LV **Longview Economics**

Investments. Trades. Macro.

Tactical Equity Asset Allocation No. 218, 3rd March 2022

(1 – 4 month outlook for risk assets)

Written by: Harry Colvin, CFA, Director & Senior Market Strategist

Major Buying Opportunity for 1H 2022?

Summary Extract:

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Important disclosures are included at the end of this report

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Major Buying Opportunity for 1H 2022?

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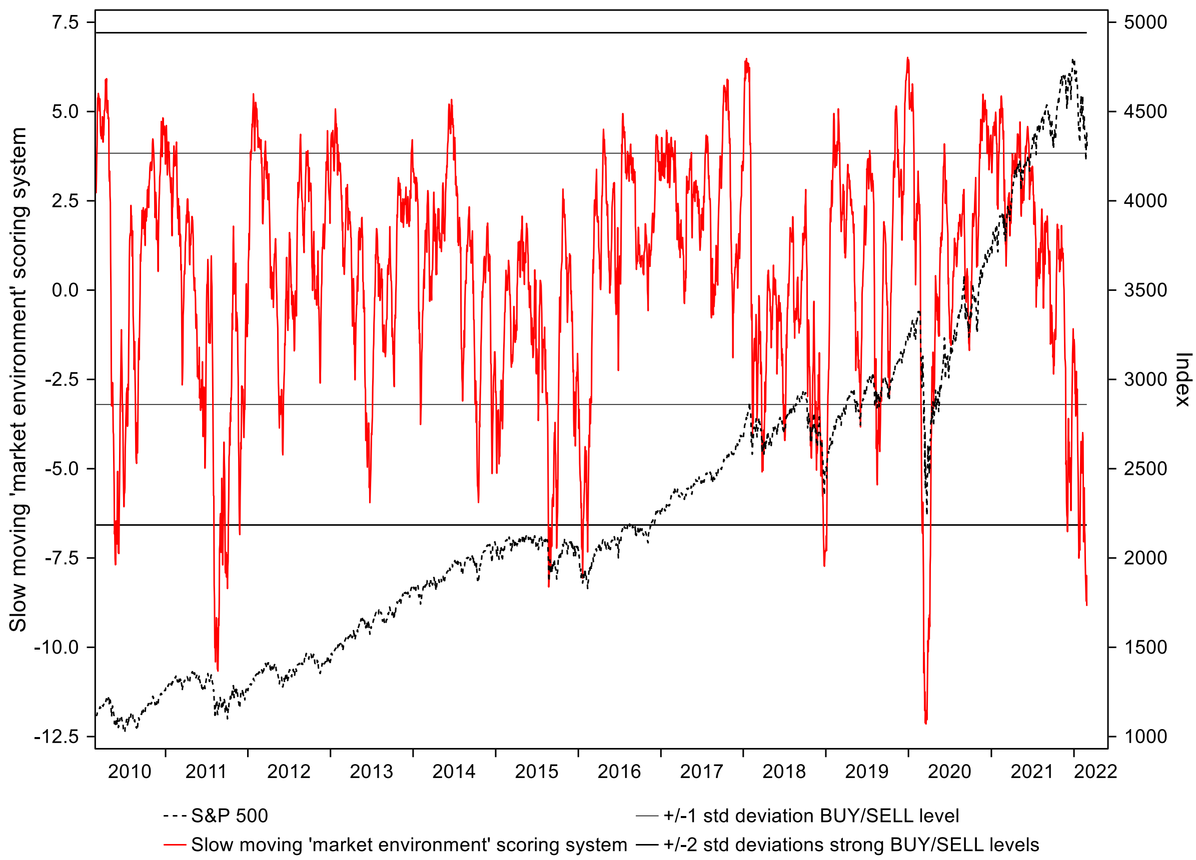
Section 1: Summary & Conclusion

US equity markets have been in the midst of a major SELL-off for the past two months. Initially, that was driven by sector rotation (on fears of higher rates/inflation). The pullback then deepened on news of the Russian invasion. Peak to trough declines in the S&P500 (15%), NASDAQ100 (22%); and Philly SOX (23%), amongst other key US indices, are now, therefore, relatively large.

In our view, though, **the lows of this pullback are probably in place and US equities are poised for a strong rally over coming weeks and months**. The rationale for that is fourfold, and includes: **(i)** extreme levels of fear/panic in portfolios; **(ii)** a clear BUY/strong BUY message from our medium term indicators; **(iii)** a robust US economic and earnings growth outlook; and **(iv)** evidence that US bond yields have probably peaked (for now) and that liquidity concerns are likely to ease into the summer (see Key Points below for detail).

Fig 1: Longview 'slow moving' scoring system vs. S&P500



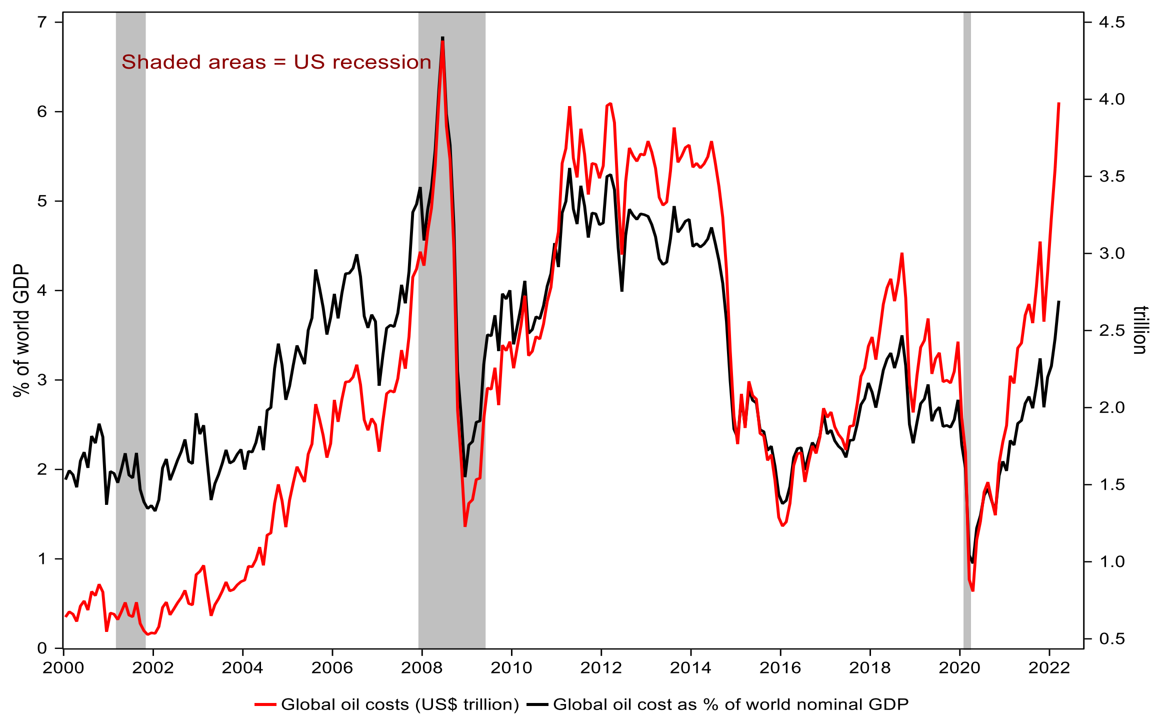
Source: Longview Economics, Macrobond

As such and having increased LONG/OW equity exposure in tactical portfolios last Friday*, we recommend staying with current OW positions (please see Appendix A for detailed portfolio recommendations).

Risks, as always, are multiple and include the potential for a further, meaningful oil (& natural gas) price spike. That could happen, for example, if the Russia situation escalates again and results in the full weaponization of Russian energy production, albeit that is not our current central expectation (for detail see 25th February 2022 LV on Friday: Longview on Friday: "Equities – BUY, HOLD or SELL?"). In a similar (and troubling) vein, there are reports that buyers are boycotting Russian energy (i.e. 'self-sanctioning'), either due to fears about reputational damage, moral objections and/or confusion about what is/isn't legal.

While the oil price is a key risk it should, though, be considered **in the context of what oil costs the global economy**. In that respect, at $110/barrel, the world is spending ~$3.9 trillion annually on oil. That is similar to the levels being spent when oil prices were troublingly high in 2011-2013 (see fig 1a). As a share of GDP, though, oil at $110 only costs 3.8% (which is close to the average of the past 10 years, fig 1a). That reflects the fact that **the global economy is now ~40% bigger** than it was at that time (2011 - 13). For the cost of oil as a share of GDP to rise to 2011-2013 levels (e.g. to 5.5% of GDP), the **oil price would need to average around $150/barrel**. It's also possible, in that scenario, that the impact on US/global growth would be less dramatic because of the large levels of spare cash in household bank accounts.

Fig 1a: Global oil costs (% of global GDP & US$)



Source: Longview Economics, Macrobond

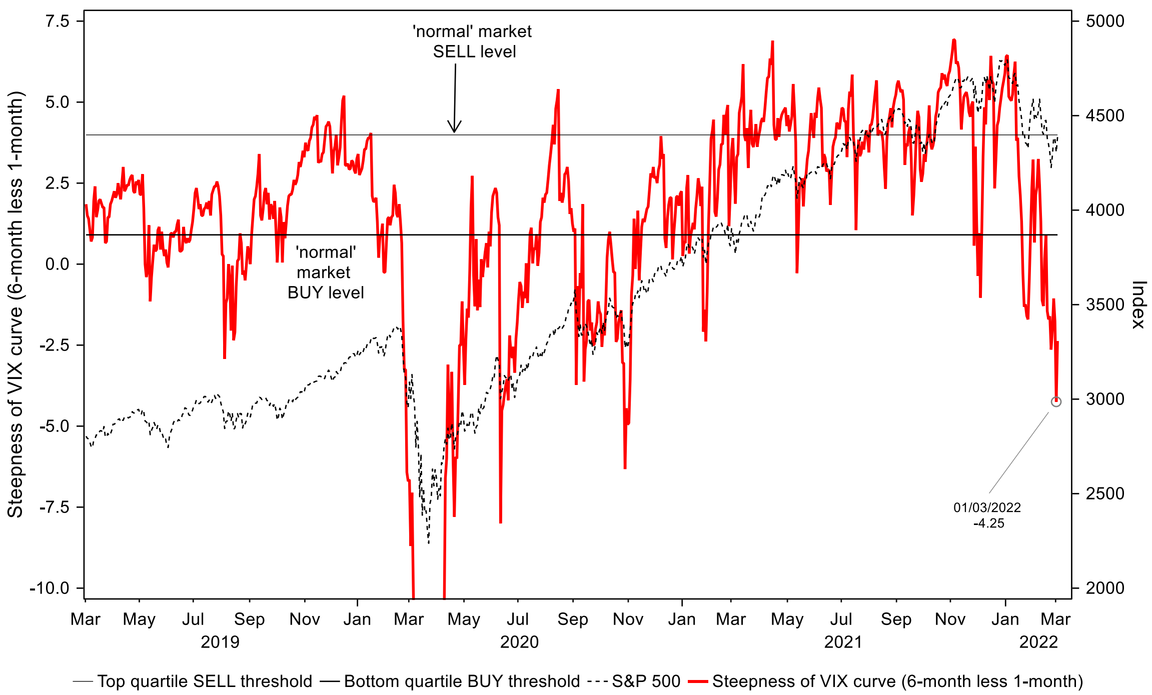
*See Longview Tactical Alert, 25th February 2022: "Increase Tactical Equity OW a.k.a. 'Wave 3' Likely Finished"

Other key risks, aside from the oil-related ones, include the potential for inflation to (continue to) surprise to the upside. In that scenario, rather than Fed hikes being priced out of the market (as has been the case in the past week), the speed/timing of Fed tightening would likely, once again, be brought forward.

Key Points

1. **Plenty of fear/panic has been priced into US equity markets**. That's clear on many fronts, with sharp spikes in volatility (e.g. see the VIX/VDAX, fig 2c); significant put protection in portfolios; and a clear BUY message from our models (see point 2 below). In that respect, equities have historically made a low on the news of major invasions** (with risk assets moving lower in anticipation of the event before it happens). In other words, there's normally a 'sell the rumour, buy the fact' price pattern around these events (in which uncertainty is rapidly priced in ahead of/on these events). If history is any guide, therefore, the 24th February low is likely to mark a medium term/multi-month change of trend. While there are risks to that view (most notably, oil price related ones – see above), the risk reward favours staying with LONG/OW equity positions.

Fig 1b: Steepness of VIX curve (6 month less 1 month VIX futures) vs. S&P500



Source: Longview Economics, Macrobond

**See 22nd February 2022 The SHORT VIEW: "Russia & Inflation Fears: How Much Is Priced?"

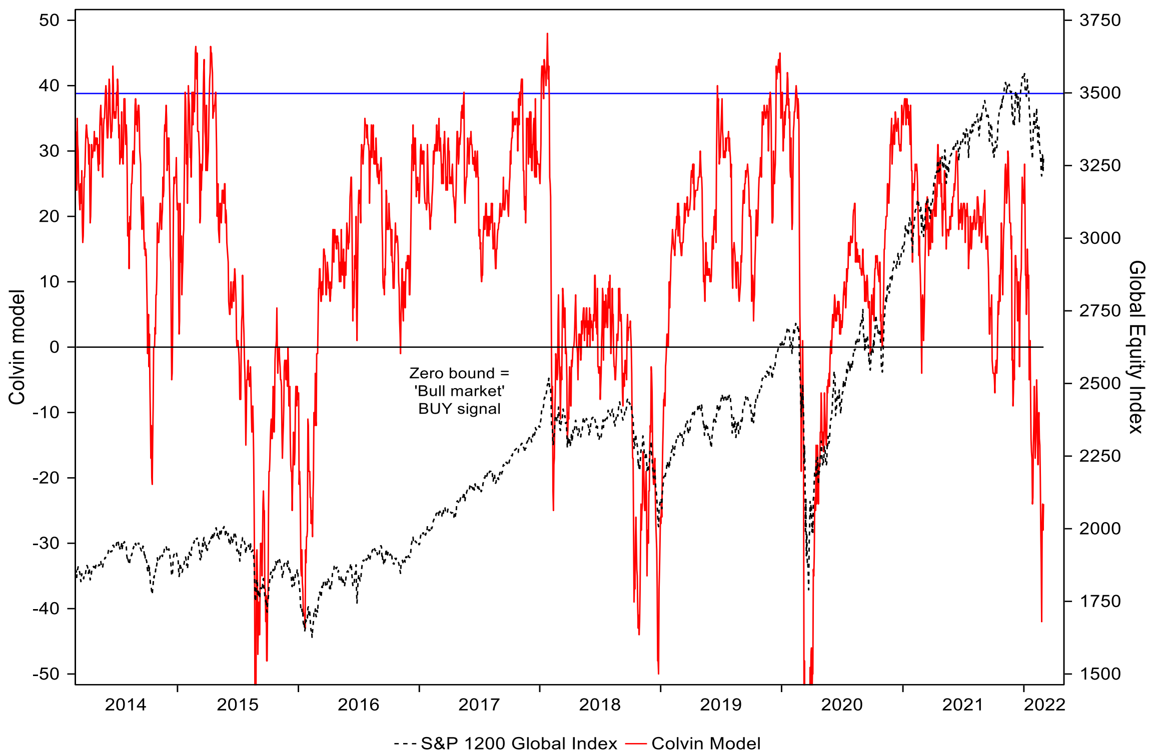
2. **Medium term models have a clear, and in some cases extreme, BUY message**. At an aggregated level, that's summarised by our main scoring systems, which score and equal weight the message of various indicators across a range of different categories. Our slow moving scoring system, for example, is currently at a multi-year extreme BUY level (fig 1). Since we built the indicator

in 2004, the current reading has only been surpassed in (i) the pandemic; (ii) the Eurozone crisis; and (iii) the GFC (i.e. major macro events which had the potential to result in a global depression). In our view, the Russia situation is unlikely to be as significant for the global economy as those events. Other key 'top level' scoring systems also carry a similar/strong BUY message (e.g. see fig 3).

Added to that, the overall signal is broad based across the breadth of types of indicators that we track: **In particular, sentiment** readings are extremely bearish. Retail sentiment, for example, is at its most bearish since 2013 (and effectively at 'max bearish' levels), see fig 2b. Our sentiment scoring system, which aggregates the message of various sentiment indicators, is on BUY at its lowest level since the pandemic/early 2020 lows (see fig 3i). Consistent with that, **breadth** readings are at multi-year low levels, suggesting that the selling of risk assets has become broad based and somewhat indiscriminate. That's the case at a single stock, sector, and index level (e.g. see fig 2) and indeed at a 'global asset price' level (see the Colvin model – see fig 1c). All of that highlights seller exhaustion and high levels of fear in markets, which is also reflected in the message of our **volatility** models (e.g. see our volatility scoring system, which is on strong BUY, fig 3g).

As such, and with our **technical** and **risk appetite** indicators also at extreme levels (e.g. see figs 2a & 3h), US equities are oversold, fearfully priced and therefore likely to rally over coming months.

Fig 1c: Longview Colvin model vs. S&P500

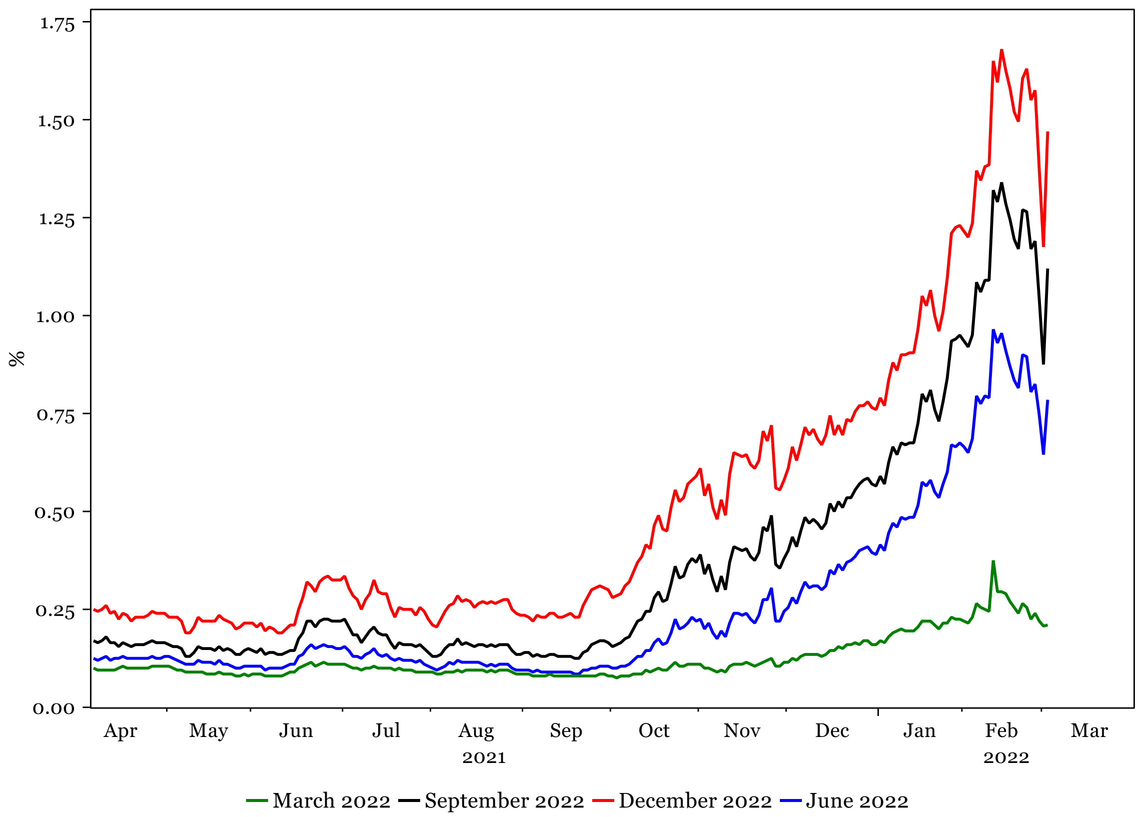


Source: Longview Economics, Macrobond

3. **Rates and bond yields have probably peaked, for now. If correct, that should support a medium term/multi-month uptrend in US equities**. Of note, rate expectations appear to have peaked in the past month (i.e. with that peak occurring on the release of the strong inflation data in mid-February, see fig 1d). With that, US nominal bond yields have moved lower across the curve and real bond yields have also fallen. Clearly that's in part been driven by risk aversion relating to the Russian situation.

   In addition, though, two key reasons suggest that a counter trend move lower in bond yields is likely in coming months. In particular: **(i)** sentiment towards bonds is at multi-year bearish levels, bonds have become deeply oversold (technically) in recent months, and (speculative) short positioning is crowded. While the longer term trend in yields is likely to be up, there's therefore plenty of fuel for a counter-trend move lower (see 1st March 2022 SHORT VIEW publication: "Bonds: Counter Trend Move Underway?"); & **(ii)** certain cyclically sensitive parts of the US economy are softening (including housing and the industrial sector), suggesting that the US economy is in the midst of a mid-cycle soft patch. If correct, then a lower 10 year yield is necessary (i.e. to reflect that weakness – and to re-stimulate growth/generate a mini-reacceleration). A phase of falling/lower bond yields would likely support US equities with leadership from the tech/growth parts of the equity market.

Fig 1d: US Fed funds implied interest rates for 2022 (%)



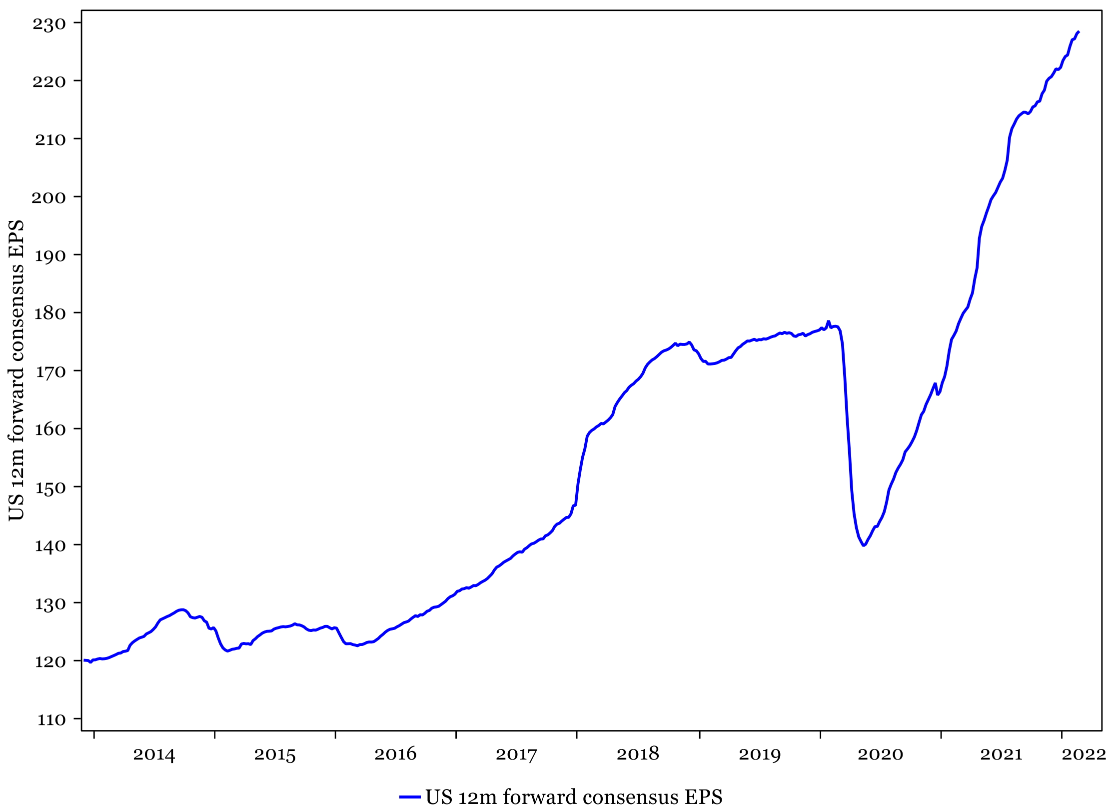
Source: Longview Economics, Macrobond

4. **US earnings growth remains strong**. In particular, the upward momentum in the earnings trend has continued in recent weeks/months (fig 1e), with 12 month forward consensus earnings currently growing by around 30% Y-o-Y. That's encouraging for the equity bulls, and supports the case that **US equities remain in a cyclical bull market.** Of note, the 'easiest' earnings growth comp was in early/mid 2021, when earnings growth was 40% Y-o-Y (i.e. given the easy comparison with early 2020). The current/strong growth rate is therefore not distorted by base effects.

   Adding to that, the US economy is structurally strong: Companies are throwing off (close to) record levels of spare cash flow; the level of spare cash in bank accounts (both household and corporate) is at extreme/high levels; household debt is relatively low as a share of GDP; wealth effects are strong; and a new cycle of consumer re-leveraging appears to be underway (most notably via the home equity withdrawal channel). All of that points to an ongoing uptrend in US corporate sector earnings.

   Indeed, as fig 1e shows, forward earnings have been growing sharply since the depths of the pandemic, and are now 28% above their peak in January 2020.

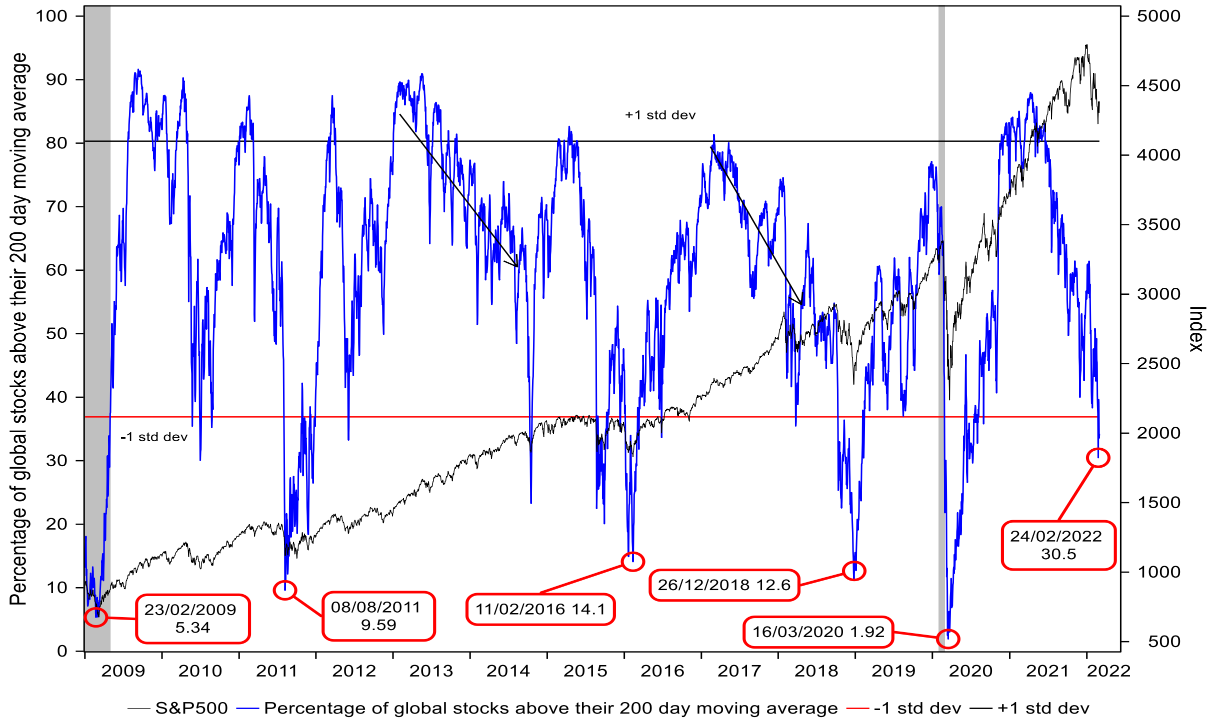
Fig 1e: S&P500 12 month forward consensus earnings (EPS)



Source: Longview Economics, Macrobond

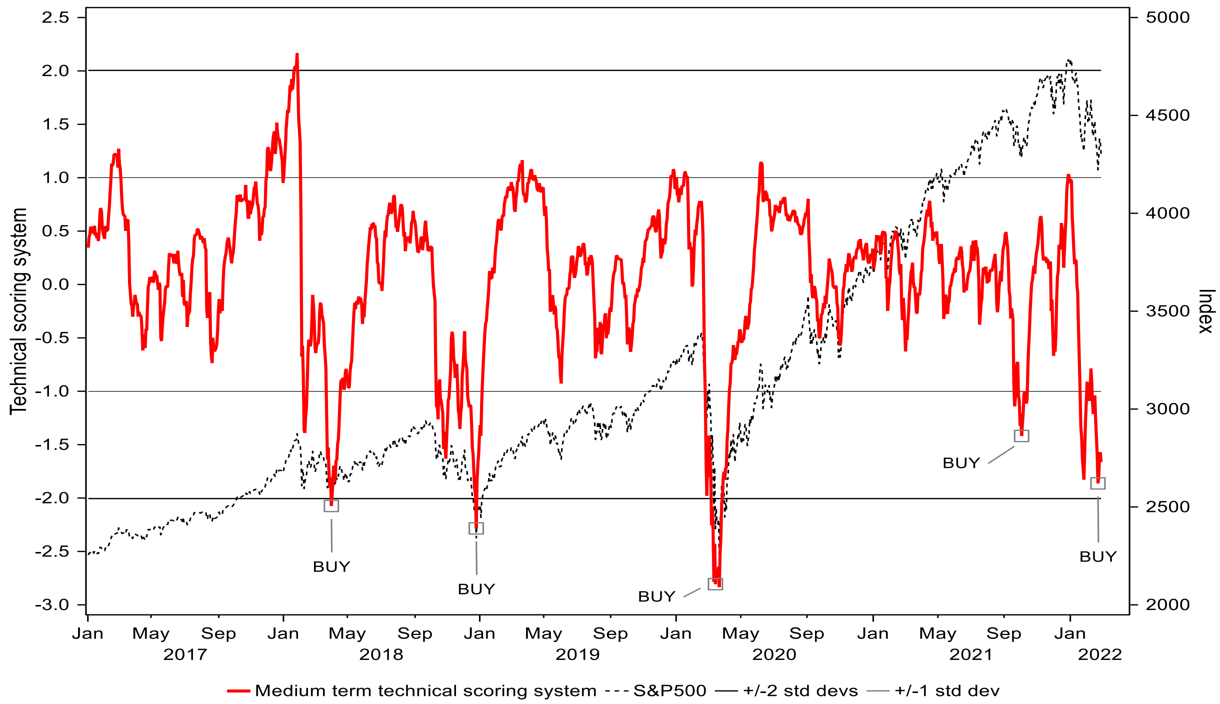
Section 2: Key Charts

Fig 2: Percentage of Western stocks above their 200 day m.a. vs. S&P500



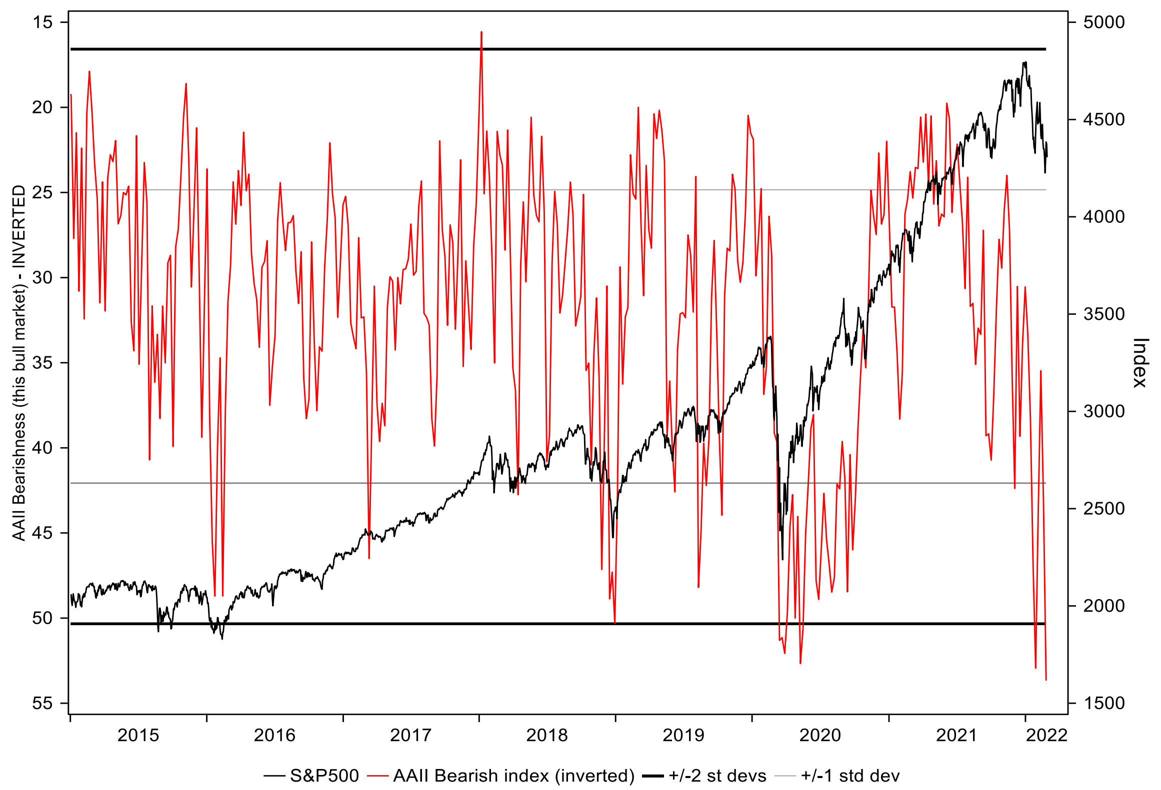
Source: Longview Economics, Macrobond

Fig 2a: Medium term technical scoring system vs. S&P500



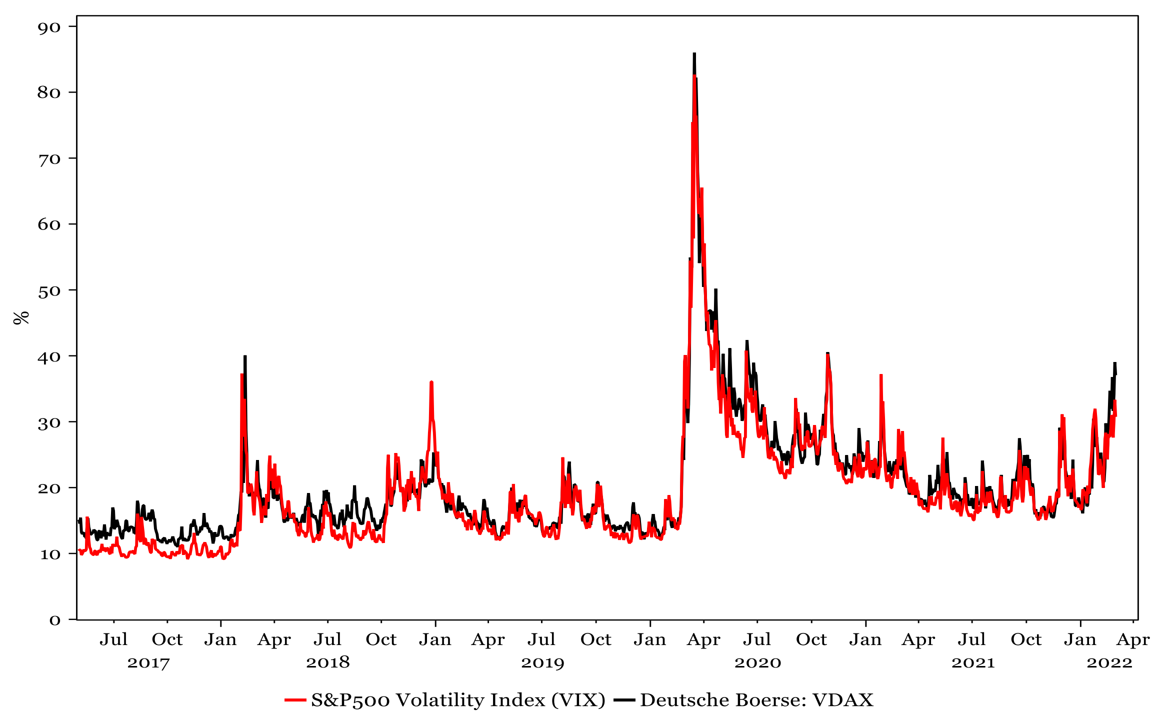
Source: Longview Economics, Macrobond

Fig 2b: AAII retail 'bearish only' sentiment (inverted) vs. S&P500



Source: Longview Economics, Macrobond

Fig 2c: Implied volatility (VIX vs. VDAX, %)



Source: Longview Economics, Macrobond

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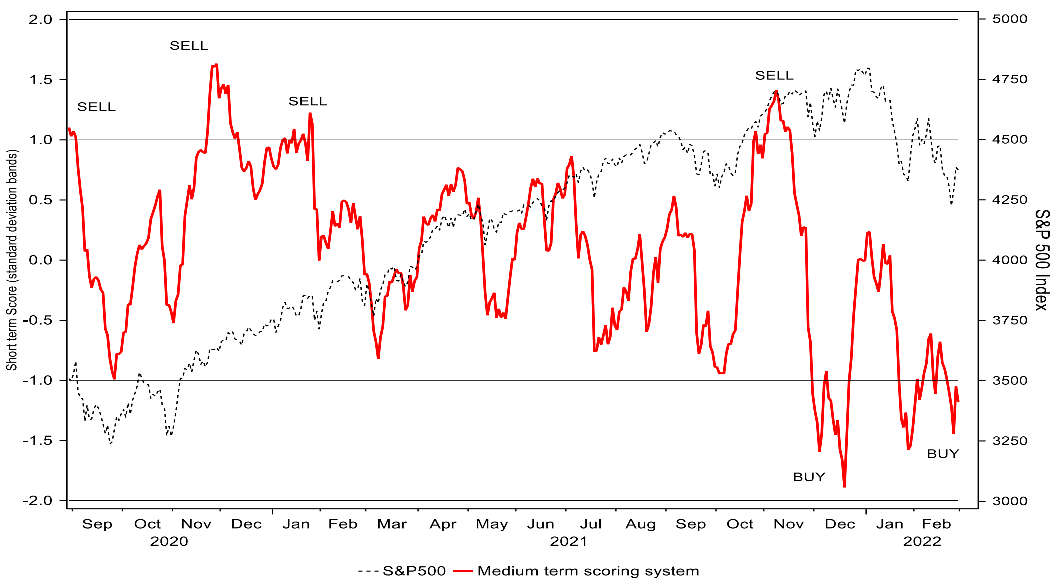
Section 3: Longview Scoring Systems

Methodology overview: In the short term (i.e. 1 – 4 months) the **trend in equity markets is driven by the ebb and flow** of **'greed and fear'** (i.e. positioning). That's why we rely heavily on our key models and scoring systems in determining our recommended monthly tactical asset allocation. The monthly tactical decision is approximately 60% models based and 40% discretion.

Our models are primarily price based/price related in their composition. They draw on a wide list of global inputs across all asset classes. There are 3 main model inputs into the monthly tactical asset allocation process. They are: i) The 'fast moving' TAA scoring system (fig 3); ii) The 'slow moving' market environment scoring system (fig 3a); & iii) the 'SELL-off' indicator (fig 3d). The 'fast moving' scoring system is timely and efficacious and helpful for pinpointing specific weeks for market timing moves. It relies primarily on risk appetite based indicators. The slow moving scoring system is designed to generate an overall picture of the general 'market environment' (including general sentiment, technical positioning, complacency measures and so on). It achieves this by incorporating a larger number and broader range of indicators than the fast moving model (e.g. including sentiment models, technical models, bond spreads and so on). We combine the message of all three model inputs (plus any other models that are of occasional interest) and couple that with judgment (and over a decade of experience using these models) to determine a recommended tactical asset allocation.

Models Summary: The Longview **'fast moving'** scoring system is on BUY while the Longview **'slow moving'** market environment scoring system is strong BUY (figs 3 & 3a). Furthermore, all five subcomponents (i.e. 'Technical', 'Bond Spreads', 'Volatility', 'Risk Appetite', and 'Sentiment') are currently on BUY/strong BUY.

Fig 3: Longview 'fast moving' TAA scoring system vs. S&P500



Source: Longview Economics, Macrobond

Our medium term 'fast moving' scoring system is on BUY

This scoring system is comprised of eight models, with each scored daily and individually.

The Longview 'fast moving' scoring system generates more frequent signals aimed at shorter time frames than the 'slow moving' scoring system. It's more effective in picking turning points, especially local market highs. The choice of indicators is tighter (it includes only 8 models in total). We deliberately exclude slower moving models which often generate signals (especially SELL signals) significantly early, for example sentiment and overbought technical indicators. The key models are risk appetite based. Some models also measure over-exuberance (excessive risk taking).

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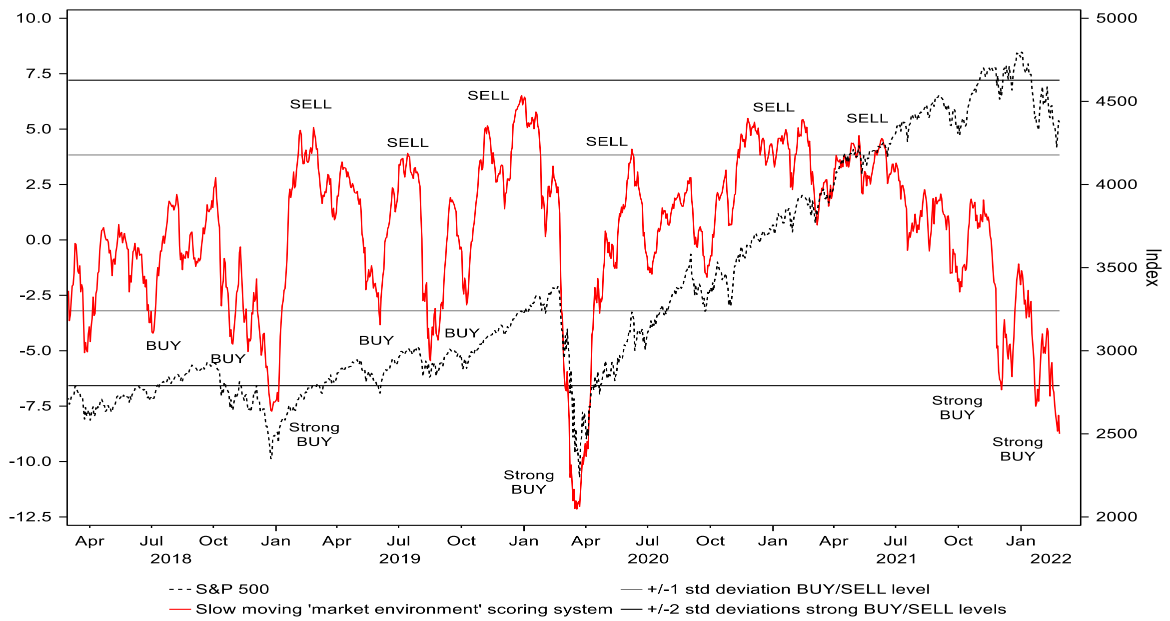
Fig 3a: Longview 'slow moving' market environment scoring system vs. S&P500

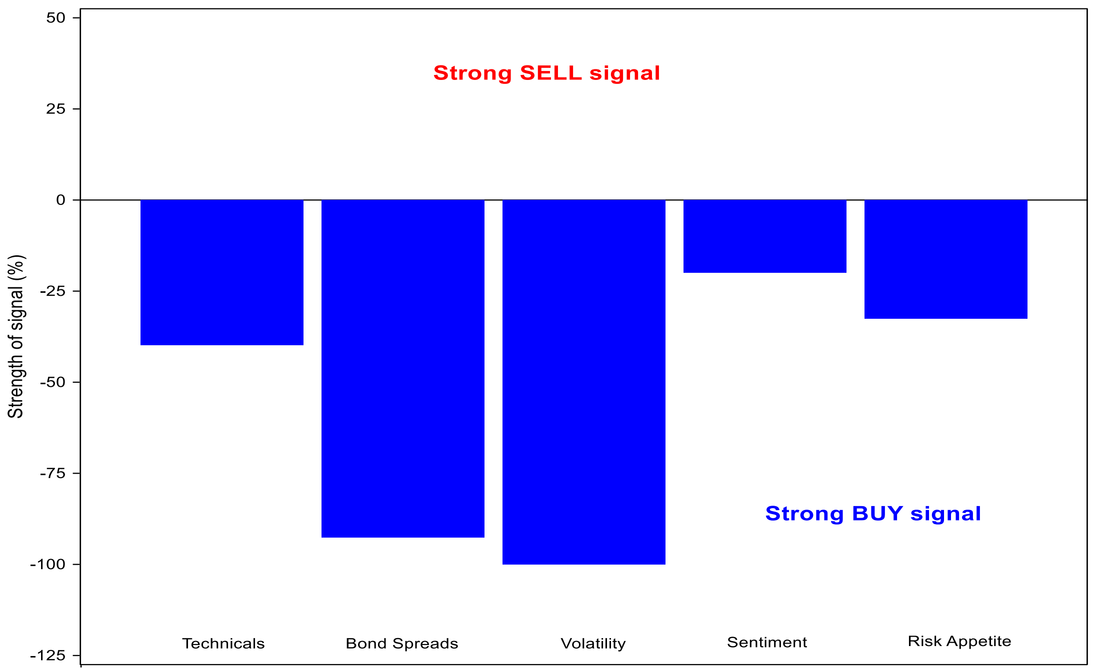


Source: Longview Economics, Macrobond

Our slow moving 'market environment' scoring system (fig 3) aggregates a suite of models across a number of categories (namely: Technicals, Bond Spreads, Volatility, Risk Appetite & Sentiment). This scoring system is entirely mechanistic. Typically, a score of -3.5 (i.e. -1 std deviation) indicates a BUY signal (within a cyclical bull market) and +3.5 a SELL signal. The individual categories are scored and then aggregated to create the scoring system (see fig 3a). The 'fast moving' TAA scoring system (fig 3b) is an aggregation of 8 faster moving indicators, and is used to finesse entry points into medium term trades.

For further detail/explanation of any of the models within this section, please see 'models explanation' at the back of this publication, or contact us via email.

Fig 3b: Longview 'slow moving' Market Environment scoring system – key categories



Source: Longview Economics, Macrobond

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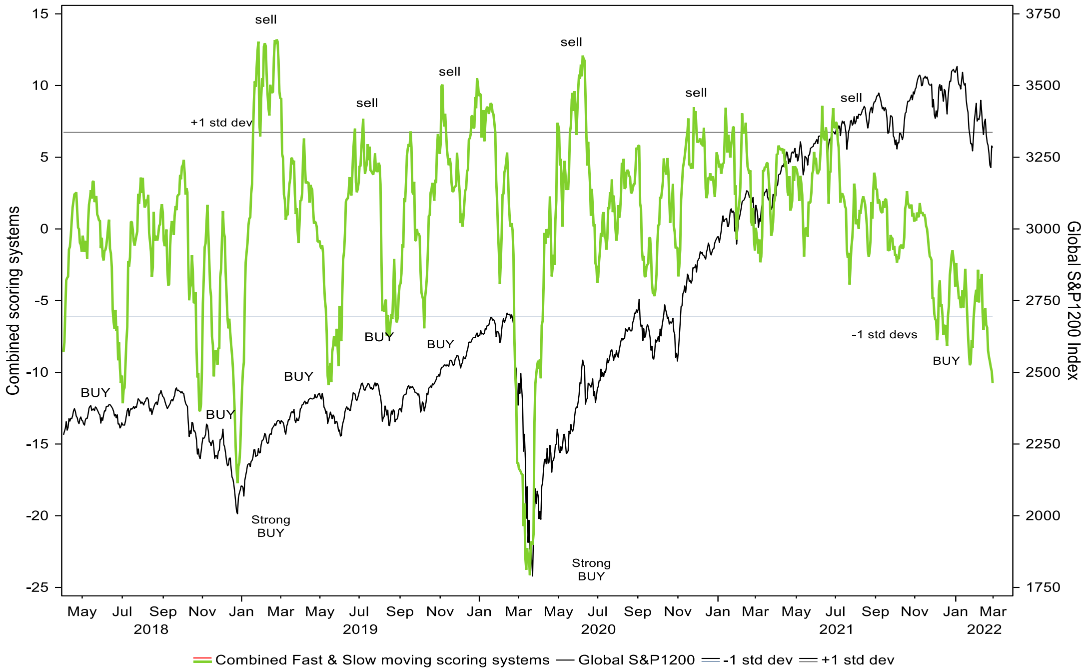
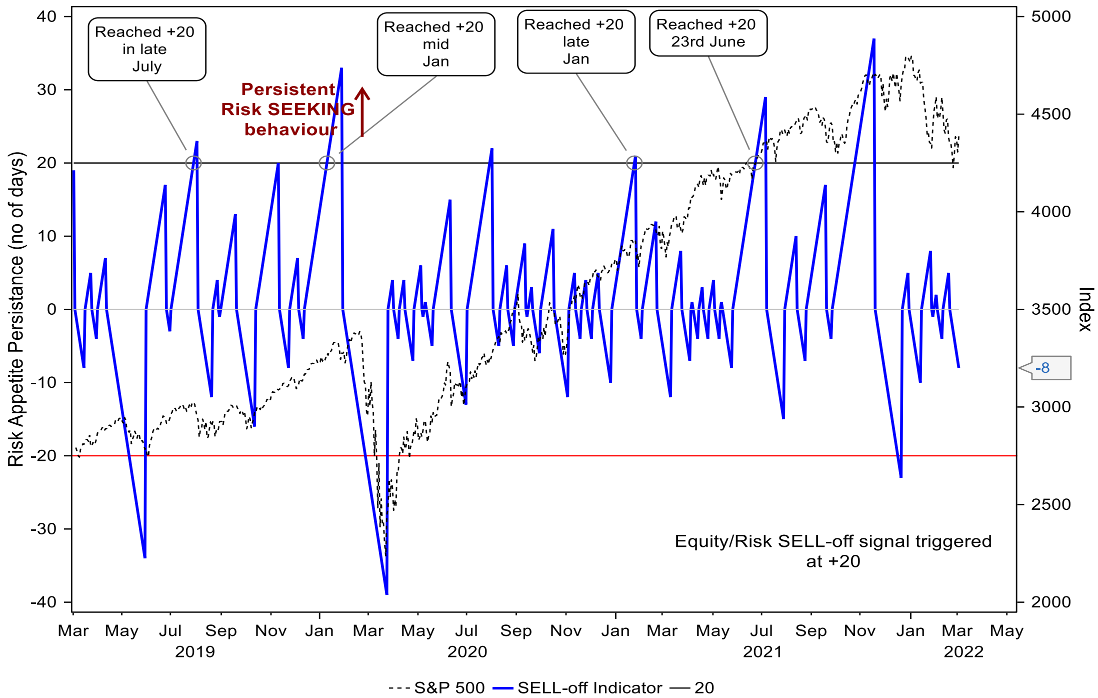
Fig 3c: Combined Slow Moving & Fast Moving Scoring systems vs. S&P500



Source: Longview Economics, Macrobond

The combined slow & fast moving scoring system is on BUY

Fig 3d: Longview SELL-off Indicator vs. S&P500



Source: Longview Economics, Macrobond

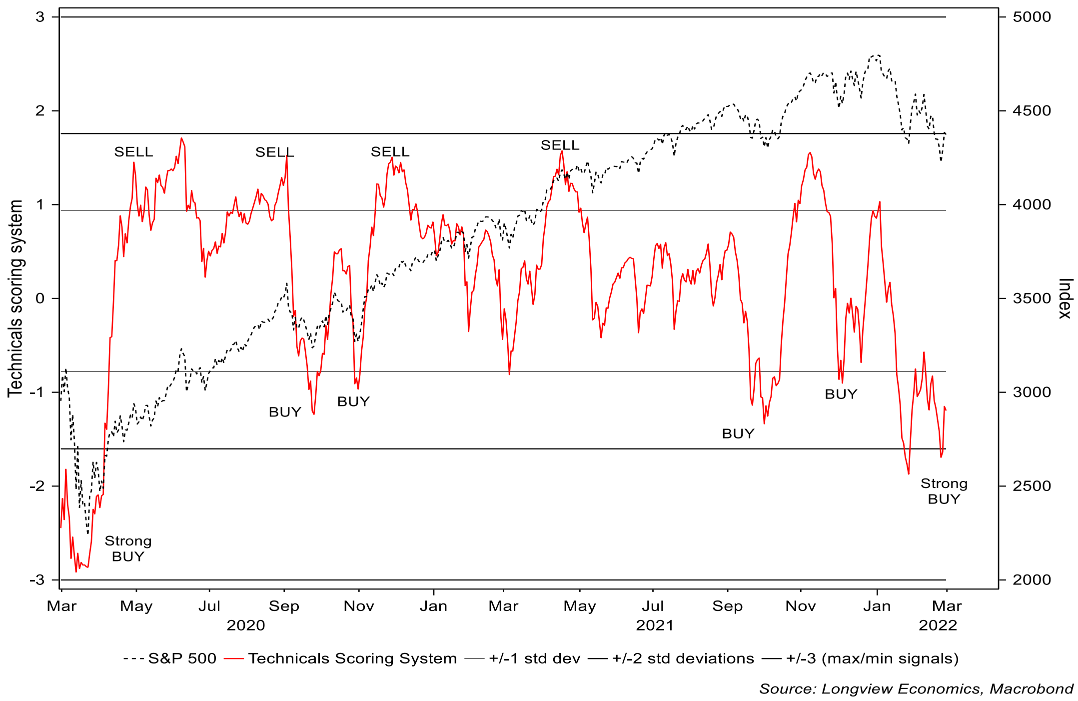
The Longview SELL-off indicator is NEUTRAL

(N.B. +20 is the SELL-off warning threshold).

The SELL-off indicator is an indicator derived from the Longview short term risk appetite model. It highlights phases of excessive greed in global financial markets – i.e. phases of overexuberance. It generates a signal when it reaches +20. At that time, the probability of a near term 5 – 10% pullback in the S&P500 is high.

Section 3i: Longview Scoring Systems – Key Sub Categories

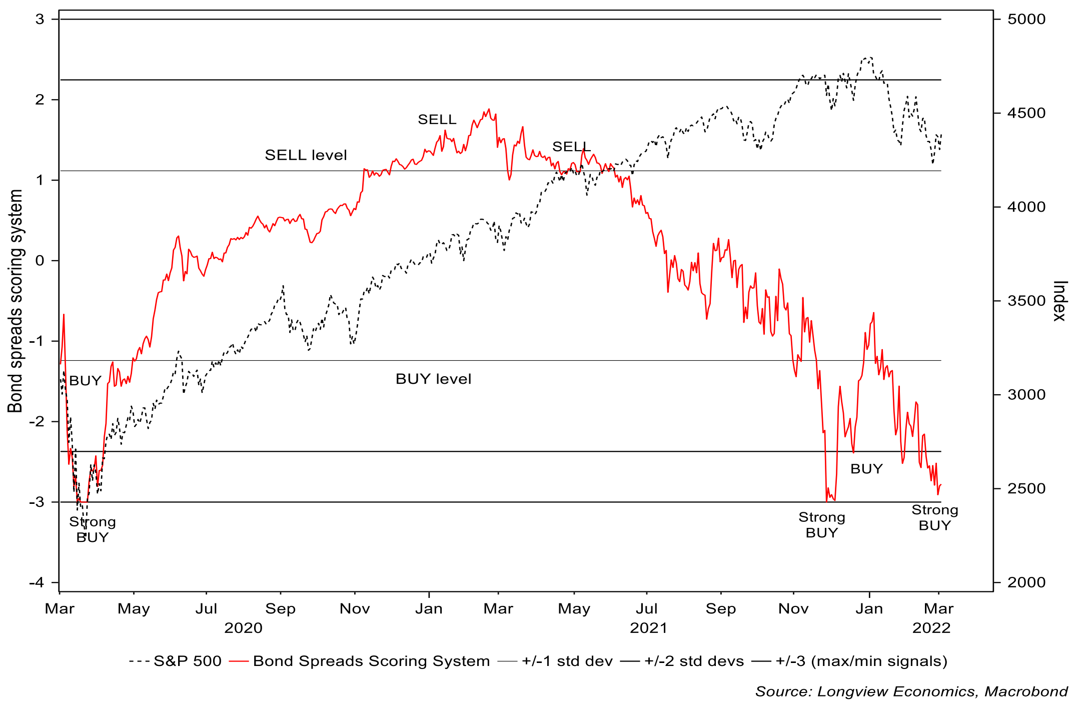
Fig 3e: The 'Technicals*' scoring system vs. S&P500 index



Technical factors summary: Technical models are on BUY

*The 'technicals' scoring system scores and aggregates the signals from 9 different technical type indicators including overbought-oversold models, breadth models and put to call models

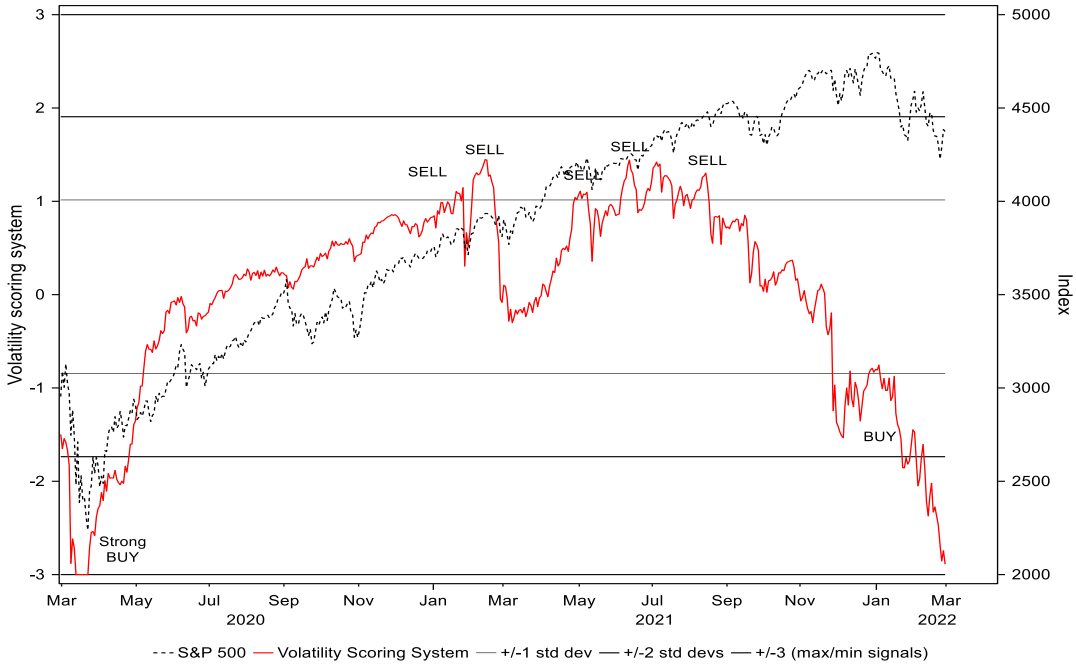
Fig 3f: 'Bond Spreads'* scoring system vs. S&P500 index



Bond Spreads Summary: This model is on strong BUY

*Bond spreads measures, scores and aggregates risk premium in the credit markets across corporates and EM debt

Fig 3g: 'Volatility' scoring system* vs. S&P500 index

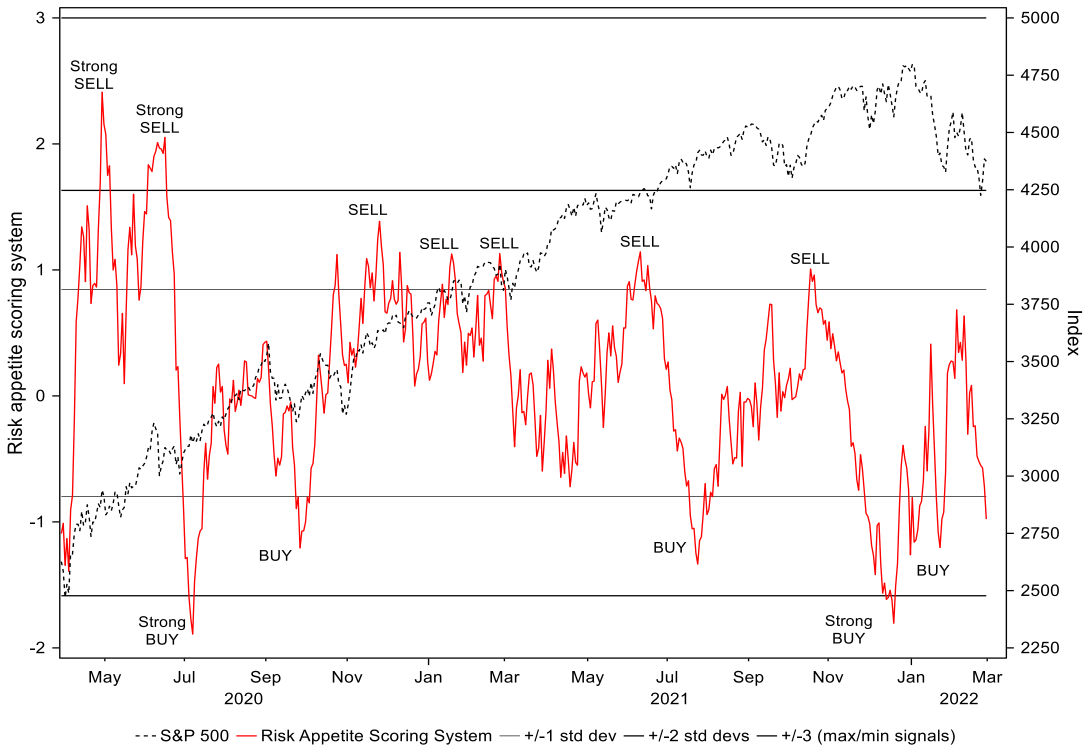


Source: Longview Economics, Macrobond

Volatility summary: Volatility model is on Strong BUY

*The volatility scoring system aggregates the signals from a variety of volatility measures/models drawing upon a variety of types of financial assets across various geographies

Fig 3h: 'Risk Appetite' scoring system* vs. S&P500 index



Source: Longview Economics, Macrobond

Risk appetite summary: is on BUY

*The risk appetite scoring system aggregates the scores of 3 Longview in-house medium term risk appetite models

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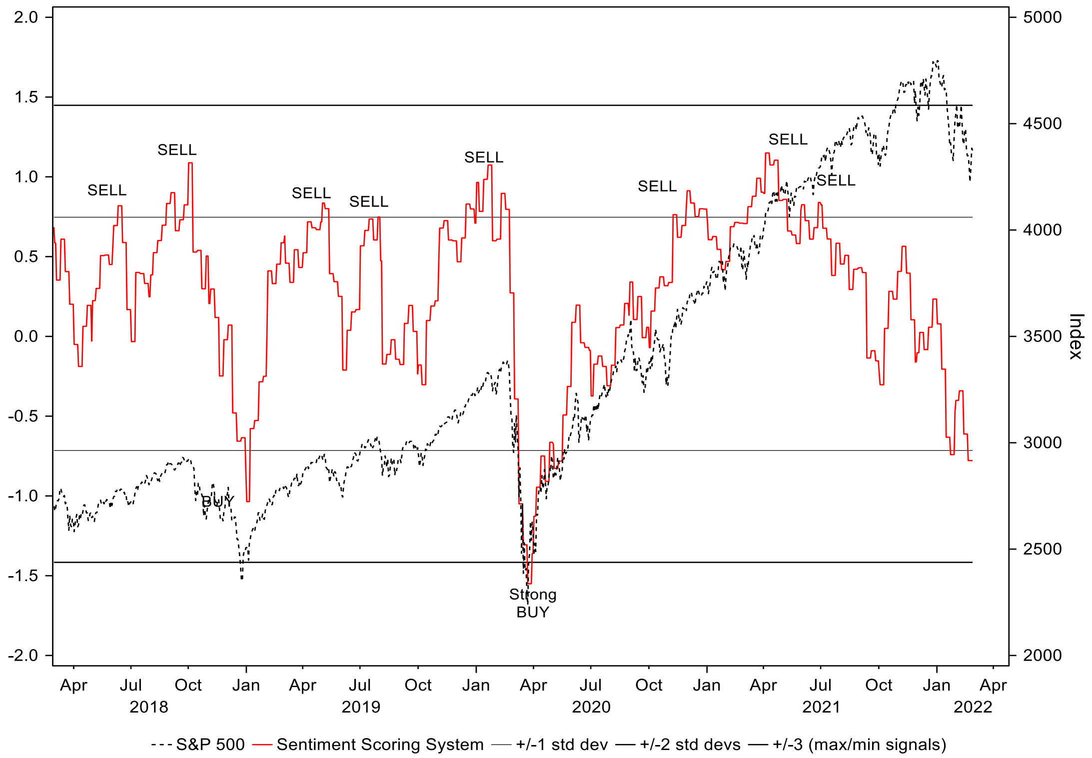
Fig 3i: 'Sentiment' scoring system* vs. S&P500 index



Source: Longview Economics, Macrobond

Sentiment models summary: The sentiment scoring system is on BUY

*This scoring system scores and aggregates the message from 4 sentiment indicators including: AAII retail sentiment, US Equity Advisory Optimism and Consensus Bullish Sentiment (which is based on market opinion published by brokerage houses and available at: http://www.consensus-inc.com/)

Appendix A: Equity Recommendation – for various portfolio strategies

Table A: Asset Allocation Recommendation **– for Tactical Asset Allocators**

	US Equities* (% weighting)	US government Bonds (% weighting)	Cash (% weighting)
Permitted Range	+/-10pp	+/-10pp	+/-10pp
Longview benchmark	45.0	45.0	10.0
Over-under weight	**+5.0**	**-**	**-5.0**
Current recommendation	**50.0**	**45.0**	**5.0**

Source: *Longview Economics*

We favour staying tactically OW equities & UW cash (having added to OW positions last week)

The tactical asset allocation (TAA) decision is between US equities*, government bonds & cash with a 1 – 6 month time frame. The aim is to mimic an institutional approach to US (mainstream) tactical asset allocation. That typically requires outperformance from a TAA overlay of between 20 – 50bps (and in some cases higher). For the purpose of performance measurement, the allocation is assumed to be implemented at the close of trading on the business day immediately prior to publication of the report. The permitted range on the allocation to each asset class is as in Table 1 above. Performance history is shown below on an annual basis and on a monthly basis.
*US equities are measured using an S&P500 total return index; US 10 year government bonds are measured using a JP Morgan total return 10 year government bond index. Cash is measured using US 3 month T Bills.

Table Ai: Equity Strategy for the Simulated Global Macro Fund Product

	US Equities
Equity Strategy for Simulated Global Macro Fund:	net (SHORT)/LONG
Permitted Range (aggressive)	-100% to +150%
Current recommendation (for global macro fund)	**+50%**

Source: *Longview Economics*

N.B. Table Ai used to be an Equity Long-Short recommendation. These have been changed as of 1st February 2017. These recommendations in Table Ai above will now be part of the simulated macro fund (and subsumed into that performance). The aim is to create a 1 – 4 month equity market weighting for a global macro hedge fund, thereby taking advantage of market pullbacks and market rallies (on a 1 – 4 month basis). Shorter term market movements (i.e. 1 – 2 weeks) are picked up in the Daily RAG product.

Table Aii: Top level Strategy Recommendation – **for LONG ONLY Equity Portfolios**

	Global Equities (S&P1200)	Global Cash
Range	85 – 100%	0 – 15%
Longview benchmark:	92.5%	7.5%
Over-under weight	+5.0	-5.0
Current recommendation	97.5%	2.5%
Sector split of Equity allocation:		
S&P1200 Cyclicals vs. Defensives*	S&P1200 Cyclical sectors	S&P1200 Defensive Sectors
Range	+/-10pp	+/-10pp
Longview benchmark:	72.0%	28.0%
Over-under weight	0.0	0.0
Current recommendation	70.2% (i.e. 72% of 97.5%)	27.3% (i.e. 28% of 97.5%)

Source: *Longview Economics, Standard & Poors*

The aim of the strategy recommendation for long only equity portfolios is to make the top level strategy call (not to make sector strategy recommendations). That top level call can primarily be captured in 2 key ways: i) cash levels within a portfolio; and ii) top level sector strategy asset allocation – i.e. defensives vs. cyclical sectors. Hence we show in this table both a recommended cash weighting (between 0 and 15%) as well as a split of the equity weighting between defensive and cyclical sectors. We use the S&P1200 global index as the basis for evaluation of our recommendations.

*The classification of **cyclical sectors** includes the following sectors: IT, Consumer Discretionary, Materials, Energy, Financials and Industrials. **Defensive sectors** are Telecoms; Utilities, Healthcare and Consumer Staples.

Table Aiii: Global S&P1200 sector heatmap****

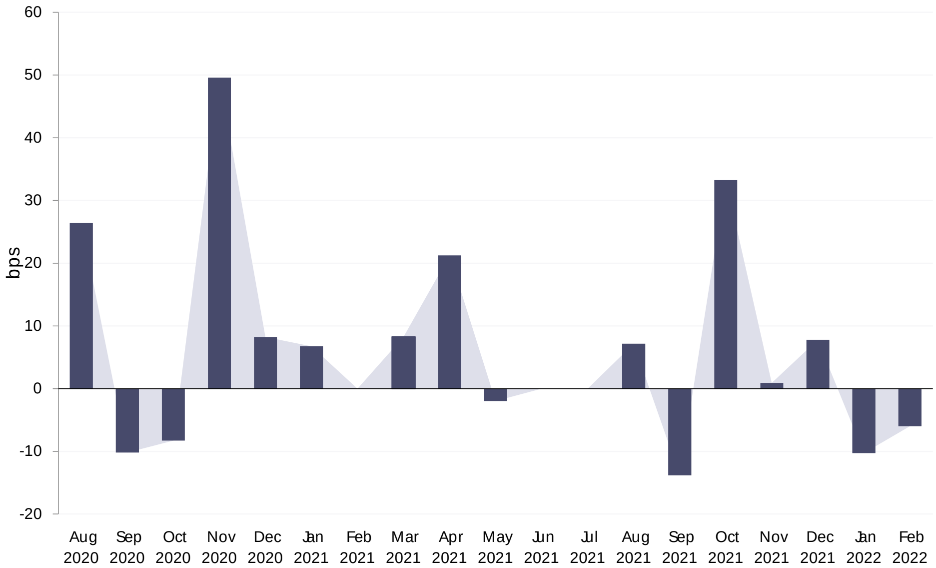
01/03/2022 12:12	Cons disc.	Cons staples	Energy	Financials	Healthcare	Industrials	Info tech	Materials	Comm. Services	Utilities	Index
Cons disc.		12	2	8	16	11	67	4	45	65	14
Cons staples	89		4	23	28	65	83	14	71	87	67
Energy	99	97		100	98	99	97	99	96	100	99
Financials	93	78	1		54	87	80	30	74	93	85
Healthcare	85	73	3	47		76	83	31	81	96	80
Industrials	90	36	2	14	25		75	6	62	85	47
Info tech	34	18	4	21	18	26		14	40	56	25
Materials	97	87	2	71	70	95	87		85	99	91
Comm. Services	56	30	5	27	20	39	61	16		57	35
Utilities	36	14	1	8	5	16	45	2	44		13
Index	87	34	2	16	21	54	76	10	66	88	

Source: Bloomberg Consensus Estimates, S&P, Longview Economics

***re: Sector choices – please see Global sector heat map laid out above showing relative PE ratios of all sectors versus each other. Of note, relatively cheap sectors include financials, healthcare, consumer staples and industrials. Relatively expensive sectors include utilities, communication services. materials & IT.
****NB this table should be read as 'columns versus rows' – i.e. the sector name above, relative to the sector name to the left.

Appendix B: Historical Performance – Equity Recommendations

Fig B: Monthly performance of Longview TAA portfolio vs. benchmark (bps)



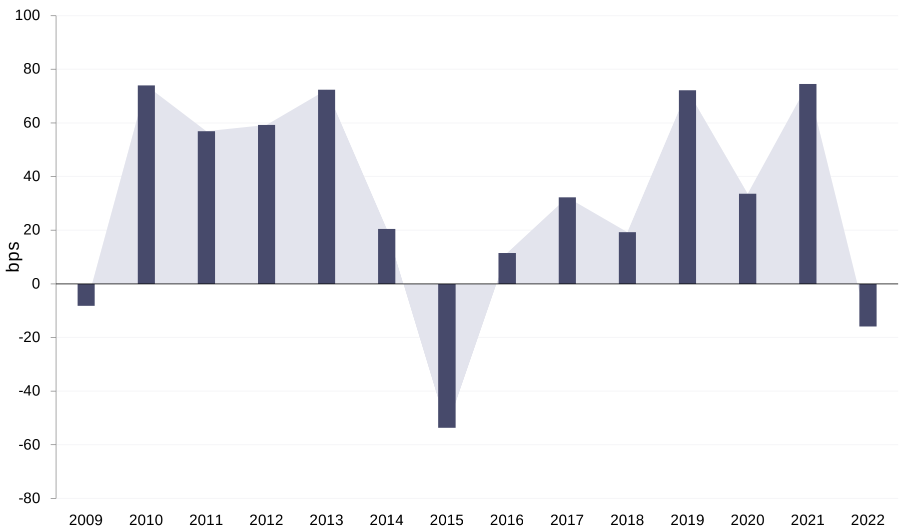
Source: *Longview Economics*

Table Bi: Historical performance* of Longview Economics' asset allocation recommendations

	2016 bps	2017 bps	2018 bps	2019 bps	2020 bps	2021 bps	2022 bps
Benchmark	552	1054	-145	1816	1502	1047	-475
Longview absolute	563	1086	-125	1888	1536	1122	-491
Longview rel. to benchmark	+12	+32	+19	+72	+34	+75	-16

** N.B. sums may not add due to rounding*
NB Longer history available on request (i.e. back to '04)

Fig Bii: Historical performance of Tactical Asset Allocation recommendations (last 10 yrs)



YTD performance is -16 bps.

NB annual target is +20 – 50bps

Source: *Longview Economics*

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