Truist Advisory Services, Inc.

Market Perspective from the Investment Advisory Group

The Tepper trade in reverse

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What happened

After strength to start the week, the S&P 500 is now down about 6% off its intra-day high hit on Tuesday, with small caps off 7%.

- The reversal appeared to gain steam after the Federal Reserve (Fed) raised short-term rates by a half percent as expected but projected a higher terminal rate than the consensus expected—with Fed Chairman Powell staying focused on taming enemy number one, inflation.
- The European Central Bank also took on a more hawkish tone – indicating that it would increase short-term rates more aggressively than anticipated to cool elevated inflation.
- Weak U.S. retail sales on Thursday raised concerns about a slowing economy at a time of less potential support from monetary policy.

Our take

Our work has suggested the market risk/reward has been unfavorable following the sharp rally from the October lows. When the S&P 500 clipped 4100 earlier this week, it was trading at a 17.5x P/E on consensus forward earnings, which also appear overly optimistic. In our view, that valuation embeds a lot of good news and doesn't provide much of a cushion considering downside risks for the economy and corporate profits.

Moreover**, in some ways the current macroeconomic environment reminds us of the *reverse* of what became known as the *Tepper trade* in September 2010.**

Then, David Tepper, a prominent hedge fund manager, appeared on CNBC and described a potential win/win proposition for asset prices. At the time, there were still many investor concerns about sluggish economic growth and deflationary pressures lingering from the financial crisis and their impact to asset prices.

However, Tepper made a clairvoyant point then that either:

1. The economy was going to get better, and that would be positive for stocks and asset prices.
2. Or, instead, the economy would weaken, but the Fed would step in to support the market, which would also be positive for asset prices. This worked out relatively well as this was the early stages of a decade-long bull market.

We argue there is somewhat of a reverse Tepper trade underway today.

The reverse Tepper trade:

1. Either the economy is going to weaken, and that will tame inflation but also likely hit corporate profits and challenge asset prices.
2. Or instead, the economy stays stronger as does inflation, and the Fed and other central banks will continue to tighten policy, also challenging asset prices.

In either case, there's a potential headwind for investors. To be fair, there is a third path, where inflation comes down, and the economy avoids recession, the so-called soft landing. It's possible.

However, the path still appears somewhat narrow given the lagged impact of the most aggressive monetary tightening in forty years and the triggering of several historically reliable recession indicators, such as:

- The yield curve inversion
- The decline in leading economic indicators
- And the weakness in housing.

Bottom line and positioning

The core themes discussed in our 2023 outlook (*Three Keys to 2023*, 12/6/22) apply:

- **We remain defensive** given the recent pullback has helped ease valuations and prices somewhat, but it's not enough yet to suggest the risk/reward has flipped in a meaningful way.
- **We plan to remain tactical**. We have seen six moves of at least ±10% over the past year—three to the upside and three to the downside. While the recent decline has relieved some of the frothiness, most of our technical indicators are not yet at an extreme, nor are valuations compelling.
- **We plan to continue to keep an open mind** as we get further data on economic, earnings, and inflation trends into the new year.

Until the weight of the evidence shifts, we maintain our overweight in fixed income, where we are focused on high quality bonds, and a relative underweight in equities.

Within equities, we still favor the U.S., a value tilt, and see better opportunities below the market's surface, such as the equal-weighted S&P 500, a proxy for the average stock.

From a sector standpoint, we advocate for a barbell strategy, which is aligned with our value style tilt. This includes higher weightings to health care and consumer staples, which are more defensive in nature given their lower sensitivity to weakening economic growth. We pair this with industrials, which should benefit from increased defense spending and reshoring, alongside energy, which is still relatively cheap and a partial hedge to a smoother China reopening.

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