course of many business cycles.

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