



## Q3 2023 — STRATEGY & MARKET UPDATE

### THE SEQUEL TO WALL STREET'S BEAR MARKET (THAT HASN'T BEEN)

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#### EXECUTIVE SUMMARY

Q3 demonstrated that the market is not bluffing—it's willing to decline to undercut the Fed's harmful interest-rate crusade. Such slides have the power to curtail the central bank's policy by incentivizing layoffs and tipping over vulnerable banks, as we witnessed in Q4 2022 and Q1 2023. Our strategies' lens reveals that this dynamic negates the widespread Wall Street pessimism that we are in a bear market. We believe the opposite is true—those targeted declines safeguard the market's long-term upward trajectory and protect investors' ultimate interests. Veritable bear markets rise on positive and fall on negative background news. In contrast, since the start of 2022, and especially during Q3 2023, the market has consistently exercised its intelligent adaptation by countering with quickly reversible preemptive declines any good economic news. Such news can give the Fed license to maintain or extend its harmful crusade, a crusade predicated on the erroneous assumption that our supply-driven inflation could be cured by monetary means. Currently, our strategies assess that the Market Regime remains healthy and investment-worthy and are positioned adaptively to capture the market opportunity while remaining risk-vigilant and tax-aware.

#### Q3 2023 AND THE BEAR QUESTION

The third quarter saw the broader market taking a step back (S&P 500 Total Return -3.3%) as the Fed telegraphed its willingness to contemplate another interest rate hike in its November meeting and limit its rate cuts in 2024. This propelled the intermediate interest rates to break out above last year's high, with the 10-year US Treasury finishing the quarter at a lofty +4.59%, a level not seen since 2007.

Wall Street got rattled, with many analysts returning to their bearish assessment and many investors reconsidering their exposure.

But is this the correct read—is the market falling apart again?

Let's start with the "again" qualifier. What was the last time the market fell apart, as in going into a real "bear" defined as a "lower for longer" decline with capital destructive consequences?

Wall Street's answer to this question is straightforward. Outside of our strategies, the widespread belief is that 2022 ushered in a veritable bear market highlighted on industry charts with the same characteristic vertical gray stripe used for the legendary bears of 2000 and 2008.

Our strategies beg to differ and, among many others, here are some powerful disconfirmations they offer:

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- The broader market's favorite proxy, the S&P 500, registered its most recent all-time high on Jan. 3, 2022, with its 4,796.56 close. If a bear market had ensued, that would be its starting day.
- Past that starting point, the first time the index fell below -20%, thereby confirming a new bear market by traditional measures, was on June 13, 2022, some 112 trading sessions later. But once that red line was crossed, the supposed new bear market treated us to a slew of unbecoming characteristics:
- As of October 4, a full 427 trading sessions into its supposed new bear phase, the market has registered a maximum drawdown of only -25.4% when it fell to 3,577.03 on a closing basis on Oct. 12, 2022. For such a lengthy bearish stretch, this is an extremely shallow maximum drawdown, unlike any other in the history of veritable bear markets.
- And speaking of lengthy durations, this alleged bear market has only spent in the critical, capital-destructive territory below -20% only 56 of its 427 sessions, or an insignificant 13%! This is a mere flash—much unlike the grinding, lower-for-longer moves of genuine bear markets.
- And there are additional disconfirmations: Since reaching its shallow bear market trough, the S&P 500 has rebounded as much as +28%, enough by most traditional calculations to erase any bearishness. This is even more evident once you consider that the market's leading segment, the Nasdaq 100 index (NDX), has rebounded from its trough as much as +48%! No rational investor should be prepared to ignore a +28%, let alone a monstrous +48% leg higher, shrugging it off as a bearish "dead-cat bounce."
- In combination, the uncharacteristic shallow drawdown and extra-brief tenure in the critical sub-minus-twenty-percent zone, along with the indices' subsequent vigorous and enduring rebound off their troughs, severely limit the capital-destructive nature of the ongoing decline and invalidate its characterization as a veritable bear market. Our strategies proceed to find additional corroborating evidence:
- Setting aside all technicalities like drawdown, duration, and rebound measures, where else can we find evidence that the market has not fallen into a new bear phase? That's easy—in the market's complexion!

Bear markets dethrone the leadership of the bull runs that precede them and, when they bow out, install new leadership in the succeeding bull market. Here is a closer look at this litmus test:

While at the end of 2000, the collective market cap weight of the then-top 100 US companies was 51.7%, by 2010, the weight of the very same companies had fallen to 43.3%. This reduction represents the dethronement of the previous flag-bearers due to the structural changes in the overall market complexion that were ushered in by the two major intervening bear markets of 2000 and 2008.

But as we fast-forward to the current, post-2008 era, the picture is very different:

The 54.9% commanding footprint of the top 100 market cap leaders at the end of 2010 remained

virtually unchanged by 2020 despite the much-touted bear market of the CoViD crisis. Moreover, that commanding footprint remains intact today despite the alleged additional bear market of 2022! There has been no change in market leadership despite Wall Street's supposed two back-to-back bear markets in 2020 and 2022.

From yet a different angle, we get additional confirmation along the same lines: During this supposed fresh bear market that started in Jan. 2022, Nasdaq 100—a bull market frontrunner—has edged out the defensive sector of Consumer Staples—a perennial bear-market defensive leader—like it did during the bullish year that preceded that peak. Again, there is no indication of a change in leadership that would validate the hypothesis of an intervening bear market.

## **POSITIONING FOR THE FUTURE – ASSESSING THE MARKET REGIME**

At the beginning of Q4 2023, our strategies assess that the market is in good health and continues to be investment-worthy. In other words, we find compelling evidence that the all-important Market Regime remains uninterruptedly bullish.

Our research shows that the Market Regime has been bullish since the bottom of the last bear, in March of 2009, without experiencing any interim bearish shift—notwithstanding the CoViD crash or the rolling 2022 correction.

This is not a prediction for what is coming. Our approach eschews all forecasts as futile. Instead, it is an affirmation of the market's trend and a reminder to investors that when they focus on aligning their portfolios with the market's unfolding dynamic, they take the most actionable step to secure a robust wealth trajectory that can sustainably stair-step upward with low shortfall risk.

Our strategies' capacity to render such an unambiguous assessment is a noteworthy exception to the double-speak investors are treated to nowadays across most Wall Street guidance—the dreaded “on the one hand... on the other hand....” We consider our strategies' capacity to deliver decisive, black-on-white assessments like this the crown jewel of our proprietary research that leverages concepts and tools from the latest 4<sup>th</sup> Generation in the evolution of Finance.

The ideas underpinning the industry's ubiquitous pie-chart constructions, like the “Moderate” 60/40 and all other risk-rated and goal-oriented portfolios, are rooted in early Finance. As we have argued in this series, those Gen 1 - 3 principles have not worn out well and have been visibly challenged since CoViD. Remember that the ubiquitous “Moderate” 60/40 portfolio last year registered its third worst performance since 1928, worse than its showings in 2008 or 2000 – 2003 and second only to its Depression-era losses (1931, 1937)!

But what about this market's mounting challenges? What about the lingering risk of inflation, the Fed's hawkishness, the skyrocketing US debt, the anemic recovery in China, the continuous political clashes both domestically (looming government shutdown, House speakership upheaval...) and internationally (Ukraine war, South China Sea confrontations...)? Can't the constellation of those challenges tip the market bearish?

The answer depends on our understanding of the market and its workings:

Last century's Finance (Gen 1 – 3) understood the market as an arena where security prices are passively shaped by external forces—chiefly corporate earnings, economic growth, central bank policies, and geo-politics.

The operative term in this understanding is “passively”—meaning causally (with the market prices being the effect of all other causes) and in a direct, straightforward, and proportionate way. Old Finance expects positive developments within the various “causative” factors to lift market prices, not depress them.

But this is frequently not happening, especially at crucial junctures of market activity, like during Q3's backpedaling.

All too frequently in Q3 and since the start of 2022, we observed good news on the economy (robust employment, consumer resilience), driving market prices...lower instead of higher! This challenges Finance's 20<sup>th</sup>-Century Gen 1 – 3 understanding and critically validates the Gen 4 ideas that power our strategies.

Our strategies espouse the idea that the market is a self-organizing entity with emergent autonomy and a self-regulating orientation that can both accommodate (reflect faithfully) and assimilate (reinterpret, reverse, counter) external influences. Specifically, concerning our current environment:

Our strategies detect that the only enemy of this market is the Fed with its fallacious interest rate crusade. The evidence for that looms large:

In 2021, during one of the most dramatic leaps in inflation's history (CPI +417%), the market demonstrated no concern, rising vigorously alongside (S&P 500 +28.71%). This happened while the Fed remained on the sidelines (and in denial). The market's behavior in 2021 was eminently intelligent—the market assessed that our inflation is supply-driven, which meant (a) it could not be cured but could get worse by the application of monetary treatments, and (b) it could and ultimately would, improve mainly on its own as industry and governments mobilized to reopen the global economy.

Yet, in 2022, when the Fed awoke from its stupor and decided to treat the screw of supply-driven inflation with the hammer of Volker's-era interest rate hikes—a hammer suitable only for the nail of demand-driven inflation—the market started protesting. As an independent and intelligent agent, the market had to counter the Fed's detrimental crusade to protect its long-term upward trajectory.

There can be little doubt about the harmful side effects of the central banks' interest-rate medicine: In the aftermath of those crusades, the traditional bond-heavy portfolios of the most vulnerable (older/less affluent) and most conservative investors have suffered massive losses as bonds fell hard (the long-duration US Treasuries have lost nearly half of their value since 2022 start). In many cases, such an adverse development has skyrocketed the shortfall risk of long-term savers. In parallel, mounting government debts worldwide are refinanced at ever higher rates, threatening to suffocate valuable discretionary spending. In addition, smaller enterprises that rely on bank financing have seen their cost of capital explode. Not to mention that high mortgage rates have rendered the path to homeownership unpassable for most renters, turning them into captives of rent increases. Rent hikes further fuel inflation as housing costs are the leading component of (you guessed it!) ...inflation! Finally, banks have been forced to navigate an environment that is becoming increasingly hazardous not only for their liquidity but also for solvency.

Given all that, one can understand how the “intelligent, autonomous, self-regulating, and self-organizing” Market postulated by our Gen 4-power strategies had to stage a rolling correction to exert pressure and curtail the central bank's detrimental crusade.

And how does the market communicate to the Fed its cease-and-desist signals? Simply through effecting outcomes that are hard-wired Fed warnings:

By staging a rolling correction since the start of 2022, the market has incentivized CEOs to launch cost-cutting layoffs, undermining the Fed's number-one mandate—preserving full employment.

The same rolling correction has destabilized the bottom-decile banks by decimating the value of their treasury reserves. This is a high-visibility warning the Fed has learned to pay attention to after its 2008 mistake of letting Lehman Bros. and Bear Stearns collapse during the earlier stages of the Global Financial Crisis.

With this in mind, we now can understand how our strategies view the market declines on otherwise positive background news (like low unemployment) as a confirmation of the market's good health. The market knows that positive background developments give license to the Fed to maintain or even extend its harmful treatment, in the absence of which the market is otherwise ready to advance.

To wit: A market in a bearish mode celebrates positive background developments and falls on bad news—not the other way around. But a healthy market that intends to go higher but needs first to remove its impediments must stage a sufficient correction that can neutralize the roadblocks. Bear markets fall on bad news and rebound on good. Only healthy markets can afford to counterbalance good news with a corrective action. That is the meaning of the market decline in Q3, in response to the Fed's saber-rattling during its Jackson Hole conference and Sep. FOMC meeting.

Thankfully, the combination of the natural decline in inflation (down to the CPI 4% zone, as the global economic reengages), plus the market's watchful countermeasures, has brought the Fed's crusade to what appears to be a visible end-stage. Forecasters would naturally be tempted to time the market's next advance. But our strategies know better—they eschew all forecasts and instead maintain a pro-growth exposure focused on the areas with the most vital trends.

## **LAST WORD**

We invite you to spread the word about your investment experience within your circles of influence. The last five years have been challenging for most investors. They have been battered by the historic bond market fall and whipsawed in the steep downdraft of 2018, the crash of 2020, and the rolling turmoil since the start of 2022. And throughout the last fourteen years, they have been torn between the Scylla of speculation and greed and the Charybdis of worry and indecision. As our veteran clients have discovered, our strategies' adaptability and risk controls have been an excellent antidote to haphazard performance and a booster of investor confidence. Please assist us in spreading the word.

We remain grateful for your trust, loyalty, support, and friendship!

On behalf of our entire team with Henrik, Richard, Chad, and Isabel,

*Kostas*

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