US Equity Market Enters Correction Territory

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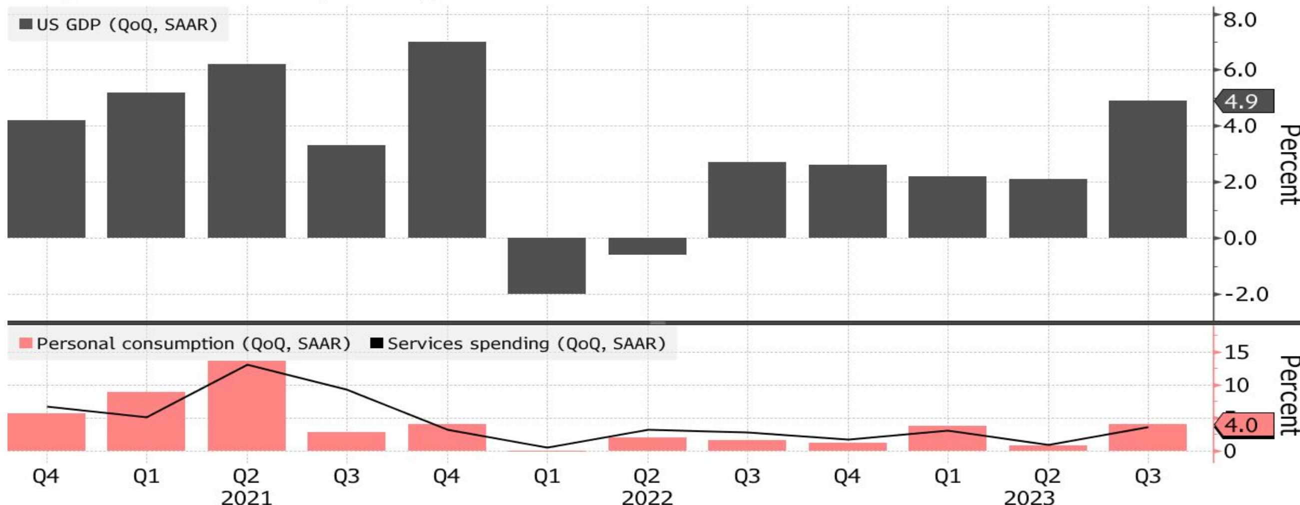
INDICES	1 WEEK %
MSCI China TR	2.50
MSCI Europe ex UK TR	-0.45
MSCI AC Asia ex Japan TR	-0.61
MSCI Emerging Markets TR	-0.71
Nikkei 225 in JP	-0.86
FTSE 100 TR in GB	-1.50
MSCI India TR	-2.32
S&P 500 TR in US	-2.52
Bond: UK 10 Year Yield	4.548
Bond: US 10 Year Yield	4.845
Currency : GBP/USD	1.213
OIL: WTI $	85.160

The US equity market slides into correction territory, as the S&P 500 index has now fallen more than 10% from the July peak. In fact, with the exception of China, it was a rough week for all the major equity markets. Bond yields finished about where they started, despite the US 10-year flirting with the 5% level and the Oil price was only a little higher despite escalating tensions in the Middle East. It was a busy week for sure and there was no shortage of economic data and company results for investors to chew over, although it is still difficult to isolate the exact reason for the continued sell off in risk assets.

Sometimes it just boils down to sentiment as the primary cause of short-term market movements. In a parallel universe, the data flow from last week could have been taken positively and equity markets could have been setting the highs of the year, rather than breaking below their moving averages. Arguably the most important data that was released last week was the third quarter GDP advance guidance in the US, which suggested the economy had grown at an annual rate of 4.9% last quarter, ahead of expectations and more than double the pace in the prior period.



The world's largest economy has spent all year refusing to buckle as a strong jobs market, higher wages and a reduction in household savings continue to power consumer spending and it would seem the pace of growth is re-accelerating. Now 'Economics 101' would tell you that the primary driver of stock market returns over the long run is corporate earnings and that in turn, GDP growth is the biggest driver of corporate earnings. Ergo, strong economic growth should be good for the stock market, but not so on this occasion as it means that it is becoming ever more apparent that the Fed will stick to its 'higher for longer' interest rate policy. I may be a bit naive here, but as a long-term equity investor, I would far rather have the manageable problem of a stronger economy than the other way round, assuming inflation is reasonably anchored and herein lies the first possible cause of the negative sentiment.

On Friday we had the release of the core personal consumption expenditures price index (core PCE), the Federal Reserve's preferred inflation measure, which rose by 0.3% (excluding Food & Energy) and reached a four-month high. Service-sector prices rose significantly, driven by spending in various areas including automobiles, prescription drugs, and international travel. Markets were expecting a monthly increase, but it was a little hotter than expectations and I am afraid this means that it keeps the door open for more interest rate hikes in the coming months, although probably not at the next meeting at the beginning of November. Just like for the GDP figures, it was the labour market's strength that was the key factor supporting household spending.

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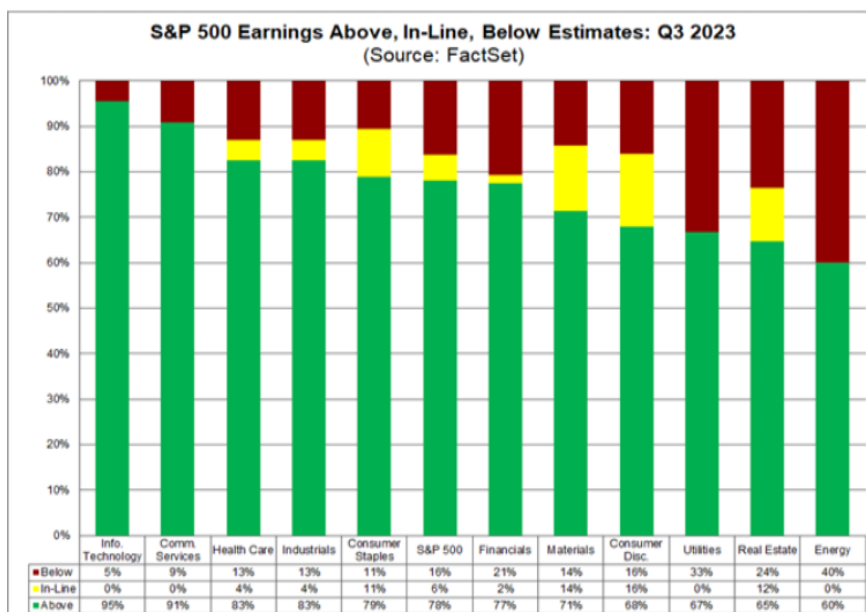
Further interrogation of the release does, however, highlight that despite a rise in wages and salaries, real disposable income has been declining, causing a decrease in saving rates to 3.4%, the lowest this year. Not for the first time in history, consumers continued to live beyond their means in September, with personal spending growth far outstripping income gains. Typically, households save around 6% of their disposable income and that's just not happening now, with the average closer to 3%. I happen to think we must be reaching a point where that dynamic cannot persist much longer. Certainly, that must be what the Fed are hoping, and with the recent rises in bond yields not yet fully weighing on household debt repayments (higher mortgage and credit card rates), this could change consumers cavalier spending patterns. Other factors on the horizon, including the resumption of student loan payments and the war in the Middle East, could also stifle spending and help ease inflationary pressures.

Earnings

As well as the big macro data last week that could be read both positively and negatively by investors, exactly the same is true of the flood of corporate earnings results we got last week and we have now reached just about the half way point and here are the scores on the doors, courtesy of Factset



	Info. Technology	Comm. Services	Health Care	Industrials	Consumer Staples	S&P 500	Financials	Materials	Consumer Disc.	Utilities	Real Estate	Energy
Below	5%	9%	13%	13%	11%	16%	21%	14%	16%	33%	24%	40%
In-Line	0%	0%	4%	4%	11%	6%	2%	14%	16%	0%	12%	0%
Above	95%	91%	83%	83%	79%	78%	77%	71%	68%	67%	65%	60%

Overall, 49% of the companies in the S&P 500 have reported actual results for Q3 2023 to date. Of these companies, 78% have reported actual EPS above estimates. The blended (combines actual results for companies that have reported and estimated results for companies that have yet to report) earnings growth for the third quarter is 2.7% today.If 2.7% is the actual growth rate for the quarter, it will mark the first quarter of year-over-year earnings growth reported by the index since Q3 2022.

The forward 12-month P/E ratio is 17.1, which is below the 5-year average (18.7) and below the 10-year average (17.5). It is also below the forward P/E ratio of 17.8 recorded at the end of the third quarter (September 30). During the upcoming week, 162 S&P 500 companies (including four Dow 30 components) are scheduled to report results for the third quarter.

Again, in a parallel universe this Q3 earnings season could have driven equity markets higher, but investor reaction has been firmly in the glass half empty camp as most results have been accompanied by weaker guidance than hoped for. Take Alphabet's (Google) results as a prime example. It beat analysts expectations by some margin both in terms of revenue and earnings, but the share price fell from around $140 at the beginning of the week to $122 at the end. That's a fall of more than 10% on an earnings beat, so you can only imagine how hard the share prices of companies that have missed have been!

Email: info@idadfunds.com Telephone: +44 (0)1730 776757 www.idadfunds.com

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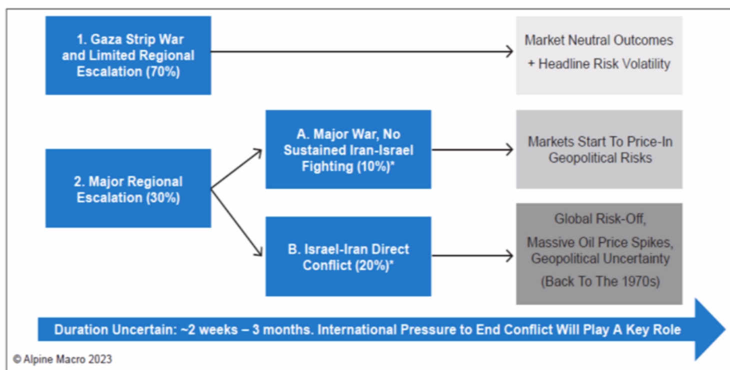
Middle East

Perhaps the alternative reason for sentiment to be so poor at the moment, is a delayed reaction to the outbreak of conflict in the Middle East, certainly that is what is primarily behind the move in Gold above $2000 an ounce. Bullion has jumped about 9% since Hamas attacked Israel on Oct. 7, bouncing back from a seven-month low at the time. And I am afraid it looks like things are continuing to get ugly, as they were always likely to, with news that Israel forces are expanding their ground activity in Gaza. The hope remains that this war can be contained within boundaries and limited to Israel and Hamas, but the rhetoric is suggesting probable escalation. Iran's foreign minister warned that new fronts would open against the US if it keeps up unequivocal support for Israel and that they warned that the US won't escape unaffected if the Hamas-Israel war turns into a broader conflict



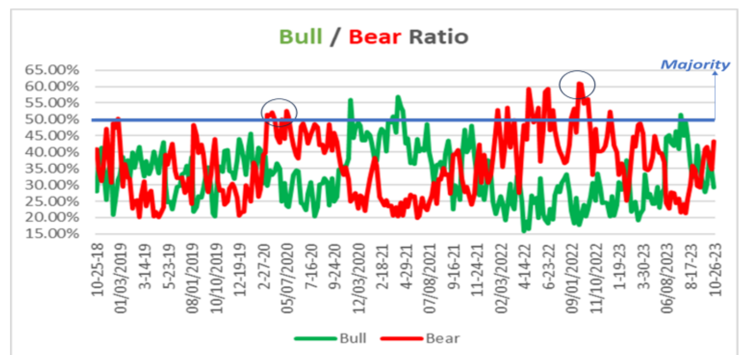
* Scenarios 2A and 2B shown as a percentage of the total 100% probability for all 3 scenarios. A major war escalation (Scenario 2) would have a 2-out-of-3 chances of becoming an Israel-Iran direct war (2B)

Israel's immediate objective is to eradicate Hamas' military capability and this is achievable, but there is a non trivial possibility this widens to a major regional conflict *(scenario table provided by Alpine Macro), leading to a direct confrontation between Israel and Iran. The latter would entail Israel targeting Iran's nuclear capability with Iran probably moving to block the Straight of Hormuz, seizing the flow of oil to global markets. Oil prices would then spike to the region of $150 a barrel according to commodity experts and we could see an oil price shock reminiscent of the 1970s. On the flip side, it is just possible that war can, counterintuitively, be bullish for equities. Monetary tightening usually ends during wars, which could give equities a lift, but that would be unexpected right now as US growth is probably too resilient for the Fed to reverse course . We wait and watch and remain deeply sympathetic to those in the firing lines.

China

The reason China managed to buck the downward trend in equity markets was news that President Xi Jinping has intensified support for the nation's economy, by approving a significant rise in the fiscal deficit ratio to 3.8% of GDP and issuing an additional 1 trillion yuan in sovereign debt.

This move, a rare mid-year budget adjustment, is part of a broader strategy to bolster the economy, which includes efforts to aid the private sector and a shift in fiscal policy to increase central government responsibility. Chinese stock markets reacted positively to these developments, but beware, several times we have seen them stage a recovery this year, only to see that fade, so I would wait to see



* Data is from the Association of Individual Investors in the US based on their weekly survey data, going back 5 years.

if this is sustainable before getting too excited. Amidst political reshuffles and strategic policy changes, these measures do at least underline China's commitment to achieving its growth targets and stabilizing the economy, including property market issues and deflationary pressures.

On a positive note

Given that just about everything you are likely to hear from market pundits over the next few weeks could make for grim listening, I thought I would sprinkle a little optimism. First, the cliché that I trot out at regular intervals, ' the market will do that which is necessary to prove the majority wrong '. Now if we look at the chart which plots those in the Bull camp and those in the Bear camp, you will see that more than 40% now have negative views on the market with under 30% positive (the balancing herd are neutral). When that has gone above 50% (the majority) it has typically been accompanied by a strong equity market (March 2020 and October 2022 spring to mind), and we are not too far away from that point.

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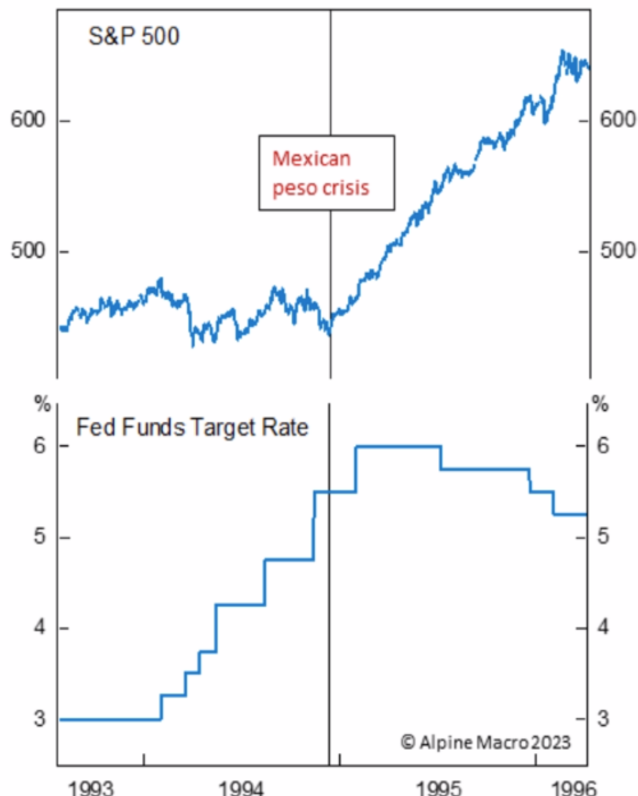
And secondly, when rates were last held higher for longer than expected in the mid 1990's, equities (S&P 500) traded in a range as rates rose, but once financial conditions caused a market event (the Mexican peso crisis) sufficient to alter monetary policy in 1994, stocks soared, because it was a signal of imminent monetary easing.

You can argue that the S&P 500 is currently following a similar pattern now. Something might need to break again, it almost did with the regional banking crisis in March. Perhaps the war in the Middle East might yet prove a sufficient catalyst, or perhaps the lagged impact of monetary tightening will finally take effect, but at some point in the next six months I think we will get sight of a change in Fed policy. The mix of monetary constraint and weaker fiscal stimulus will finally succeed in dropping inflation and that will bring lower yields (a rally in bonds) first, and then a revival in the equity market. The caveat being, only if the economic downturn is mild and short lived. Until then, expect things to remain choppy and it probably makes sense to overweight cash and short-dated high yielding quality bonds. Long bonds are unlikely to rally until the Fed pivot is within sight, which remains unlikely given strong retail sales and labor market resilience. Once the Fed capitulates, long dated assets should bounce back strongly and I would not be surprised to see mega tech once more lead the charge.



And finally, something I whole heartedly believe in, which is a key argument in favour of economic optimism is that technological advancements could accelerate productivity growth, thereby reducing costs and inflation while enhancing overall growth and corporate earnings. Technology's role in economic transformation isn't a novel concept. The information technology revolution, which started decades ago with the development of computers and microprocessors, took a significant leap in the 1990s with the advent of the internet.

The internet, has been pivotal not just in enhancing existing operations but also in spawning new products, industries, and radically altering economic and societal structures. Its impact is comparable to historic innovations like steam power, electricity, and the internal combustion engine, which were all instrumental in boosting productivity.

While the commercial internet has been around for over thirty years, its potential hasn't been completely tapped into. After, the initial surge in productivity gains seen in the late 1990s and early 2000s, the pace of improvement had started to slow as we entered the 2020s, but the pandemic brought an unexpected twist with the widespread adoption of working from home. This shift has saved countless hours of commuting and reduced costs associated with travel and remote working. My hunch is it has also reduced the time wasted in 'meetings for meetings sake' - middle managers beware ! The long-term productivity impacts of this change are still unclear but I suspect they will be profound. When you add in the ever-increasing adoption and the potential of artificial intelligence (AI) in to the mix, there is the potential for an economic revolution as powerful as the one fuelled by the introduction of the PC.

Tom McGrath
Chief Investment Officer & Portfolio Manager

Email: info@idadfunds.com Telephone: +44 (0)1730 776757 www.idadfunds.com

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