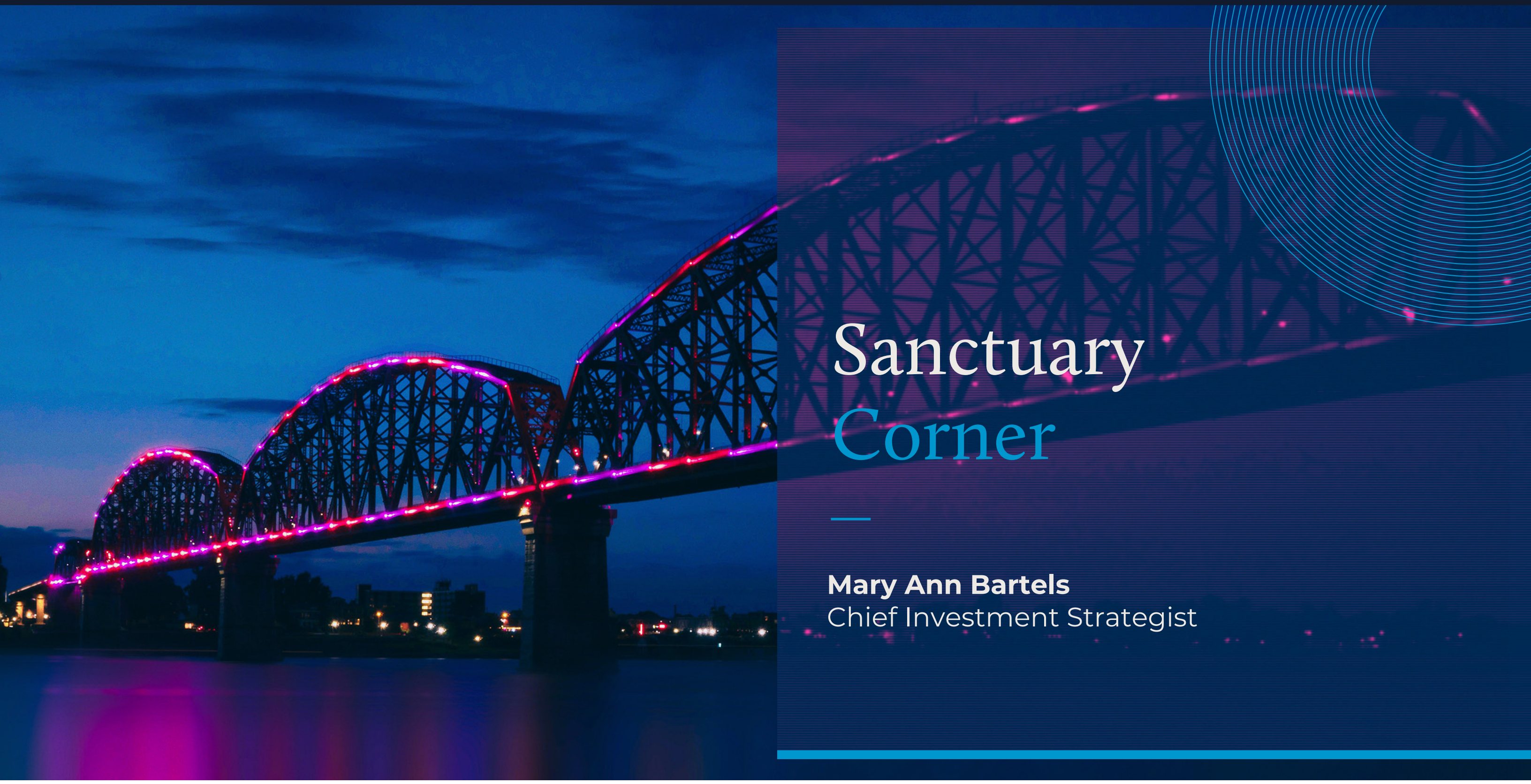
SANCTUARY



Sanctuary Corner

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February
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Executive Summary

We retain our thesis that the Bull is already running – and we offer below a slew of charts as evidence. But that doesn't mean we're ignoring the expectations for two additional rate hikes or the distraction that is the debt ceiling. Yet the market may already be pricing in these hurdles, as economists have begun to revise their forecasts, and a portrait of market resilience is now overshadowing the dread of a recession.

We're finding optimism in earnings reports and strength in new market leadership. Cyclical sectors hold the key. But we'll still be held hostage by jobs data, the Fed's biggest bugaboo. So, buckle up for continued volatility, and let the Bull take you for a ride.

Whipsawing Rate Expectations Won't Cut the Legs Off This Rally

February opened with an expected 25 bps rate hike accompanied by dovish comments from Fed Chair Jerome Powell – maybe a little more dovish than expected. This gave confidence to the markets, which had been expecting the terminal rate to come in below 5%. But then surprisingly strong jobs data (what we called "off-the-charts positive") sent everyone running for cover as the Fed looked to dig in its heels, sending the terminal rate expectations back up, north of 5% again.

The market expects the Fed to raise rates in March by at least another 25 bps and possibly an additional 25 bps after that hike. Powell mentioned that the labor market is still a concern and because the Fed's actions are data-dependent, we'll all be watching unemployment, jobless claims and wage data like a hawk – no pun intended.

So, what's the forecast?

The market is expecting a terminal rate of 5.13% in July – and we believe this should be close to the peak if not the peak in rates.

What's also being pushed back is a U.S. recession. (More on that below.) So, when you add up a delayed U.S. recession, no recession for the Eurozone, and China enjoying an economic rebound, you have three bullish factors that indicate growth – and growth is bullish for earnings and bullish earnings is bullish for stock prices.

Let's say it again: The Bull is already running.

The Technicals of the Market are Very Bullish

We reiterate that the October lows will not need to be tested. The technicals of the market have been showing significant improvement across these measures: (a) volume, (b) the breadth of the market (i.e., more net advancing issues), (c) the percentage of stocks moving above various moving averages, and (d) the New Highs/Lows Ratio ("NH/NL Ratio").

On February 3rd, the S&P 500 formed a "Golden Cross" – this is a bullish technical pattern that occurs when the 50-day moving average crosses above the 200-day moving average. First time since July 2020. According to Bank of America, 30, 65 and 195 days after this signal, the S&P 500 is up 75% of the time.

Importantly, volume has been improving as the market has rallied. Volume leads price, so this is an important confirmation indicator. With investors underweight in equities, there's a mountain of cash sitting on the sidelines. But it won't be long before it pours into this rally and gives it the legs to carry us into the summer months. But there are still hurdles to take into account: possibly two more rate hikes and of course the debt ceiling – which likely won't be resolved until the very last moment. As a result, we can expect volatility to stick around. (A note about the debt ceiling: Historically markets have corrected during those negotiations, but once the issue is resolved, markets have rallied. Historically.)

With the internals of the market improving so broadly, we believe this rally can last into the summer. The first target move for the S&P 500 is an upswing to the August 2022 high of 4325. The next marker would be the March 2022 high of 4637. Looking at the Nasdaq 100, a move to reach its August high of 13720 is the first target. If it has a sustainable move, the next level is the April 2022 high of 15265.

Tug of War: Don't Fight the Fed vs. Don't Fight the Tape

It's always prudent to believe the Fed – a "you can't fight city hall" mindset. Likewise, investors know not to "fight the tape" – an adage advising not to trade against the market trend. So, when stock prices are rising, do not sell. But in the current environment, these two messages are at odds. During my many years following the markets, I have learned that when the messages are mixed, "Go to the Charts!" And right now, the Charts say stocks are going up – which supports our belief that this rally can go to the summer (assuming we don't trip over the debt ceiling hurdle).

So for now, our recommendation is to not fight the tape. Okay, fine. But if you're going to ride the Bull, what is working? In this month's Corner, we highlight the sectors and industry groups that are already showing strength against the S&P 500 or Nasdaq 100 or both.

Another Wall Street Adage: "As goes January, so goes the year"

The meaning is that, if the January return in the equity market is positive, the full year will be positive, but if the month is negative, expect a negative return on the year. Need proof? Just look at 2022. This may seem trivial but its success rate is quite high. This market observation was devised back in 1972 by Yale Hirsch, who founded the Stock Trader's Almanac series. His barometer's record has been quite accurate. According to the Stock Trader's Almanac, since 1950, whenever the S&P 500 had positive returns in the month of January, the average return for the full year was 17.6%. The barometer has registered just eleven yearly errors over that time frame, resulting in 84.5% accuracy. With only two trading days left this month, it is safe to say January should post a positive gain, giving a bullish signal for the year.

Adding to this bullish reading is another observation from Mr. Hirsch, this one involving the third year of the U.S. presidential cycle, which overlaps with the strongest market gains during a president's term. According to this theory, since 1933, the S&P 500 has had an average return of 16.3% during a president's third year. This is year three for Joe Biden, and it's just another good sign that the Bull is already running.

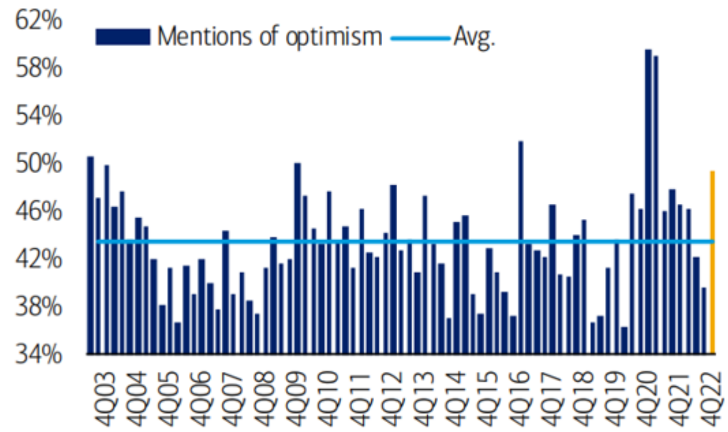
Why Would the Market be Thinking More Bullishly?

We believe the market is looking ahead, taking a recession off the table in the U.S. and Europe, and possibly discounting a trough in declining earnings estimate revisions. Looking at mentions of optimism in earnings calls, we have seen a sharp increase. Financial conditions have improved with Bloomberg Financial Conditions moving positive and Bank of America Global Financial Stress Index peaking with October's low in the stock market and falling ever since, indicating financial conditions are good. Yes, this is all surprising given how sharply interest rates have risen. Moreover, China re-opening adds a positive kicker that was unexpected. If you agree with this view, then earnings should be improving in the quarters ahead – even if this is temporary.

Optimism Soars to Highest Level Since 1Q21

With so much handwringing over inflation, rate hikes, a looming recession, etc. etc. etc., it was truly surprising to hear so many optimistic comments during this quarter's earning calls. Mentions of the terms "optimistic" and "optimism" soared to the highest level since Q1 of 2021.

Mentions of "optimistic" or "optimism" on S&P 500 earnings calls by quarter (1Q03-3Q22)

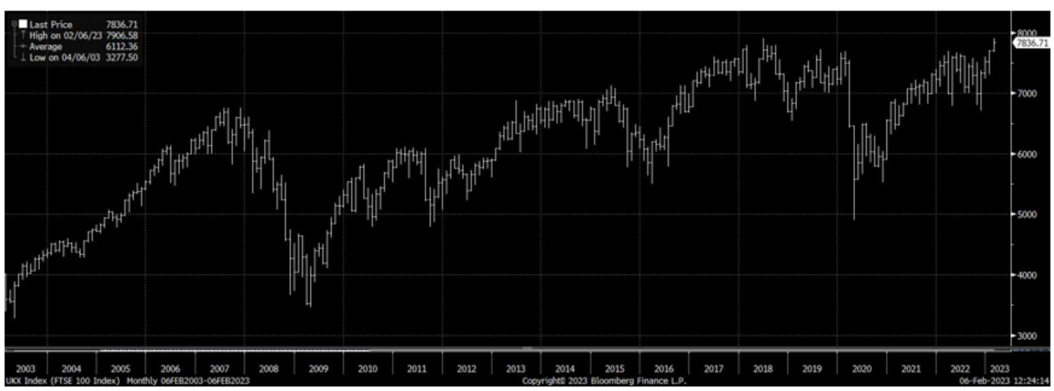


Source: FactSet, BofA US Equity & US Quant Strategy

Fun Fact for U.S. Optimists

Historically, the UK FTSE 100 often leads the U.S. stock markets. Well, guess who just hit a record high? On February 6, the UK FTSE 100 set a new record. What happens now? Well, Bob's your uncle.

UK FTSE 100 Index

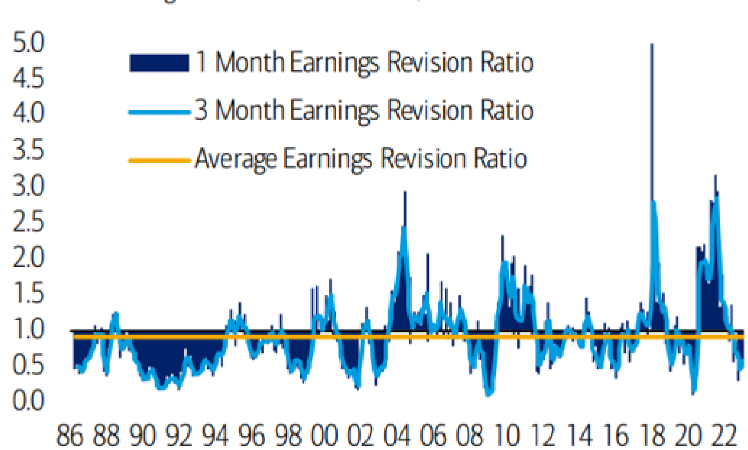


Source: Bloomberg 2/6/2023

EPS Revisions Are Negative

Revision ratios for one- and three-month earnings estimates are negative. How negative will they go? Could the market be pricing in a trough? Is it near-term? The market is behaving as if earnings are troughing. If the economy slows down in coming quarters, the risk is earnings improving then falling again. It is possible this will be a temporary cycle, so we will be monitoring it closely.

S&P 500 earnings estimate revision ratio, 1/86-1/23

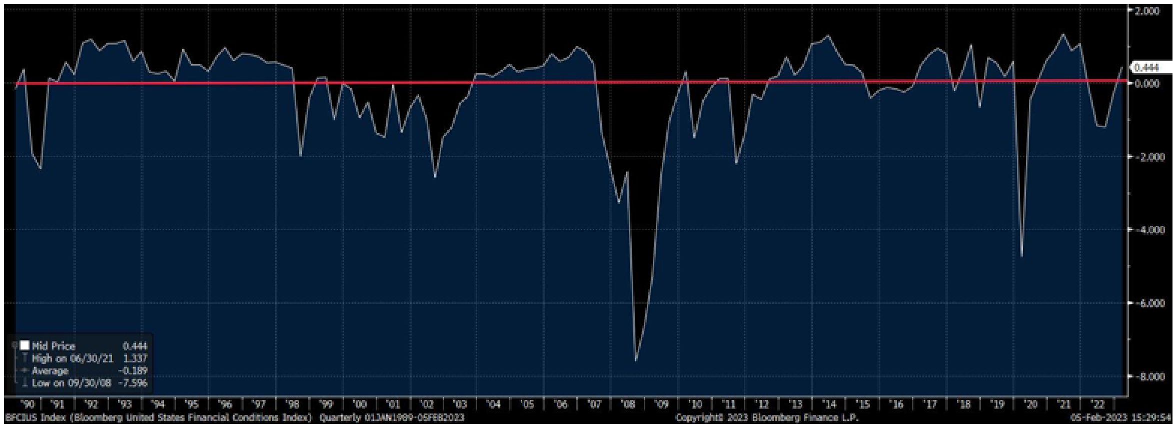


Source: BofA US Equity and Quant Strategy, I/B/E/S

From Recession to Resilience

The Bloomberg Financial Conditions Index turned positive in January – possibly transforming the specter of a recession into the spirit of market resilience!

Bloomberg Financial Conditions Index



Source: Bloomberg 2/6/23

Bank of America Global Financial Stress Index Falling Sharply

Interestingly, the index peaked last October with the market low and has been falling ever since. This is bullish.

Bank of America Global Financial Stress Index

Source: Bloomberg 2/6/23

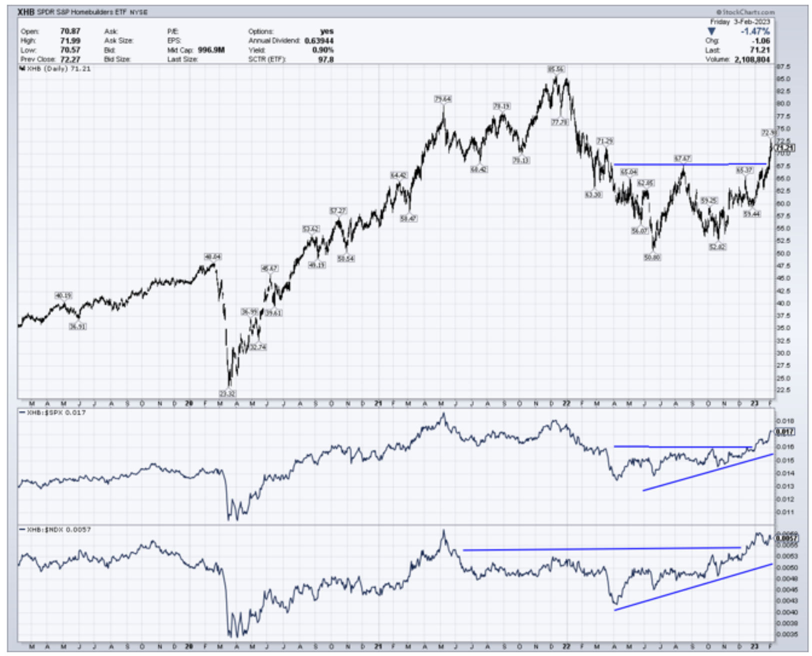
Sector Rundown

To highlight how well certain sectors/industries are currently performing (mainly the cyclicals), we've selected representative ETFs and show their charts below. The charts show trendlines relative to the S&P 500 and to the Nasdaq 100. Rising means it's beating the index, falling means it's underperforming the index.

What you'll find here is shockingly bullish!

Homebuilding – SPDR S&P Homebuilding ETF (XHB)

A significant breakout, outperforming both the S&P 500 and Nasdaq 100.



Source: StockCharts.com 2/3/2023

Metals & Mining – SPDR S&P Metals and Mining ETF (XME)

A significant breakout, leading both the S&P 500 and Nasdaq 100.

Source: StockCharts.com 2/3/2023

Retailing – SPDR S&P Retail ETF (XRT)

Shocking! Retailing has broken a downtrend and is outperforming both the S&P 500 and Nasdaq 100.

Source: StockCharts.com 2/3/2023

Semiconductors – VanEck Vectors Semiconductor ETF (SMH)

Semis has broken a significant downtrend and is beating both the S&P 500 and Nasdaq 100.

Source: StockCharts.com 2/3/2023

SPDR Software & Services ETF – SPDR Software & Services ETF (XSW)

This sector is just beginning to show signs breaking a downtrend and just beginning to beat both the S&P 500 and Nasdaq 100.

Source: StockCharts.com 2/3/2023

Industrials – iShares U.S. Industrials ETF (IYJ)

Reversing a downtrend, Industrials have been expected to beat both the S&P 500 and Nasdaq 100. That sentiment continues.

Source: StockCharts.com 2/3/2023

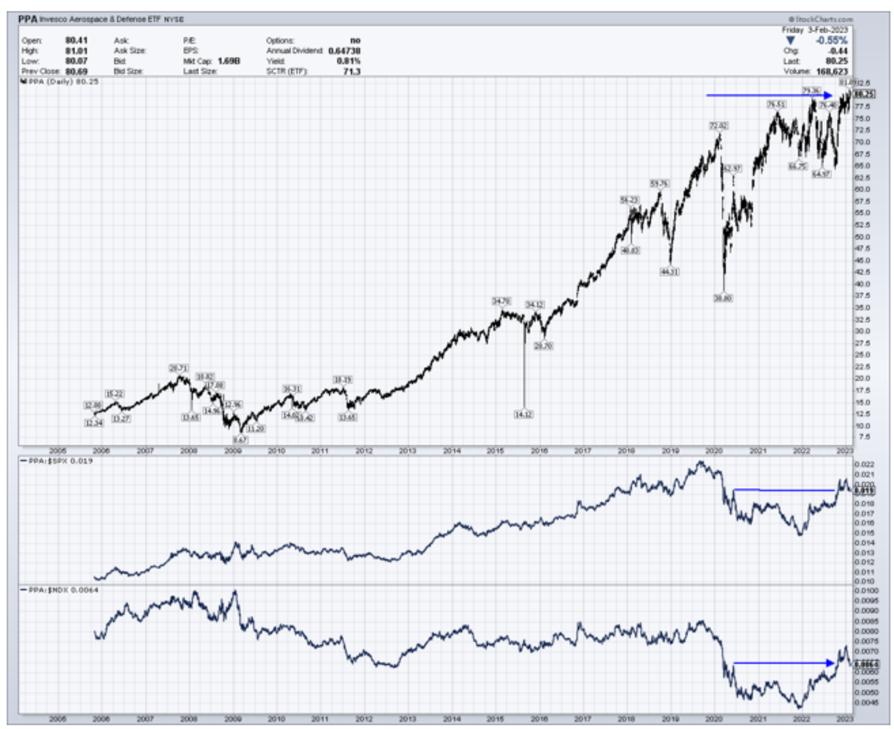
Transportation – iShares Transportation Average ETF (IYT)

Transports have reversed a major downturn and are just beginning to outperform both the S&P 500 and Nasdaq 100. Transports are an early cyclical positive indicator.

Source: StockCharts.com 2/3/2023

Aerospace & Defense – Invesco Aerospace & Defense ETF (PPA)

This particular ETF has hit a record all-time high and has the ability to continue to beat both the S&P 500 and Nasdaq 100.



Source: StockCharts.com 2/3/2023

Capitals Markets - SPDR S&P Capital Markets ETF (KCE)

Having reversed a major downtrend, it is currently beating both the S&P 500 and Nasdaq 100.

Source:StockCharts.com 2/3/2023

Banks – Invesco KBW Bank ETF (KBWB)

Reversed major downtrend and are beating the S&P 500 – but may not the Nasdaq 100 – they're likely to remain market performers.

Source: StockCharts.com 2/3/2023

Insurance – iShares U.S. Insurance ETF (IAK)

With near record all-time highs, Insurance has the ability to beat both the S&P 500 and Nasdaq 100.

Source:StockCharts.com 2/3/2023

Invesco S&P 500 Equal Weight ETF (RSP)

Having reversed an important downtrend, the S&P Equal Weight is beating the S&P 500 and might be able to beat the Nasdaq 100.

Source:StockCharts.com 2/3/2023

Russell 2000 – iShares Russell [2000 ETF (IWM)]

Having reversed a major downtrend, the Russell 2000 is beating the S&P 500 and has the ability to beat the Nasdaq 100.

Source:StockCharts.com 2/3/2023

Invesco S&P 500 High Beta ETF (SPHB)

A major reversal of a downtrend, High Beta is beating both the S&P 500 and Nasdaq 100.

Source:StockCharts.com 2/3/2023

They say a picture is worth a thousand words, and these charts – individually – testify to the bullish outlook for these sectors. But taken together, this gallery of charts speaks volumes about the Bull. It is running!

Where
We Stand

We have maintained since September that the markets are still in a secular Bull Market. We did believe the lows of October would get tested, but with the significant improvement in the underlying technicals of the market, we no longer believe that the lows need to be tested. Importantly, many of the cyclical sectors and industry areas of the market are performing well, confirming the technical improvement in the market, in our view.

Coming off a major low, markets are traditionally confusing, and the fundamentals are not always clear. The lows of '87, '90, '97,'98,'02,'09 and '18 all had their challenges, but each one of them was an important low. And we now believe October 2020 was an important low.

We still believe Value is leadership, but off of major bear market lows, investors go back to what they know and that was the leadership in the previous cycle (Mega Cap tech, in this case). Also these are the stocks that are now down the most. So they will bounce the most off the low and rally for several months, but the risk is that they will fade again.

In sum: We believe this rally can be maintained into the summer, but the debt ceiling may hold challenges for the market.

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