As Buybacks Return Can The Market Continue To Rally

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Administrator Note

Admin Note: I am traveling to see my daughter this weekend for the Texas Tech vs. Baylor football game. This week's newsletter will be shorter than usual, and most of the analytics will return next week. In the meantime, if you have any questions, do not hesitate to ***email me.***

Market Musters An October Rally

Last week, we noted that there were some short-term positive developments.

> *The market bounced off the 20-dma, turning that previous resistance level into support. That bounce came on rumors from the "Fed Whisperer," Nick Timaros of the WSJ, the Fed may be considering slowing the pace of rate hikes in December. Such was a welcome relief for the beaten-up bulls, and stocks rallied sharply to close the week.*
>
> ***It will be necessary for the market to rally some more next week and ideally rises above 3800 to confirm another "bear market" rally is underway.** Furthermore, the positive divergences of the MACD and RSI indicators also support the short-term bullish outlook.*

Such was the case this past week. The market rallied above the 3800 level, retested it Thursday, and then rocketed higher on Friday, breaking above the 50-dma and touching the 100-dma. Such confirms the bear market rally remains intact.

Over the last several weeks, we have repeatedly made the case why this market rally was likely, and all that we needed was some news flow to spark a buying panic. Of course, the rise in market chatter about a Fed' pause', 'mini-pivot,' *or 'step-down'* in its hawkishness provided the narrative to send shorts scurrying to cover.

For some context, **the Dow is on pace for its best month since 1976. It is also close to its best month since 1938. So far, the Dow is up four straight weeks (+14%) and is posting its biggest 4-week gain since April 2020. Despite dismal FANG earnings, the Nasdaq is 'only' up 5% on the month**.

With those gains, it was not surprising to see articles flipping bullish. To wit:

> *"Here?s a little news flash. Tech stocks have entered **a brand-new bull market** that could be the start of a massive 50%-plus melt-up. And certain tech plays could see a **10X surge higher!**"*

While that will likely be the case eventually, it is too soon for that now. We still have an earnings recession to get through and have just started that process. More importantly, the lag effect of rate hikes won't take hold until the first half of next year.

However, for now, there is a prime catalyst for pushing stock prices higher near term coming online - buybacks.

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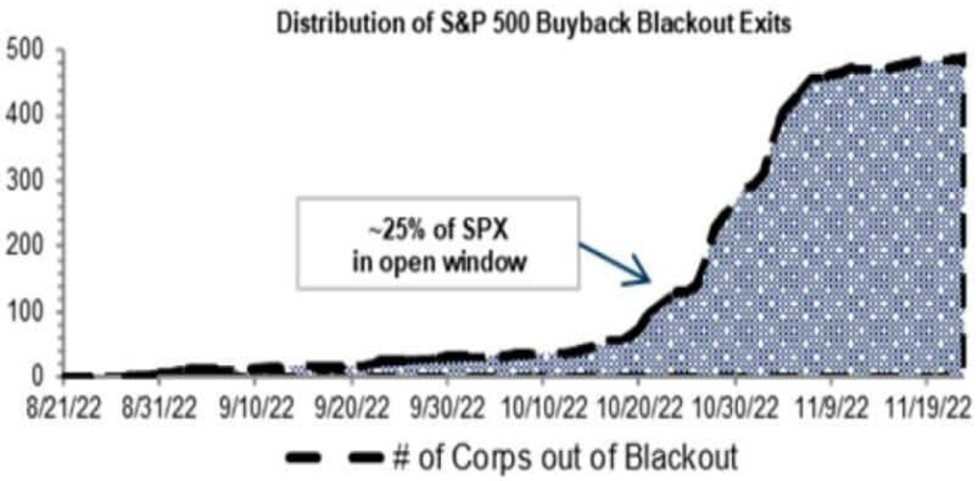
Buybacks Set To Return

Stock buybacks, or corporate share repurchases, are set to return next week as the *"blackout period"* that existed in October now expires. With roughly 80% of the S&P 500 having now reported, they can return to the business of buying shares to help bolster their stock price. Also, as I noted earlier this week, there has been a record of over $1 Trillion in buyback announcements made this year, which will potentially equate to roughly $4.5-5 Billion in daily flows into equities through year-end.

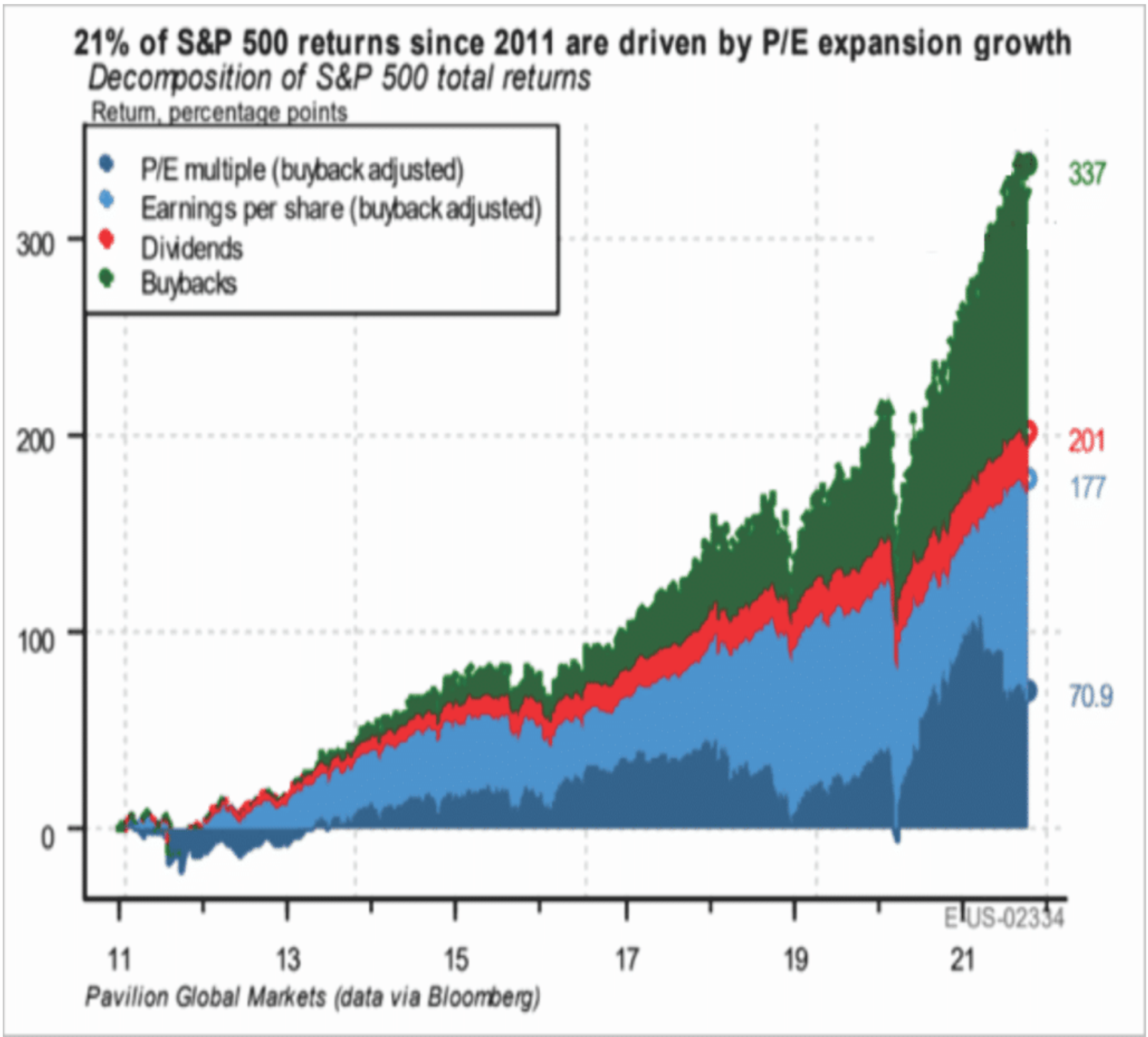


Source: GS Global Markets Division, Birinyi Associates, Bloomberg. Past performance is not indicative of future results. Inclusive of S&P 500 and R3000. As of 10/21/22.

Don't dismiss the importance of stock buybacks relative to overall market performance. Such was the point ***article I wrote in October 2021*** discussing the net effect of those stock buybacks. To wit:

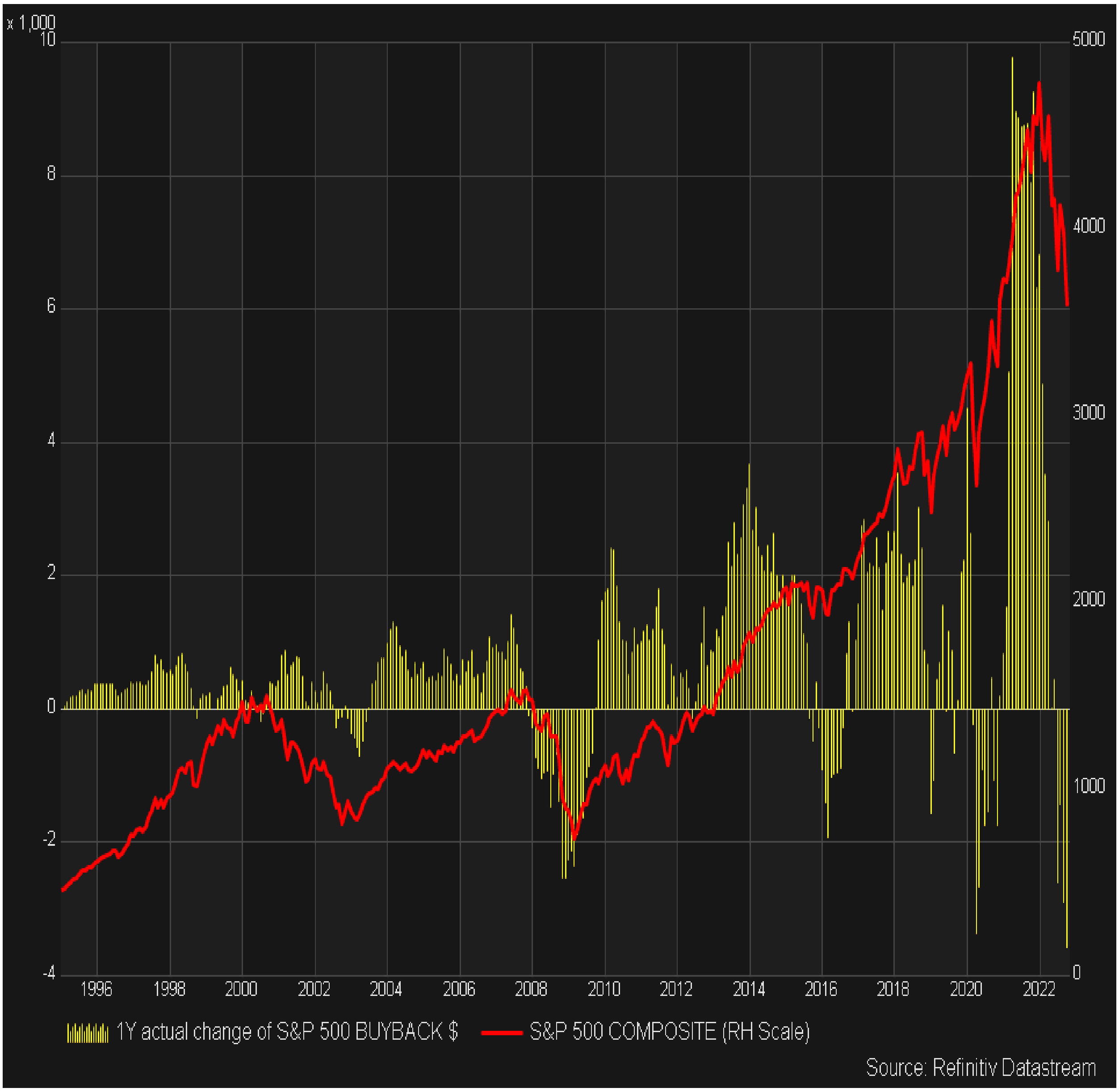
> *"The chart below via Pavilion Global Markets shows the impact stock buybacks have had on the market over the last decade. The decomposition of returns for the S&P 500 breaks down as follows:"*

- *21% from multiple expansions,*
- *31.4% from earnings,*
- *7.1% from dividends, and*
- ***40.5% from share buybacks.***



> *"In other words, in the absence of share repurchases, the stock market would not be pushing record highs of 4600 but instead levels closer to 2700.*
>
> *To put that into context, the high water mark for the S&P 500 in October 2007 was 1556. In October 2021, after 14 years, the market would be 2700 without share buybacks. Such would mean that stocks returned a total of about 3% annually or 42% in total over those 14 years."*

We warned in that report that one of the risks to the market was a contraction in buybacks which removed a *"buyer"* that had accounted for the majority of share purchases over the last few years. It is no coincidence the market declined this year as those buybacks slowed.



While buybacks by themselves may indeed be somewhat harmless, they become problematic when coupled with accounting gimmicks and massive levels of debt to fund them. **Most importantly, the money spent benefitting executives should have been used more productively to boost long-term earnings growth.**

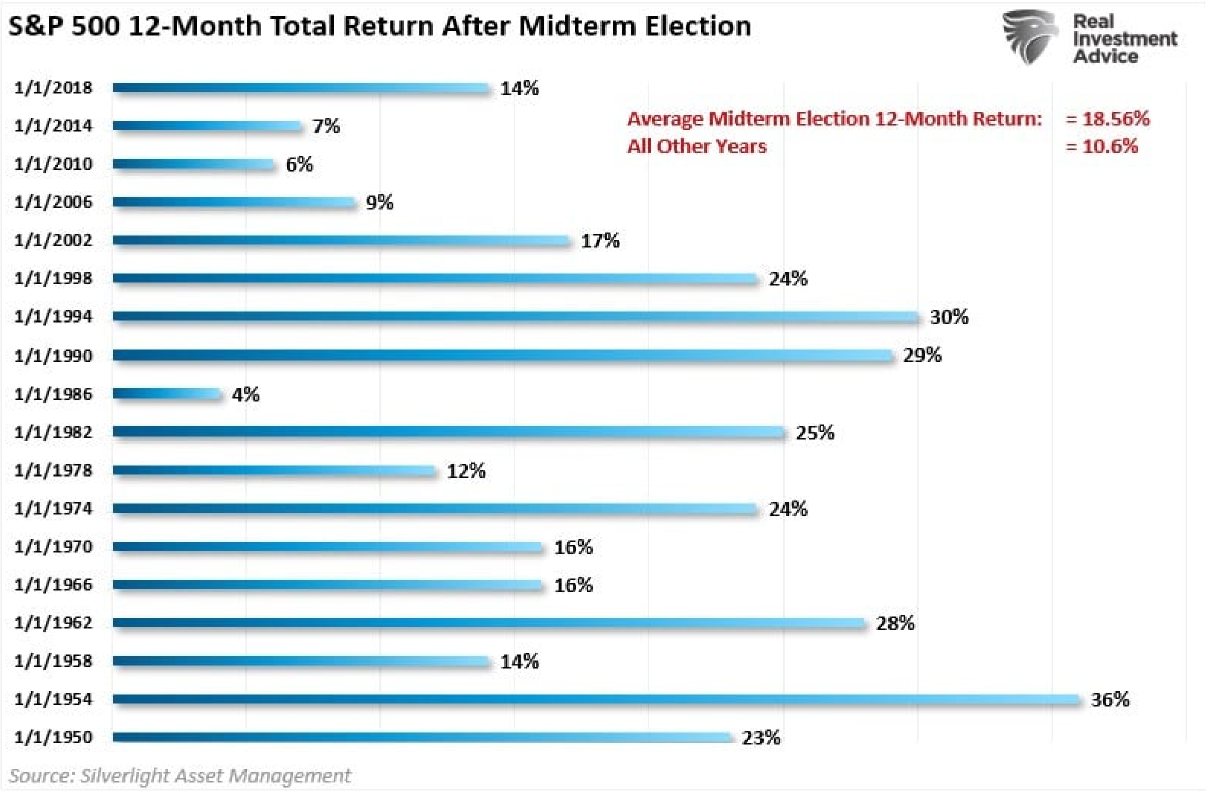
As we head into year-end, companies struggling with earnings growth will likely accelerate stock buybacks to boost their bottom line. With a record number of shares authorized for repurchase, such could translate into a continued push higher in stocks through year-end.

Another market support may come from the midterm elections.

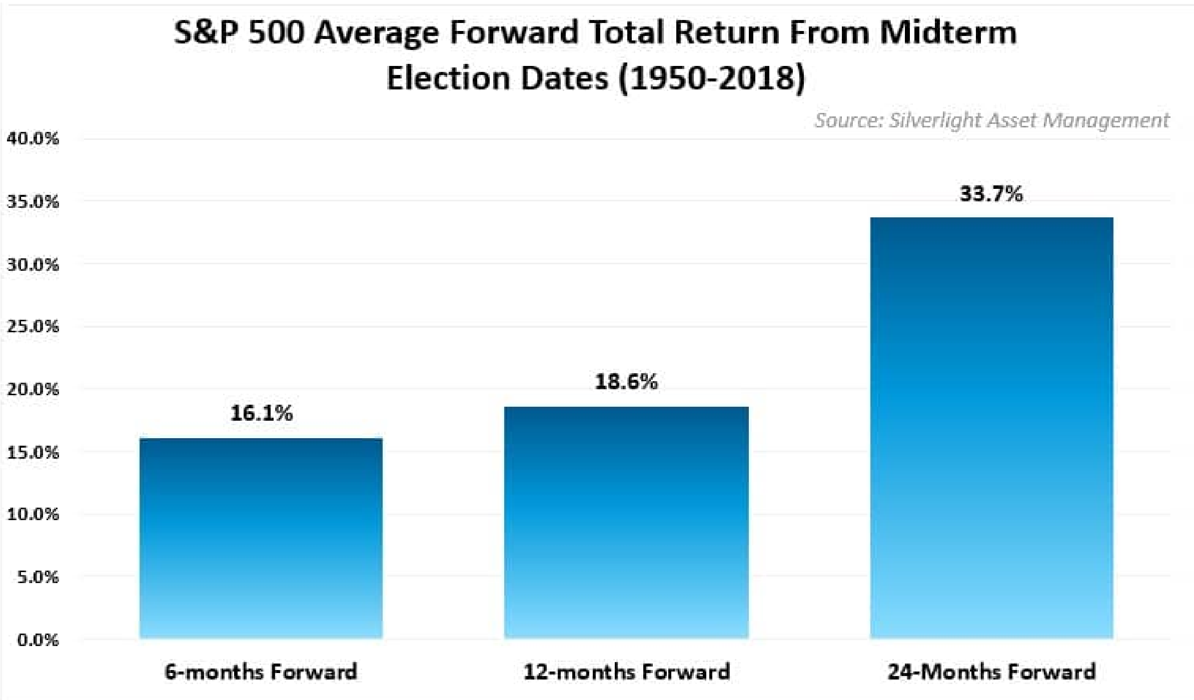
Midterm Elections And Market Rallies

While garnering less attention than a presidential election, midterm elections are important because they could lead to a change in control of the U.S. Senate and House of Representatives. Such can significantly impact policy, laws, and foreign relations. Historically, markets tend to favor "gridlock" in Washington as it dramatically reduces the risk of an adverse policy change regarding taxation, geopolitical conflict, or substantive changes to spending and debt.

Since 1950, there have been 18 midterm election cycles, and in the twelve months following each of those cycles, the stock market has had positive returns. Over the subsequent 12 months, stocks delivered an 18.56% average annualized gain compared to just 10.6% over all other years.



In the two years following the midterm elections, stocks returned an average of 33.7%.



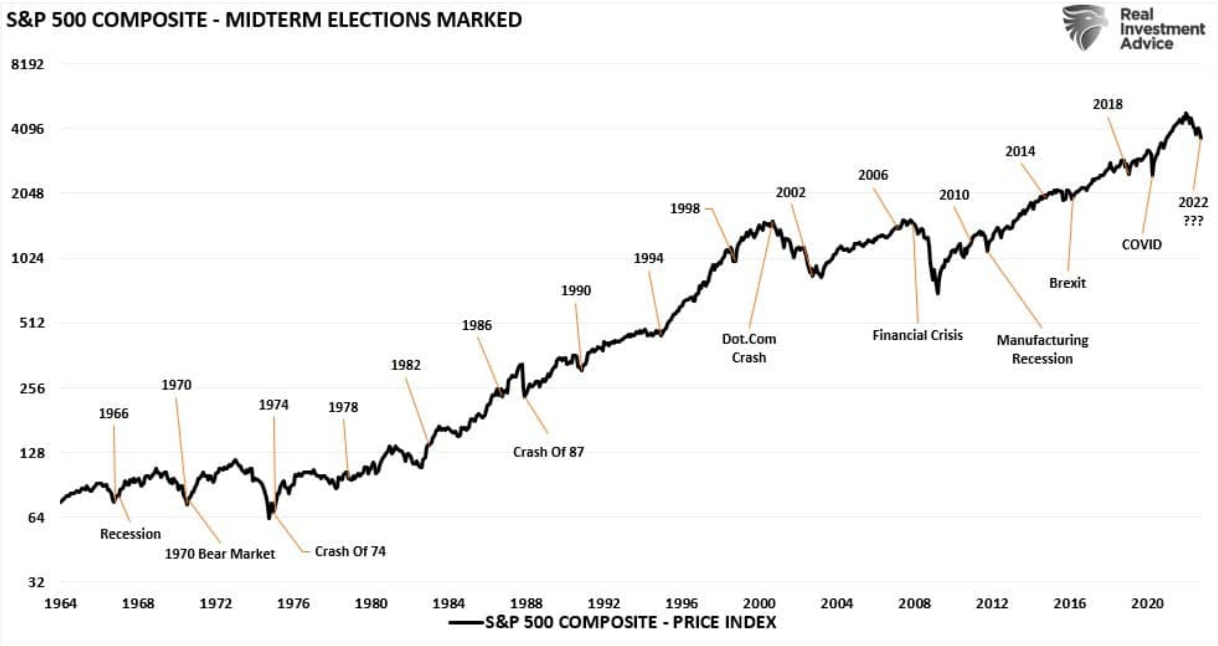
However, while the data above goes back to 1958, the last time the S&P 500 produced a negative return over the 12 months following a midterm election was 1939. Of course, there was a massive economic contraction and uncertainty at that time as the U.S. battled the Great Depression and World War II began in Europe.

Another period of interest is the late 1960s and 1970s, marked by slow economic growth, high unemployment, rising energy prices, and significant inflation. Given the similarities currently, the bearish pre-midterm market returns and an un-accommodative Federal Reserve, the outlook, while bullish, is less clear.

Breaking Even Isn't The Goal

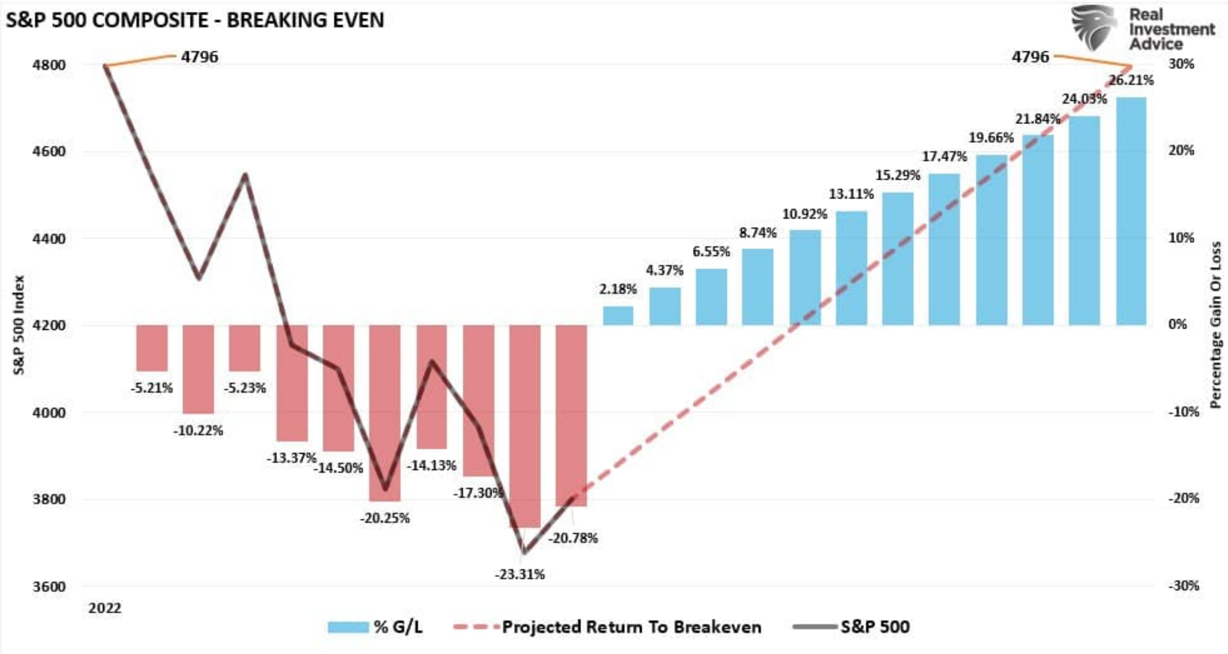
There are a couple of caveats to this analysis that one must consider. The first is that while returns tend to be positive post-midterm elections, several times, it coincides with when the midterm elections fell. The chart below shows the S&P 500 with the years of midterm elections marked and significant events.

For example, in 1966, 1970, and 1974 the midterm elections coincided with the bottom of the three recessionary bear market cycles. Coincidence? Probably. More importantly, on a longer-term basis, returns on a *"buy-and-hold"* basis were negative as the secular bear market continued. We see the same effect between 1998 and 2014, midterm elections yielded positive short-term results, but long-term returns were near zero.



The second caveat to the historical data is the difference between making money and getting back to even. While the mainstream analysis suggests that investors should buy the midterm elections for positive returns over the next 12 months, most individuals are already invested. In a year where the midterm elections fall in the middle of a bear market, like 1974, 2002, or 2022, returns generated over the next 12 months, investors are most likely *"getting back to even."*

The chart below shows the S&P 500 for 2022, starting at 4796. It will require a return of 26% over the next 12 months for investors to break even. Notably, that does not include the rate of return necessary to meet their financial goals. For example, if your financial plan requires 6% annualized returns, the 26% advance still leaves you another 12% short of your annual return goals *(6% for 2022 and 2023).* Given the average yearly return post-midterm elections is 18.6%, investors will end 2023 still well more than 20% of their goals.



While I am not discouraging you from taking advantage of the potential for a robust post-midterm election return, there is a vast difference between *"getting back to even"* and *"making money."*

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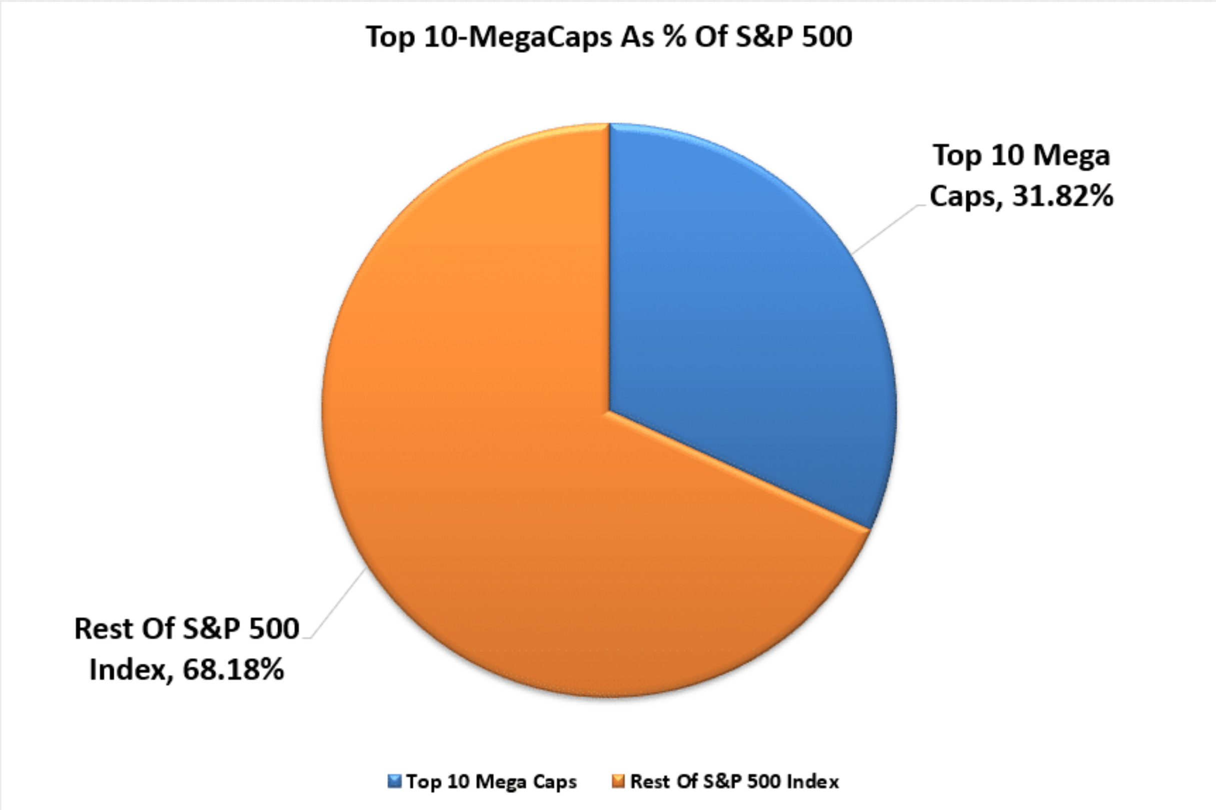
How We Are Trading It

As noted, there are many reasons the market should rally into year-end, although it could be sloppy. While buybacks could provide a boost, along with most professionals misallocated heading into year-end, we are keeping some exposure for now. However, our goal remains to reduce overall equity exposure to 30-35% of the portfolio heading into 2023.

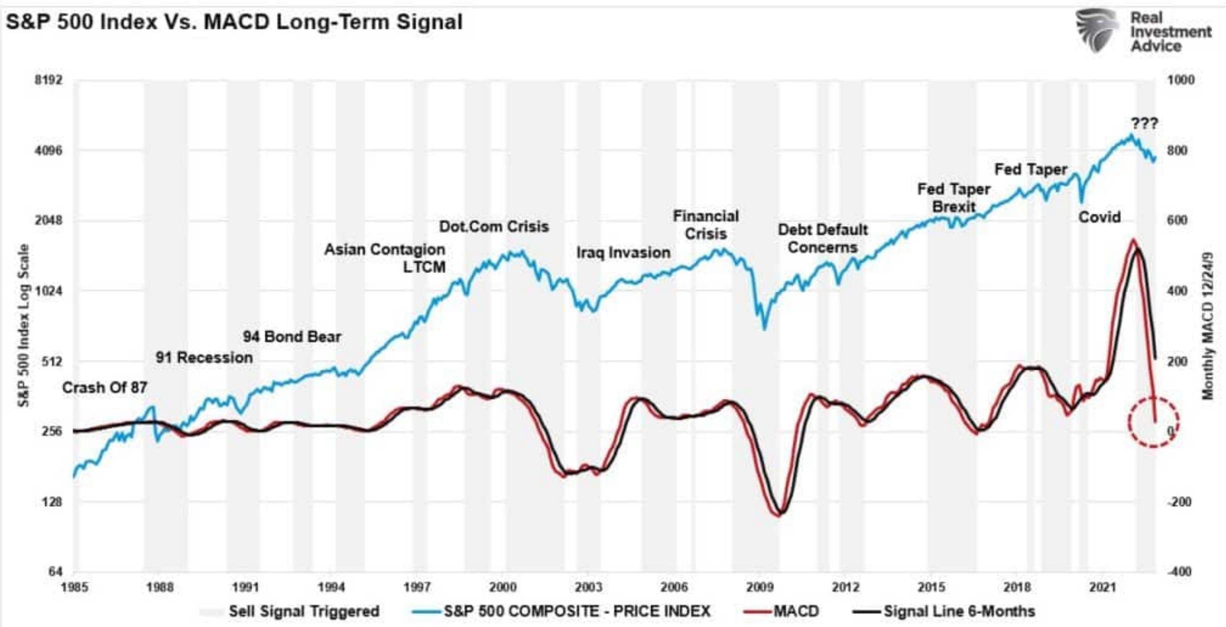
We ***previously noted that the Top-10 Mega-cap***companies in the S&P 500 index were masking the devastation below the surface.

The top-10 stocks in the S&P 500 index comprise roughly 1/3rd of the entire index. In other words, a 1% gain in the top 10 stocks is the same as a 1% gain in the bottom 90%.

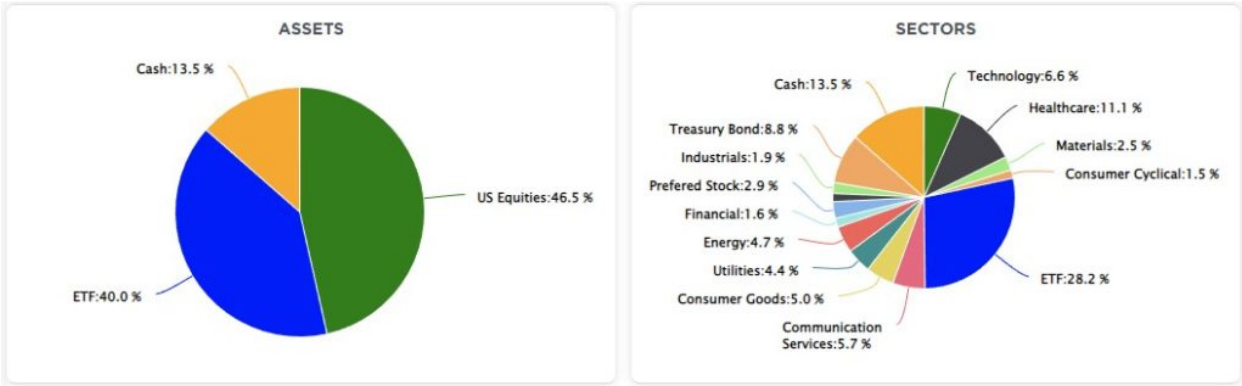


However, while the "Generals" were leading the market earlier this year, they are now under attack. The bad news is that there is still downside risk to these mega-cap companies. The good news is that by the time the leaders finally sell-off, such was typically closer to the end of the bear market cycle.

Are we there yet? I don't think so, as earnings still need to come down more, but those negative revisions are getting made. More importantly, the massively overbought conditions of the index are significantly reduced from where they were earlier this year. While the signal could certainly move lower, and we suspect it will, it is important to note we are grinding our way through this market. Eventually, a terrific buying opportunity will present itself. We have to get there first.



From an allocation standpoint, we remain underweight in stocks and bonds and overweight cash and short-term Treasuries. *(The ETF allocation comprises short-duration Treasury bonds and floating rate Treasuries, with a lesser allocation to long-dated Treasuries. You can view our models in real-time at **SimpleVisor.com**)*



We are doing our tax loss harvesting heading into year-end to reduce equity exposure further. However, keep working to rebalance portfolios for now, as this rally will likely end heading into the New Year.

1. ***Tighten up stop-loss levels*** *to current support levels for each position.*
2. ***Hedge portfolios*** *against significant market declines.*
3. ***Take profits in positions*** *that have been big winners*
4. ***Sell laggards and losers.***
5. ***Raise cash and rebalance portfolios*** *to target weightings.*

See you next week.

Research Report

The Treasury Market Is The Fed's Next Crisis

Written by Lance Roberts | Oct 28, 2022 | **Investing**

The Fed's next crisis is already brewing. Unlike 2008, where "subprime mortgages" froze counter-par...

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Stock Of The Week In Review

[Utility Stocks For The Coming Bond Rally]

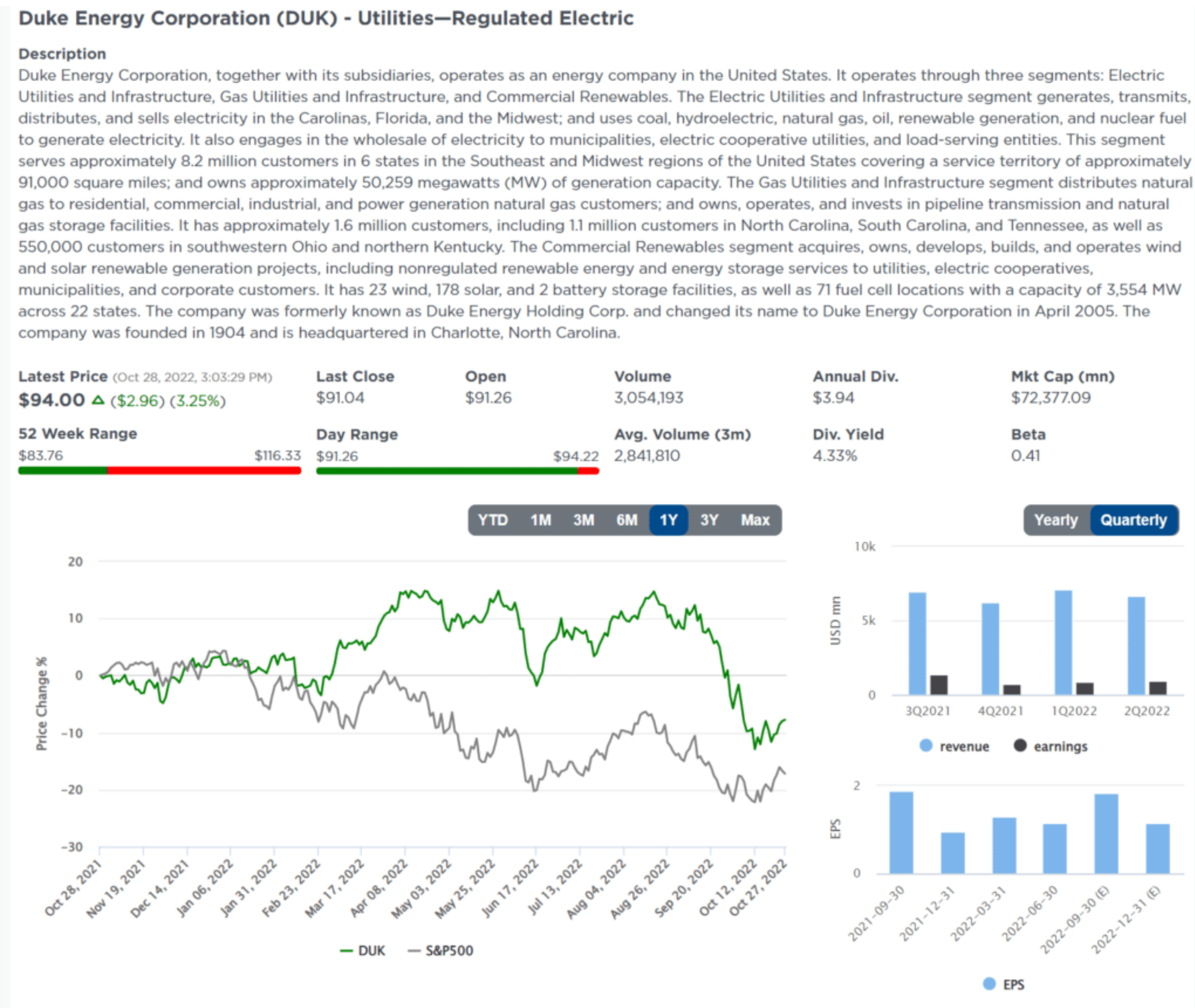
Utility stocks held up well in 2022 until the last two months. While the broader markets were down 15-20% through August, the utility stock ETF XLU was up slightly. XLU's outperformance reversed on a dime in September as bond yields rose rapidly. The 10-yr Treasury note yield increased by 1% in the last two months. XLU fell in sympathy by nearly 20% over the same period

The 4%+ bond yields for risk-free Treasury securities and 5-6% for high-rated corporate debt likely tempt traditional investors away from dividend stocks toward less volatile bonds. As such, the price of utilities has fallen, making their dividend yields more competitive with bonds.

If you think bond yields are peaking and likely to decline in the coming months, a bond surrogate like utilities may do very well. Given this outlook, we seek utility companies offering attractive dividends, decent growth potential, lower valuations, and relatively low debt ratios.

Here is one of the stocks from the scan.

Duke Energy (DUK)


Duke Energy Corporation (DUK) - Utilities—Regulated Electric

Description

Duke Energy Corporation, together with its subsidiaries, operates as an energy company in the United States. It operates through three segments: Electric Utilities and Infrastructure, Gas Utilities and Infrastructure, and Commercial Renewables. The Electric Utilities and Infrastructure segment generates, transmits, distributes, and sells electricity in the Carolinas, Florida, and the Midwest; and uses coal, hydroelectric, natural gas, oil, renewable generation, and nuclear fuel to generate electricity. It also engages in the wholesale of electricity to municipalities, electric cooperative utilities, and load-serving entities. This segment serves approximately 8.2 million customers in 6 states in the Southeast and Midwest regions of the United States covering a service territory of approximately 91,000 square miles; and owns approximately 50,259 megawatts (MW) of generation capacity. The Gas Utilities and Infrastructure segment distributes natural gas to residential, commercial, industrial, and power generation natural gas customers; and owns, operates, and invests in pipeline transmission and natural gas storage facilities. It has approximately 1.6 million customers, including 1.1 million customers in North Carolina, South Carolina, and Tennessee, as well as 550,000 customers in southwestern Ohio and northern Kentucky. The Commercial Renewables segment acquires, owns, develops, builds, and operates wind and solar renewable generation projects, including nonregulated renewable energy and energy storage services to utilities, electric cooperatives, municipalities, and corporate customers. It has 23 wind, 178 solar, and 2 battery storage facilities, as well as 71 fuel cell locations with a capacity of 3,554 MW across 22 states. The company was formerly known as Duke Energy Holding Corp. and changed its name to Duke Energy Corporation in April 2005. The company was founded in 1904 and is headquartered in Charlotte, North Carolina.

Latest Price (Oct 28, 2022, 3:03:29 PM)	Last Close	Open	Volume	Annual Div.	Mkt Cap (mn)
$94.00 ($2.96) (3.25%)	$91.04	$91.26	3,054,193	$3.94	$72,377.09
52 Week Range	**Day Range**		**Avg. Volume (3m)**	**Div. Yield**	**Beta**
$83.76 – $116.33	$91.26 – $94.22		2,841,810	4.33%	0.41

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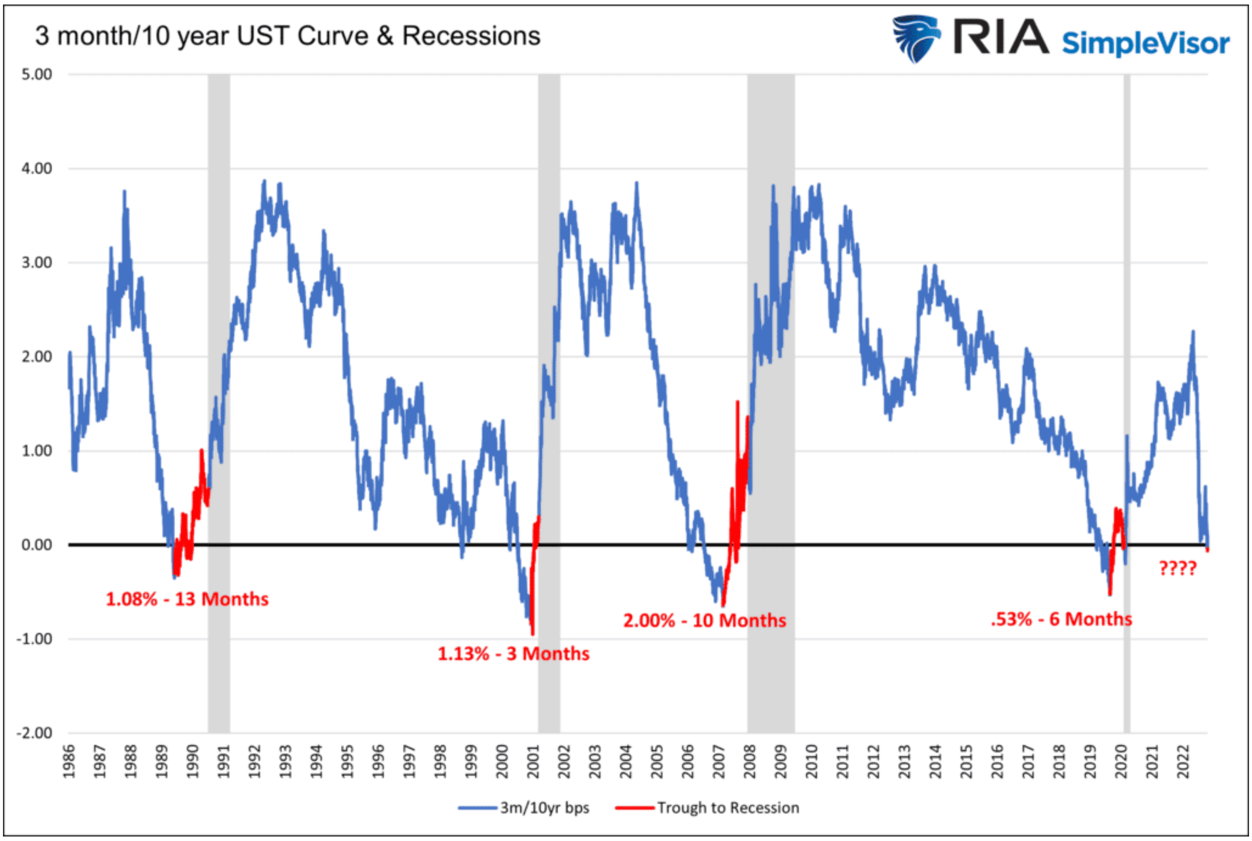
Daily Commentary Bits

[Fed's Yield Curve Forecasts Recession]

Q3 GDP rose nicely, but the Fed's preferred yield curve has spoken. It says a recession is imminent. The graph below charts the yield difference between the 3-month Treasury bill and the 10-year Treasury note. The Fed often reminds us that an inversion in the 3m/10yr UST curve is a precursor for recessions. As annotated in red, every time the 10-year yield is lower than the 3-month yield for more than a few days, a recession follows.

When should we expect a recession? As the graph highlights, it has taken between three and thirteen months from the trough of the yield curve inversion until the official NBER recession declaration. Making timing a little tricky is the clock doesn't start ticking until the yield curve troughs. Based on Fed Funds futures, we expect the three-month yield will rise from 4.05% to 4.80%. Unless the 10-year yield falls by .75% over the coming months, the Fed's yield curve will invert further. Such a trough in the Fed's yield curve may take another couple of months to form. Then we can start the recession clock.



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SimpleVisor Portfolio Changes

We post all of our portfolio changes as they occur at ***[SimpleVisor:]***

October 26th

We are starting the process of tax loss selling as we move into year-end. After disappointing earnings from both Microsoft (MSFT) and Google (GOOG), we are trimming those positions back for now, as those positions may struggle for the time being until earnings stabilize. We have taken gains in these stocks earlier this year, so the reduction gives us a tax loss against those gains. While we are reducing those holdings, we also need to maintain our technology exposure for the current rally, so we are picking up a 1% position in Facebook (META), which is trading at a fairly deep discount to fair value. There is earnings risk to the stock after the bell today, but much of that risk is likely priced in already.

Equity Model

- *Sell 0.75% each of MSFT and GOOG in the portfolio for a tax loss harvest.*
- *Add 1% of the portfolio to META*

October 27th

"If I told you about a company that:

- *Generates $33 billion annually in INCOME*
- *Has net REVENUE of 119.41 Billion*
- *An Operating Margin of 33.4%*
- *A Profit Margin of 28.2%*
- *And trades at 10x valuation*

That is a company you would want to buy every day. That company is META.

While earnings came in slightly weak, it was Zuckerberg's unyielding bet on the MetaVerse that led to a sharp decline in the stock price. The decline in ad revenue is a reversion to normal ad spending after two years of excess spending as cryptocurrency, and stock trading ad spending boomed. Ad spending should now normalize and begin to grow again over the next couple of years.

Sometimes the best-laid plans don't work as anticipated. And such is why we do it in very small steps when we take an initial position.

The position took out our stop loss level, so it was sold for the tax loss against the Amazon trade we made earlier this year.

Equity Model

- *Sell 100% of Facebook (META)*

Lance Roberts, *CIO*

Have a great week!