Market Perspective – Still neutral but view recent pullback as a healthy reset

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What happened

After the market posted strong gains through July, August has been less friendly to investors. The S&P 500 has pulled back almost 5%, the deepest decline since the first quarter. There are several reasons cited for the change in the market's tone, including the sharp rise in interest rates as well as some trepidation around weak economic data coming from China.

Our take

While there are many factors pointing to the recent weakness, our view is simply that after five straight months of gains**, the market became overextended on a short-term basis**. As we noted coming into the month, stocks were vulnerable to a setback, especially as we entered a seasonally-challenging period for markets historically and the bar for positive surprises had been raised.

We view the recent step back as a healthy reset of expectations. Indeed, markets are all about how data comes in relative to expectations. And after economic, earnings, and inflation data came in better than consensus expectations in the first half of the year, gauges of investor optimism on some metrics moved to the highest level in several years. However, **that is resetting alongside valuations and technical indicators.**

- The percentage of individual investors who consider themselves bullish cracked above the 50% threshold in July – the first time since April 2021, based on data from the American Association of Individual Investors (AAII). **Bullishness, alongside the recent market decline, has since dipped back to 36%.**
- In early July, short-term newsletter writers' **recommended equity allocation surpassed 80% for the first time since July 2019, but this has since moved down to just 14%.**
- From a fundamental perspective, **as stocks have pulled back, forward earnings estimates have moved to an 11-month high**. Consequently, the S&P 500 forward price-to-earnings ratio has reset from 19.6x, the highest level outside of the pandemic overshoot, to 18.5x. This is far from cheap by historical measures and relative to the rise in interest rates, but an improvement, nonetheless.
- Notably, the valuation of **the average stock, as proxied by the S&P 500 Equal Weight index has declined from 15.7x to 14.8x**, the lower end of the year-to-date range.
- From a technical perspective, one of our indicators shows that the **percentage of stocks in the S&P 500 moved from >60% overbought, or stretched to the upside in mid-July, to >60% oversold**, or stretched to the downside. This is the **most oversold condition we have seen since the March low**. Oversold can get more oversold, especially in a bear market like 2022, but this is a notable and healthy shift in our view.
- From a technical level, we are also in the zone of initial price support around **4330 on the S&P 500** (currently trading around 4392) and **stronger structural price support at the 4200 level, which is about 4% below current levels.**

Continued on the next page

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Lastly, while the 10-year U.S. Treasury yield's move to the highest level since 2007 is serving to pressure stock valuations, it's important to **recall the period following the global financial crisis, where stock dividend yields were on par with Treasuries, and sometimes higher, has been the outlier of the past 40 years**.

Indeed, **the more normal state, from the 1980s to the global financial crisis (2008), was to see stock dividend yields well below the 10-year U.S. Treasury yield. Yet, the overall stock market did just fine**.

Positioning

The weight of the evidence indicates a **neutral stance** across stocks, bonds, and cash given the many crosscurrents investors are facing.

Within equities, **higher interest rates reinforce our current large cap bias relative to small caps**. Roughly 29% of small cap debt carries a variable rate, and is impacted more by rising rates, relative to large caps at 8%, according to Empirical Research estimates.

We **remain negative on the real estate sector**, where refinancing rates are moving higher, and the sector is making a fresh price low relative to the overall market.

And we **continue to see weaker economic and price trends in international markets**, where we remain underweight.

Bottom line

Historically, markets have tended to have about three pullbacks of 5% or more a year. They always come with bad news. We see the recent action in prices, valuations, and sentiment as a healthy reset of an extended market.

It's still not compelling enough for us to go on offense yet, but the risk/reward appears to be improving and we would advise investors that are underweight equity targets to use this pullback to work money into the market now, and potentially become more aggressive if we move closer to the 4200 level on the S&P 500.

Likewise, while there is a lot of upside momentum in yields currently, and we would be careful to try to call the peak in yields, **we see an improved backdrop for fixed income investors**, with a focus on high quality bonds.

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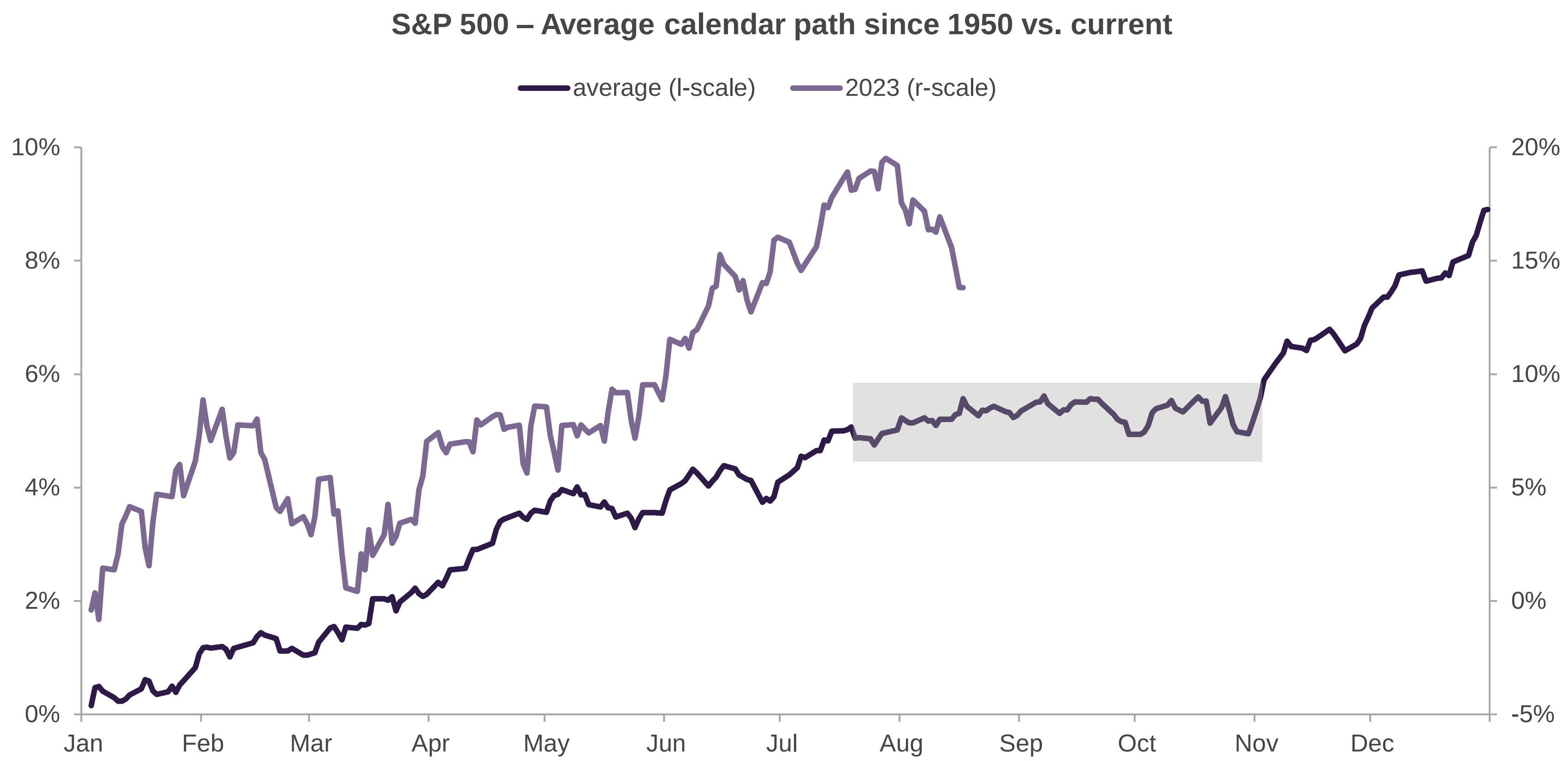
August living up to its reputation as a tough month



Data source: Truist IAG, American Association of Individual Investors (AAII), FactSet.

Past performance does not guarantee future results.

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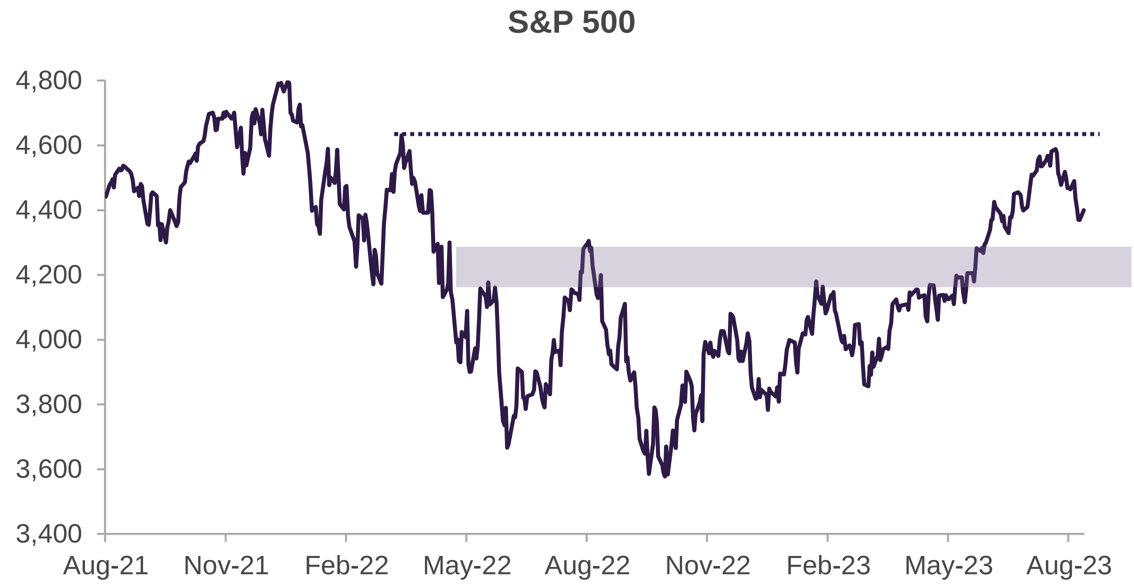
Wealth

So far normal pullback as stocks approach support zones

From a technical level, we are also in the zone of initial price support around 4330 on the S&P 500 (currently trading around 4392) and stronger structural price support at the 4200 level, which is about 4% below current levels.



Data source: Truist IAG, FactSet. Past performance does not guarantee future results.

Stocks most oversold since March

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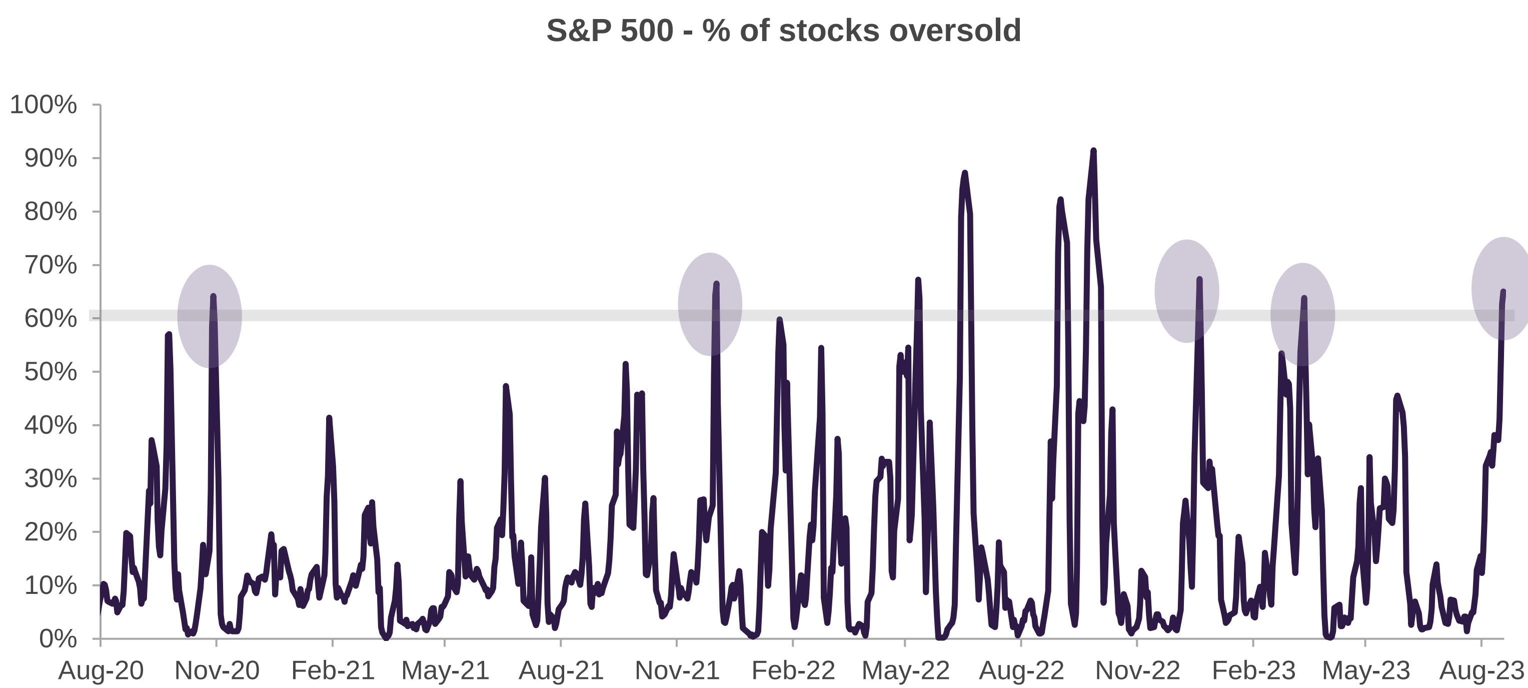

Data source: Truist IAG, FactSet. Past performance does not guarantee future results.

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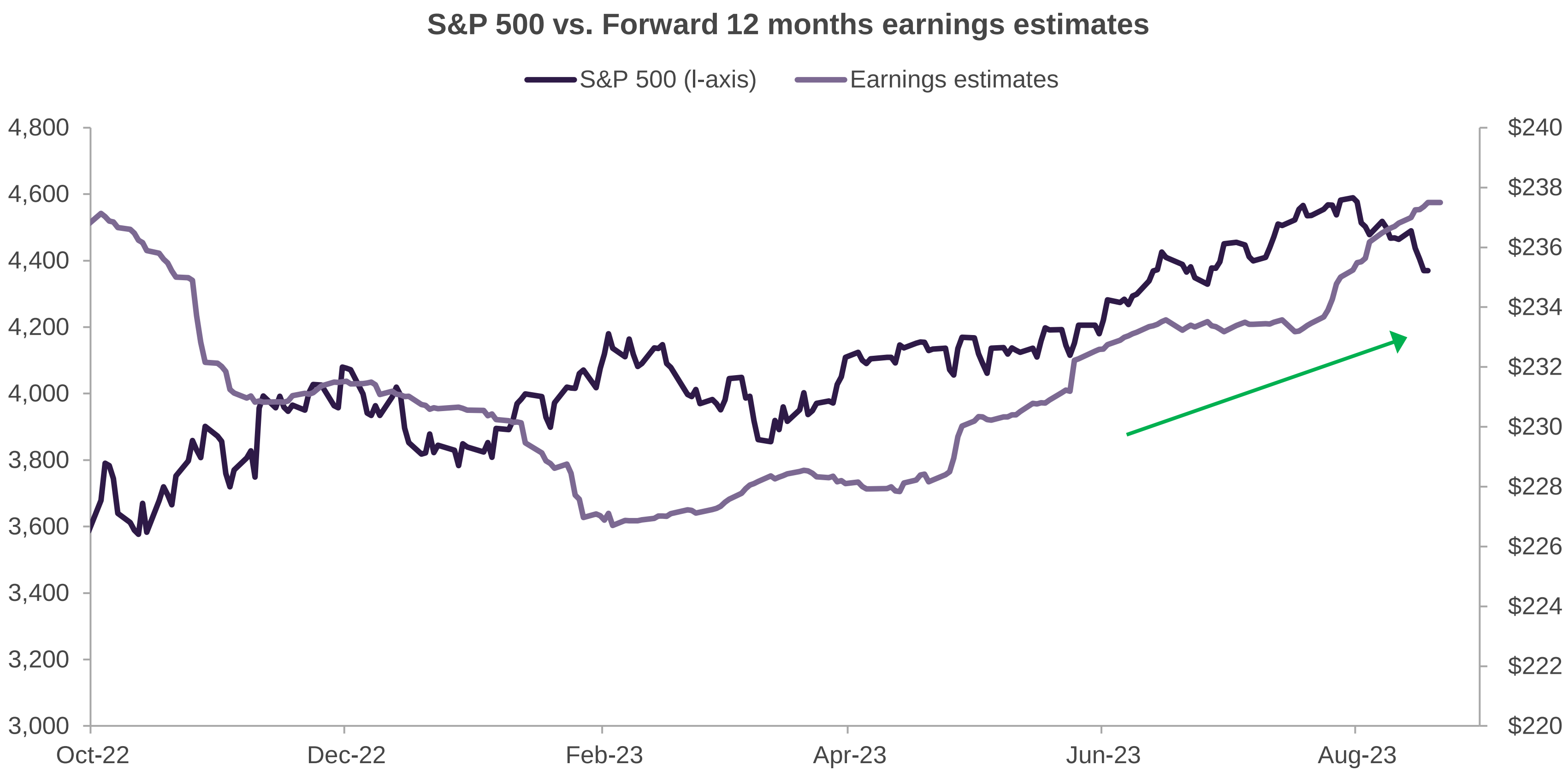
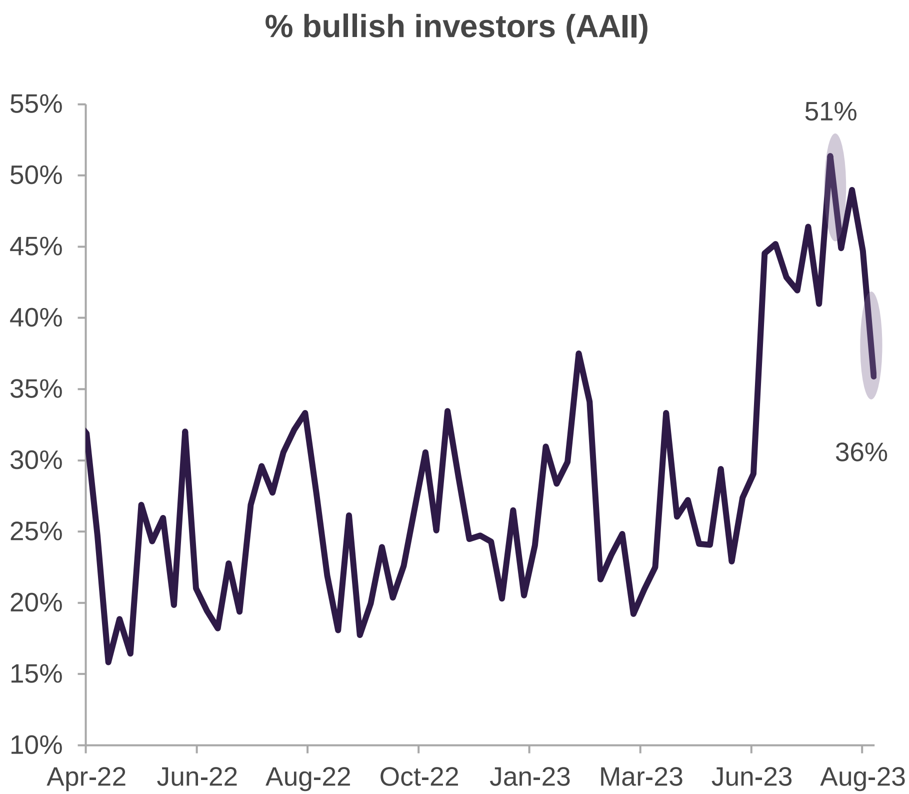
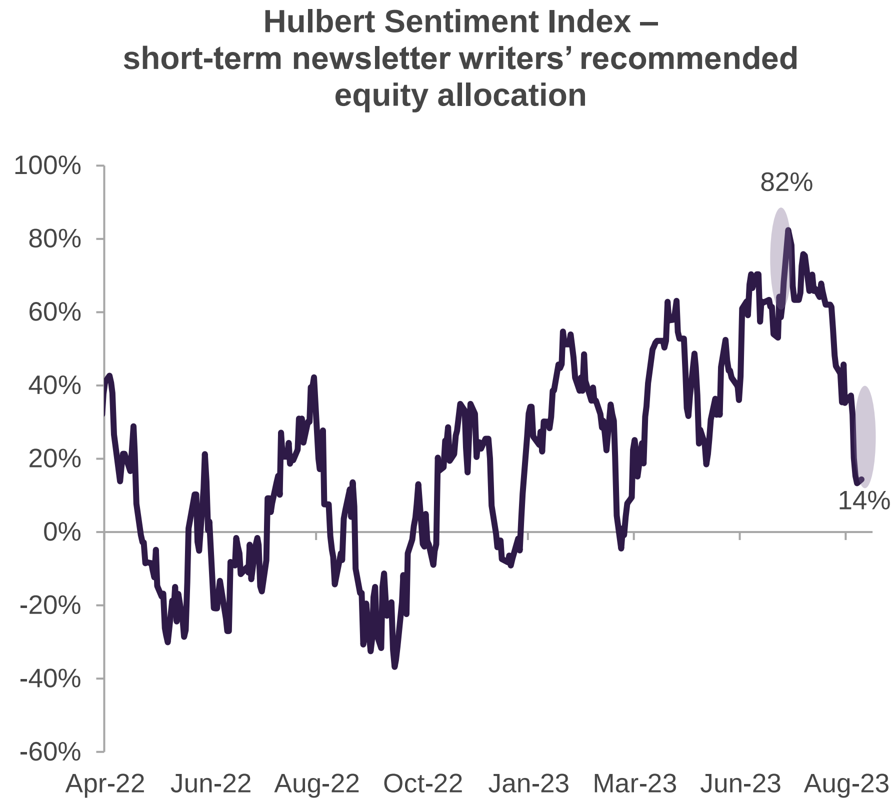
Stock prices correcting as earning estimates continue to rise



Data source: Truist IAG, FactSet. Past performance does not guarantee future results.

Sentiment resetting from elevated levels, though may have further to go



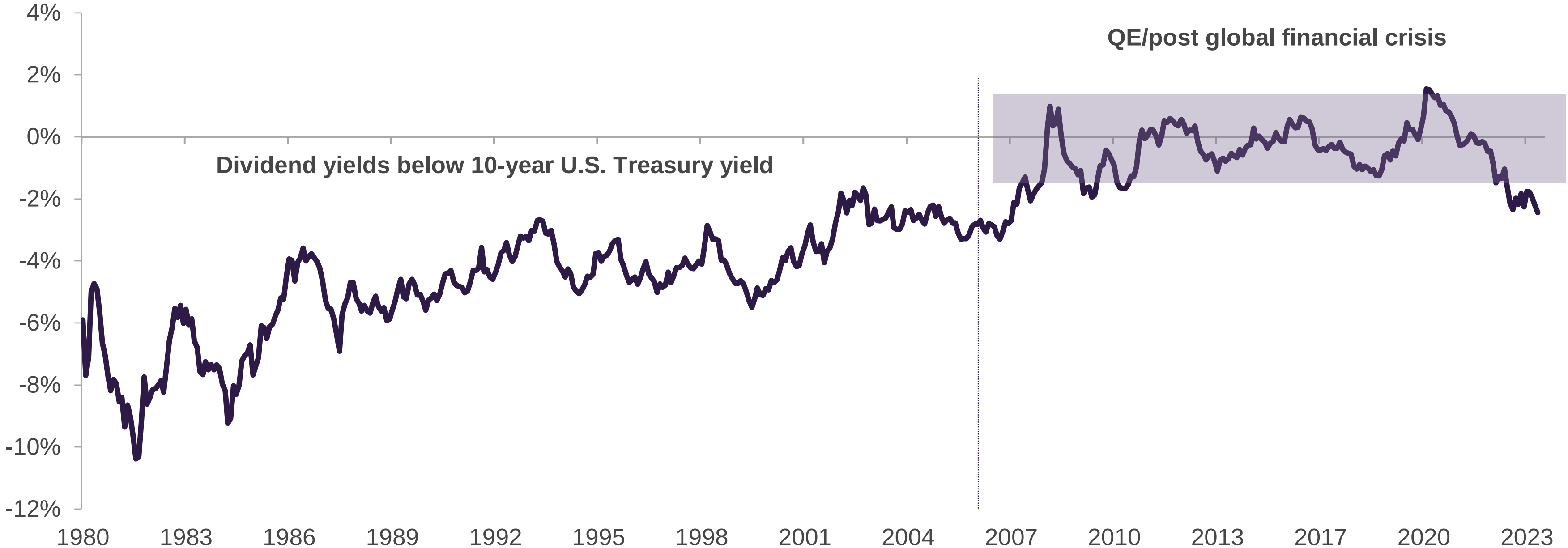


Data source: Truist IAG, FactSet, AAII. Past performance does not guarantee future results.

Going back to normal with stock dividend yields below Treasury yields

While the 10-year U.S. Treasury yield's move to the highest level since 2007 is serving to pressure stock valuations. It's important to recall the period following the global financial crisis, where stock dividend yields were on par with Treasuries, and sometimes higher, has been the outlier of the past 40 years. Indeed, the more normal state from the 1980s to the global financial crisis (2008), was to see stock dividend yields well below the 10-year U.S. Treasury yield. Yet the overall stock market did just fine.

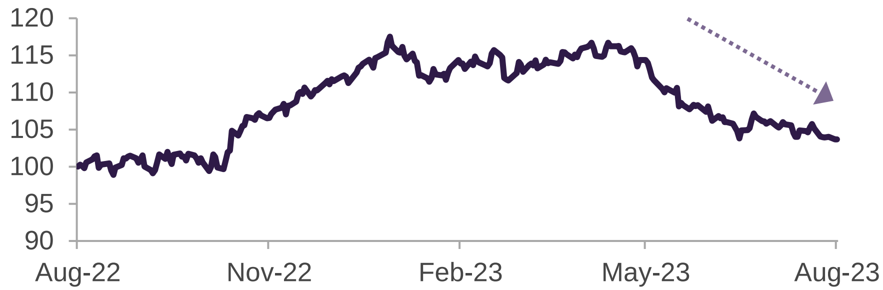
S&P 500 dividend yield minus 10-year Treasury yield



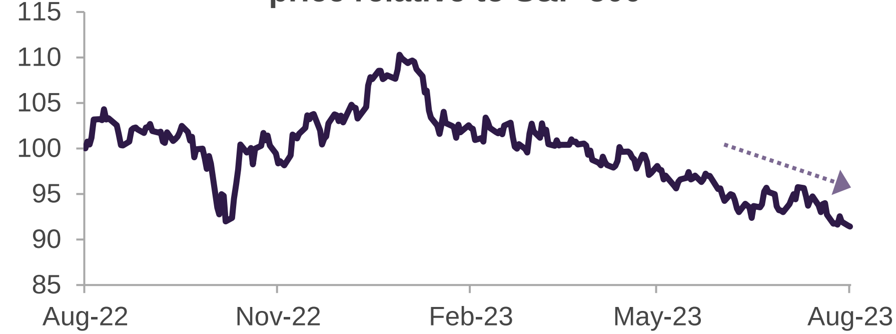
Data source: Truist IAG, Haver. Past performance does not guarantee future results.

Still favor U.S. over international, large caps over small caps and remain underweight real estate sector

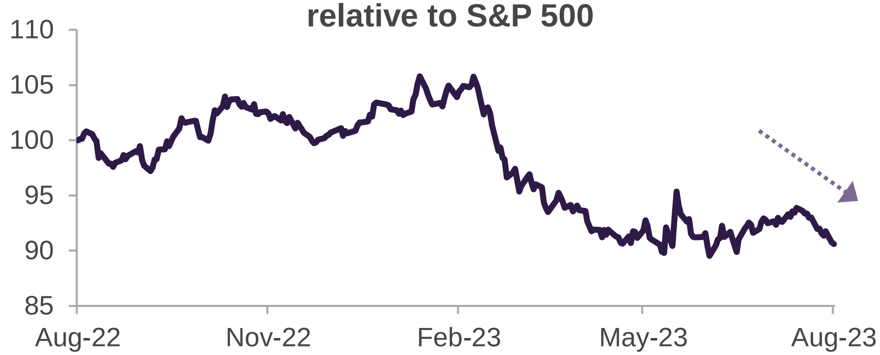
International Developed Markets price relative to S&P 500



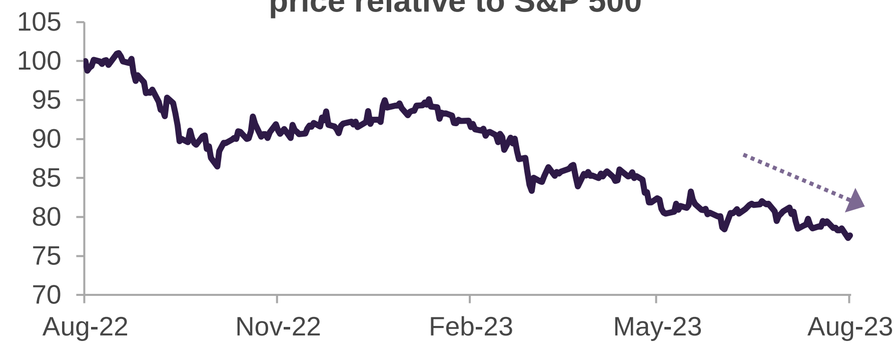
Emerging Markets price relative to S&P 500



S&P Small Caps relative to S&P 500



S&P Real Estate price relative to S&P 500



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International Developed Markets = iShares EAFE; Emerging markets = iShares Emerging markets; S&P Small caps = S&P 60, Real Estate = S&P Real Estate Sector

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