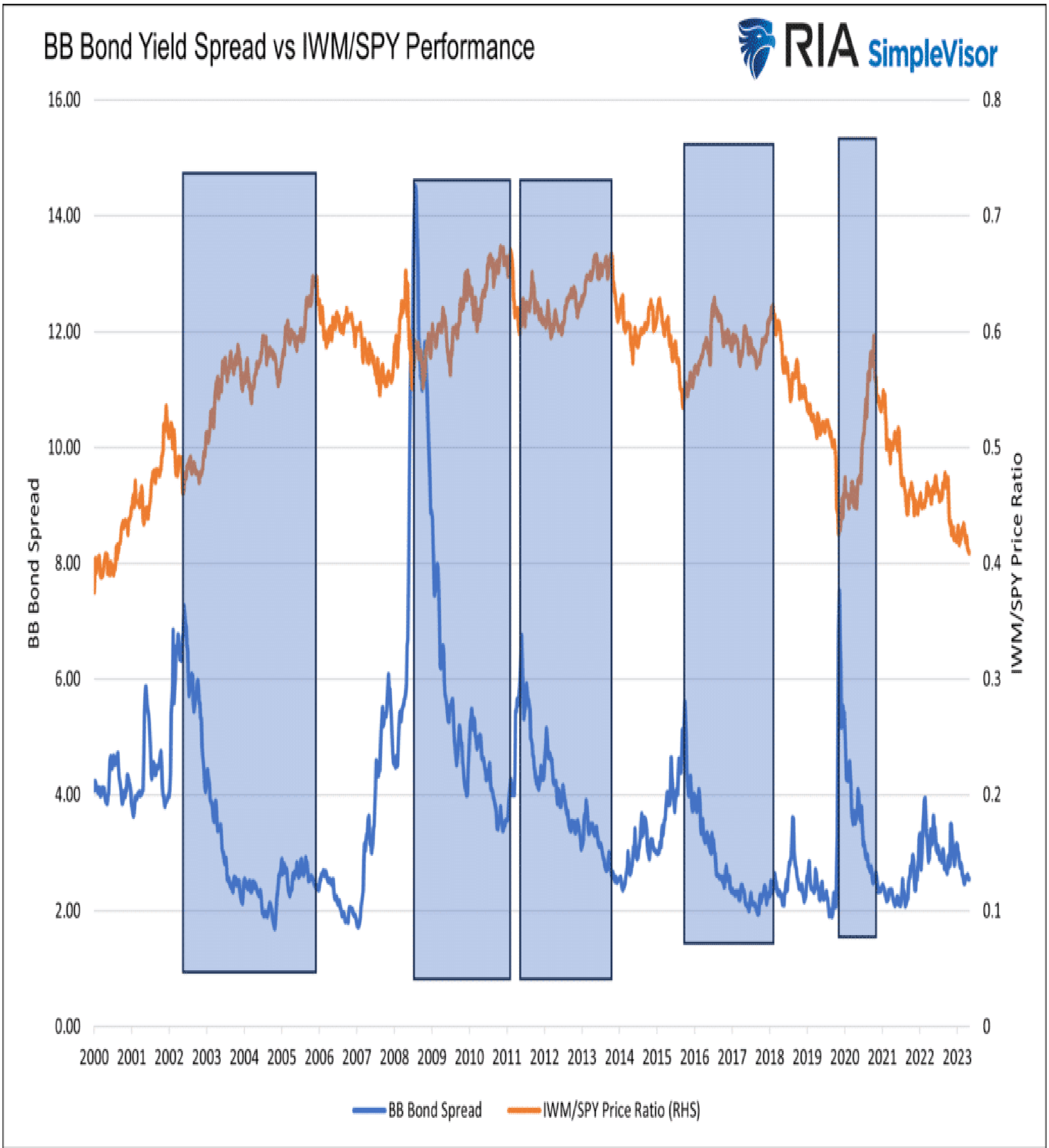
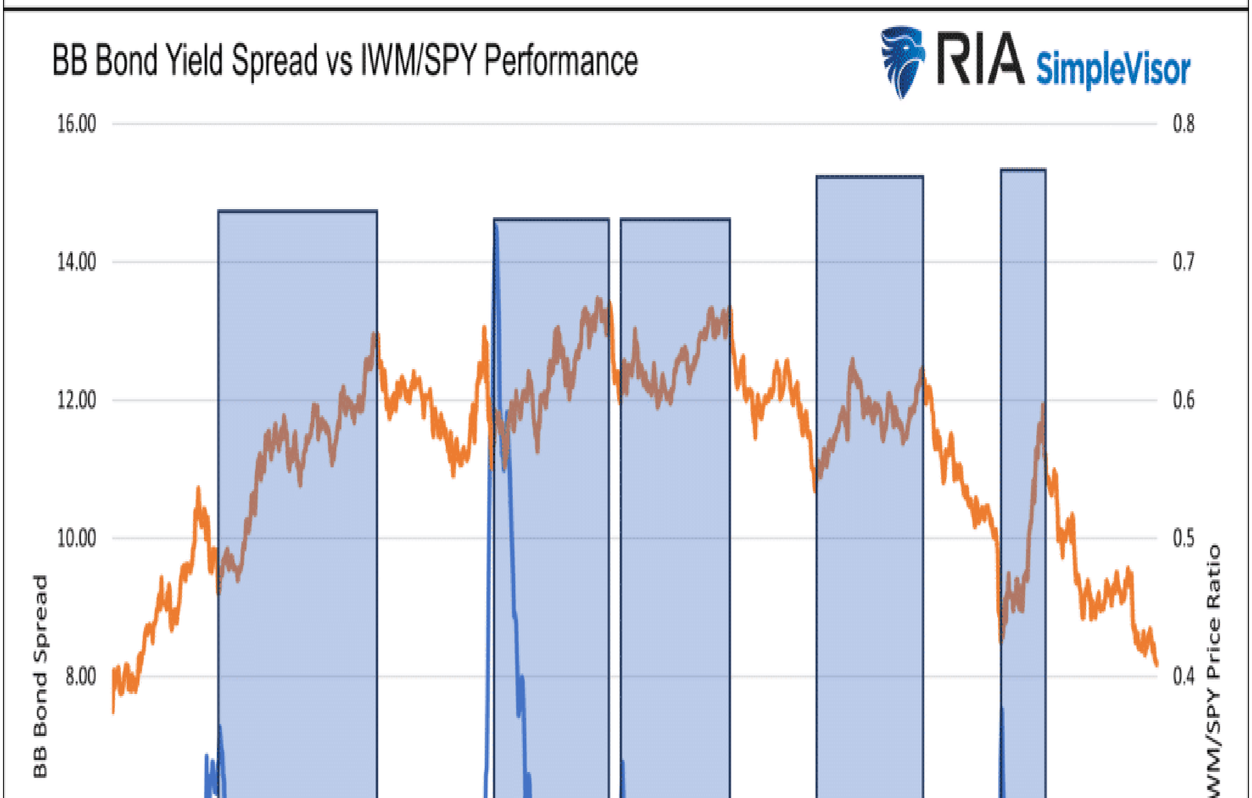
Is It Safe To Buy Small Caps?

In a recent Tweet, @samanthaladuc stated: *When is it safe to buy small caps again?* Her answer: *Not until High Yield credit spreads blow out!* Small-cap stocks are often classified as public companies with a market cap between $250 million and $2 billion. Because of their small size and higher risks versus larger companies, small-cap stocks tend to be riskier borrowers. Consequently, many of them are rated as junk by the rating agencies. Some analysts estimate that a quarter to a third of the Russell Small Cap stocks have debt payments exceeding their profits. In market parlance, we refer to such stocks as zombie companies.

With that, we slightly modify Samantha?s question. When is it safe to favor small-cap stocks over the large-cap S&P 500? The graph below compares junk/high-yield BB-rated bond spreads (corporate bond yield less Treasury yield) and the price ratio of the Russell 2000 to the S&P 500 (IWM/SPY). Based on the last 20 years, it is not safe today to favor small caps. Owning small caps versus larger cap stocks tends to be more favorable after credit spreads rise sharply. The safe time to own small caps is when BB-bond spreads are peaking, not at low levels as they are today.


BB Bond Yield Spread vs IWM/SPY Performance
RIA SimpleVisor
BB Bond Spread
IWM/SPY Price Ratio
16.00
14.00
12.00
10.00
8.00
6.00
4.00
2.00
0.00
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022 2023
BB Bond Spread
IWM/SPY Price Ratio (RHS)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What To Watch Today

Earnings

Time	Symbol	Company Name	Market Cap ▾	Fiscal Quarter Ending	Consensus EPS* Forecast	# Of Ests	Last Year's Report Date	Last Year's EPS*
	ACN	Accenture plc	$196,035,470,696	Aug/2023	$2.62	10	9/22/2022	$2.60
	NKE	Nike, Inc.	$137,957,539,893	Aug/2023	$0.74	15	9/29/2022	$0.93
	JBL	Jabil Inc.	$13,931,852,865	Aug/2023	$2.22	4	9/27/2022	$2.25
	KMX	CarMax Inc	$12,370,647,042	Aug/2023	$0.75	9	9/29/2022	$0.79
	MTN	Vail Resorts, Inc.	$9,170,374,994	Jul/2023	($3.28)	6	9/28/2022	($2.70)
	MANU	Manchester United Ltd.	$3,197,699,925	Jun/2023	$0.06	2	9/22/2022	($0.16)
	BB	BlackBerry Limited	$2,846,198,175	Aug/2023	($0.03)	2	9/27/2022	($0.06)

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Economy

Time	Event	Impact	Actual	Dev	Consensus	Previous
THURSDAY, SEPTEMBER 28						
12:30	USD Continuing Jobless Claims(Sep 15)		-	-	1.675M	1.662M
12:30	USD Core Personal Consumption Expenditures (QoQ)(Q2)		-	-	3.7%	3.7%
12:30	USD Gross Domestic Product Annualized(Q2)		-	-	2.1%	2.1%
12:30	USD Gross Domestic Product Price Index(Q2)		-	-	2%	2%
12:30	USD Initial Jobless Claims(Sep 22)		-	-	215K	201K
12:30	USD Initial Jobless Claims 4-week average(Sep 22)		-	-	-	217K
12:30	USD Personal Consumption Expenditures Prices (QoQ)(Q2)		-	-	2.5%	2.5%
13:00	USD Fed's Goolsbee speech			SPEECH		
14:00	USD Pending Home Sales (MoM)(Aug)		-	-	-0.8%	0.9%
14:00	USD Pending Home Sales (YoY)(Aug)		-	-	-	-14%
14:30	USD EIA Natural Gas Storage Change(Sep 22)		-	-	-	64B
15:00	USD Kansas Fed Manufacturing Activity(Sep)		-	-	-	12
15:30	USD 4-Week Bill Auction		-	-	-	5.28%
17:00	USD 7-Year Note Auction		-	-	-	4.21%
17:00	USD Fed's Cook speech			SPEECH		
20:00	USD Fed's Chair Powell speech			SPEECH		

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Market Trading Update

The last week of September is living up to its reputation for both weakness and increased volatility. Yesterday, the market opened higher, sold off, and then rallied back to end the day flat. The market is holding a VERY minor level of support, with the 200-DMA sitting at 4200, which will be a key support for the market to hold. The market is as oversold now on an RSI basis as it was last October when the bull rally started. Notably, the 200-DMA would be a normal 38.2% retracement of the bull rally to date.

For now, there is no reason to be overly concerned with the recent decline as it is normal within the context of corrections throughout history. Such is particularly the case given the 15% blistering run in the year?s first half. Maintain risk management practices for now, but don?t lose sight of what the market is doing versus the more bearish headlines.

Remember that no one ever wants to buy bottoms, which is what it feels like right now.

TradingView

Fed Funds: Higher and Longer

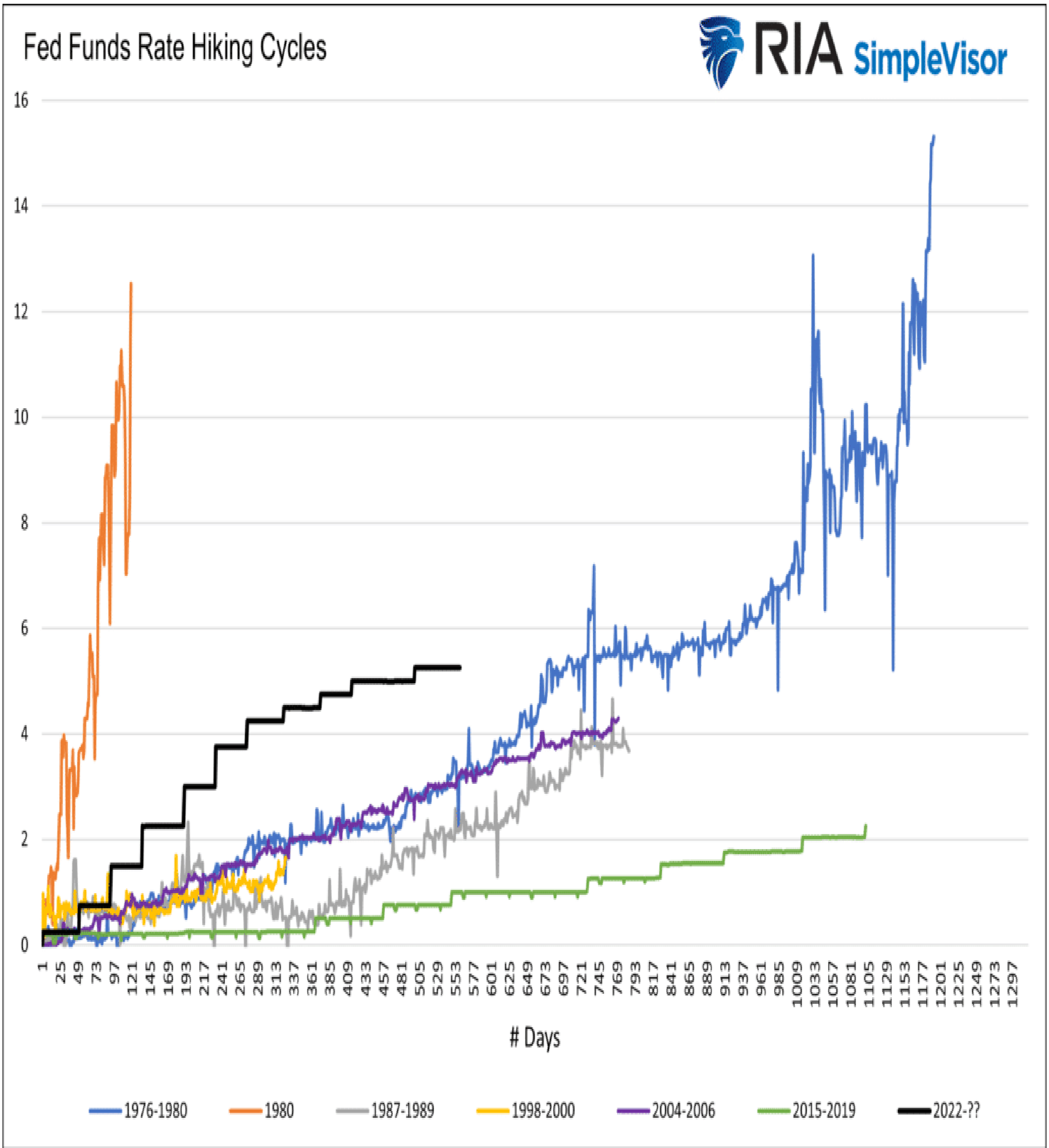
The Fed continually tells us rates will stay higher for longer. A look back at the last six rate hiking cycles shows they are thus far living up to their words. The graph below compares the amount the Fed hiked rates in prior cycles and the number of days until they stopped. As shown, the recent 5.25% in rate hikes are only topped by two instances in the late 1970s and 1980. At those times, inflation was running well above our current experience.

As far as longer, the Fed may have some ways to go before they halt increases based on history. The average hiking cycle has been 693 days, about five months longer than the current cycle.

Historical context is important. But at the end of the day, the current rate hiking cycle will end when the economy falters, inflation drops, and or a financial crisis occurs. As we wrote in A Crisis Is Coming:

> *A financial crisis will likely follow the Fed?s ?higher for longer? interest rate campaign. We are not clairvoyant in predicting a crisis; however, we do appreciate financial history. &#2013266080;*

The second graph below highlights that each of the hiking cycles in the first graph was accompanied by a crisis of sorts, which ultimately marked the beginning of rate cuts.


Fed Funds Rate Hiking Cycles
RIA SimpleVisor
Days
1976-1980
1980
1987-1989
1998-2000
2004-2006
2015-2019
2022-??


Fed Funds Rate Hiking Cycles
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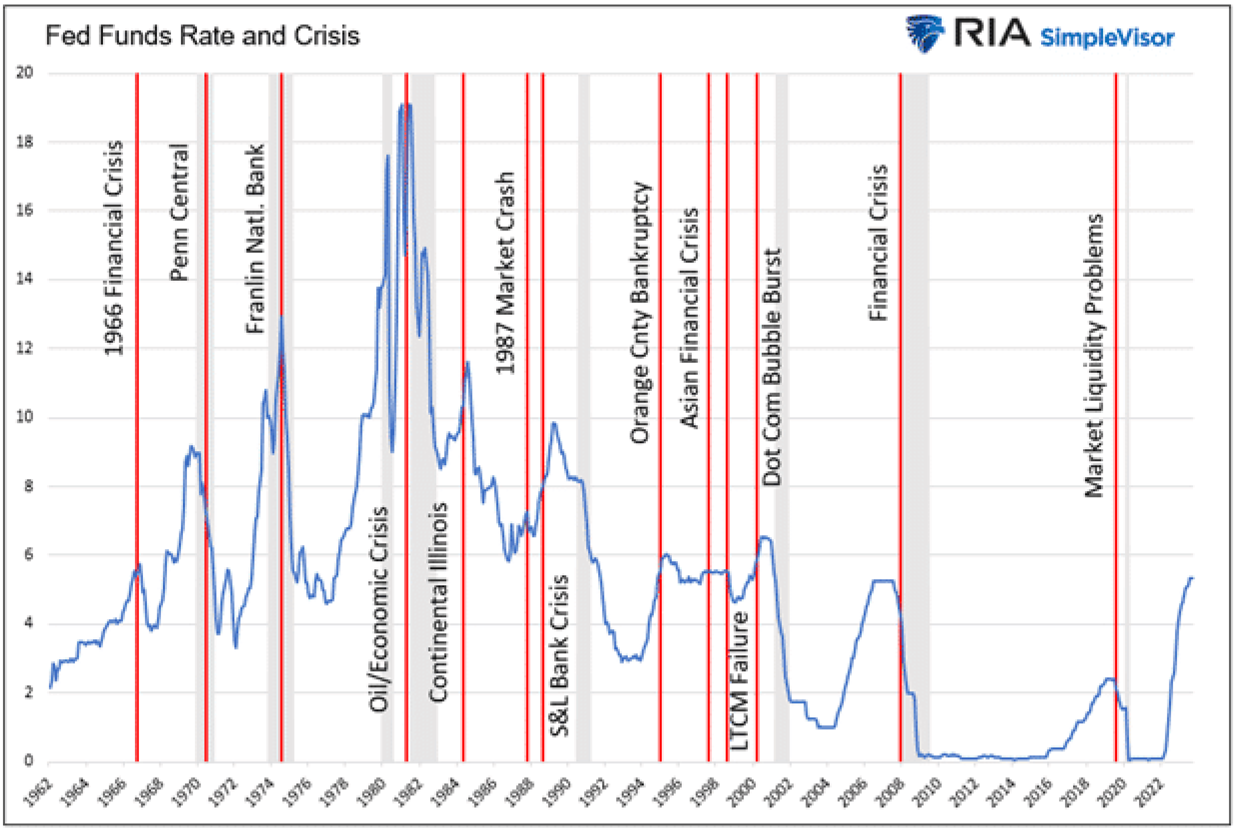
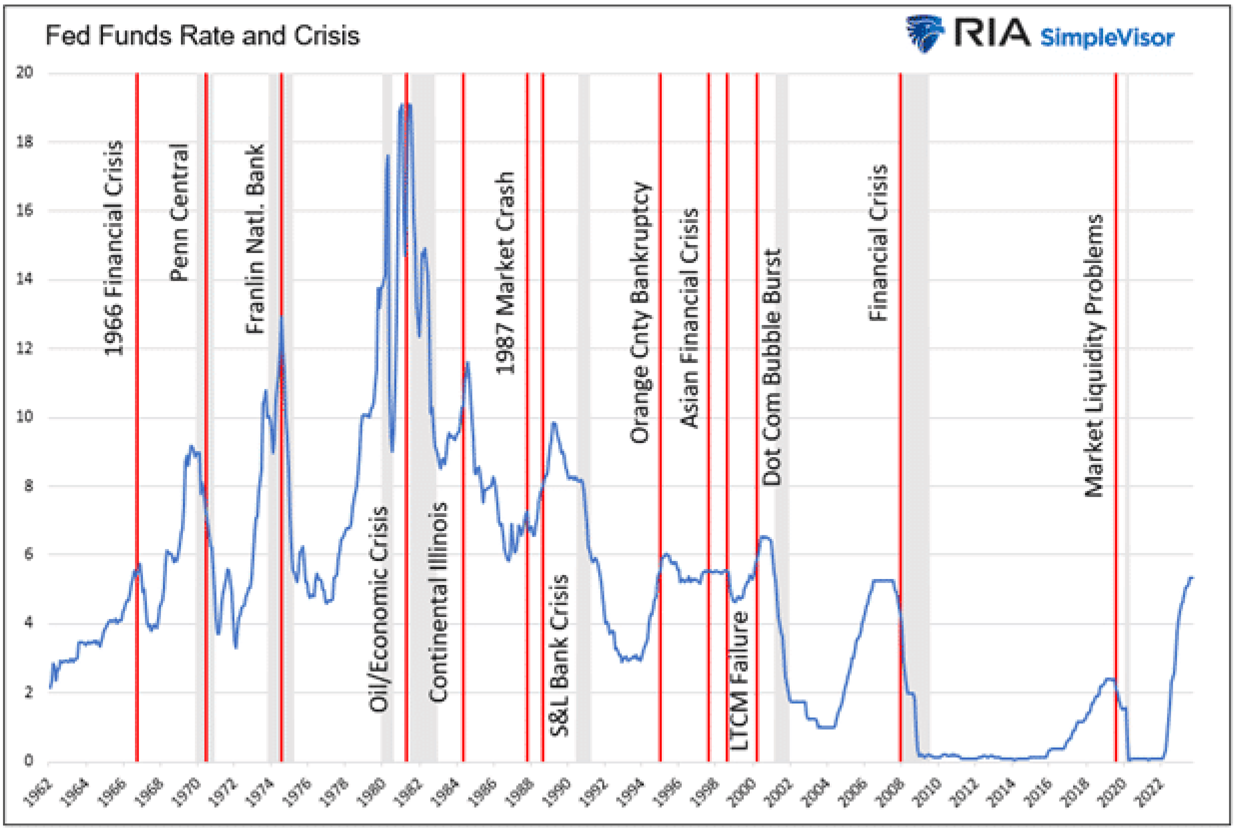




Capitulation In The Bond Market

Peter Atwater recently made a statement worth appreciating.

> *Markets bottom on the capitulation of the vulnerable ? when feelings of powerlessness and uncertainty become so great as to be unendurable.*

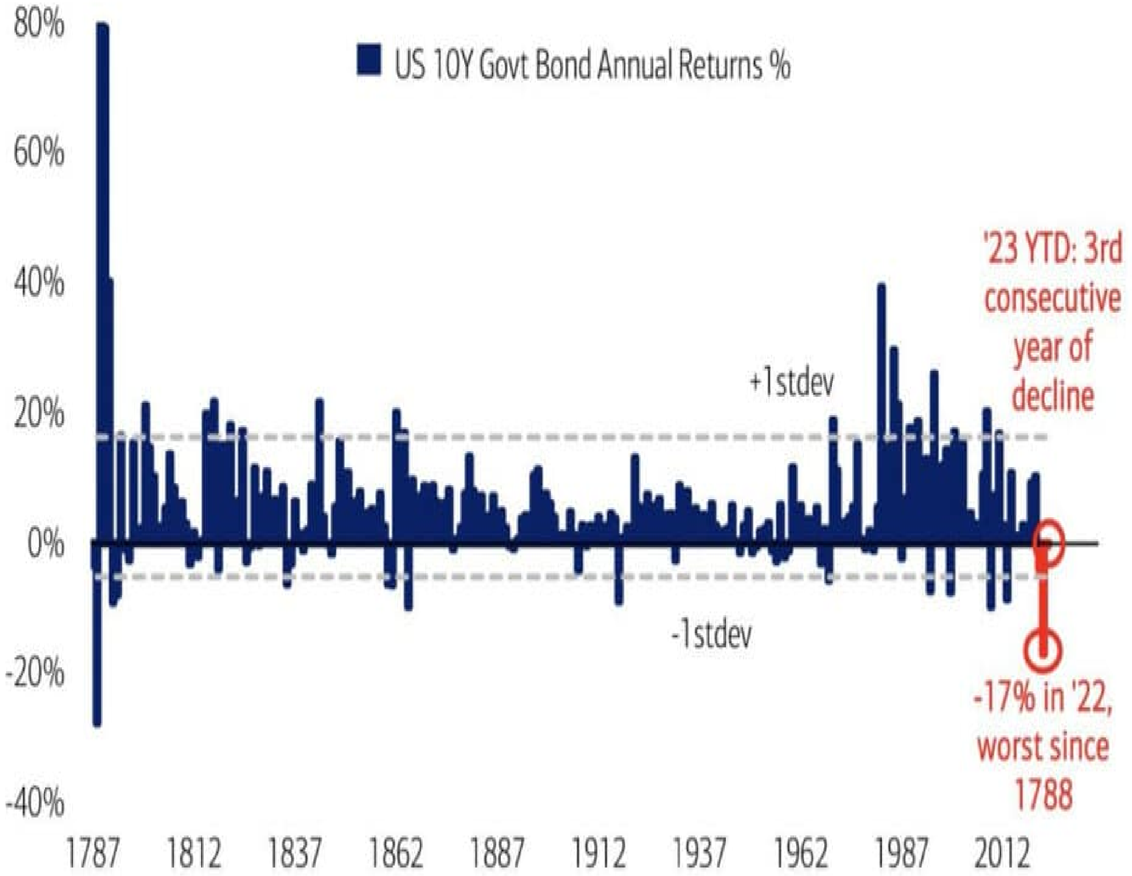
By vulnerable, he refers to investors caught in a doom loop and solely focused on bad news narratives. Even for most professionals, it?s hard not to become vulnerable when markets are falling, and all news is bad news. A market bottom usually occurs when a collective group of investors capitulate and sell out.

The Treasury bond market feels like it is close to such a capitulation. Daily, news followers are inundated with stories of massive deficit spending, Japan and China selling bonds, inflation on the uptick, and opinions from the ?smartest prognosticators? on reversing the 30-year cycle in bond yields.

Such a myopic focus is causing bond investors to fret about their financial statements and lose focus on the incredible opportunity bonds offer. Might this be the bond market?s March 2020 that we saw for stocks?

Chart 2: Never in the history of the US republic have US Treasury returns fallen 3 years in a row

US 10-year government bond annual returns %



Source: BofA Global Investment Strategy, Bloomberg, Global Financial Data

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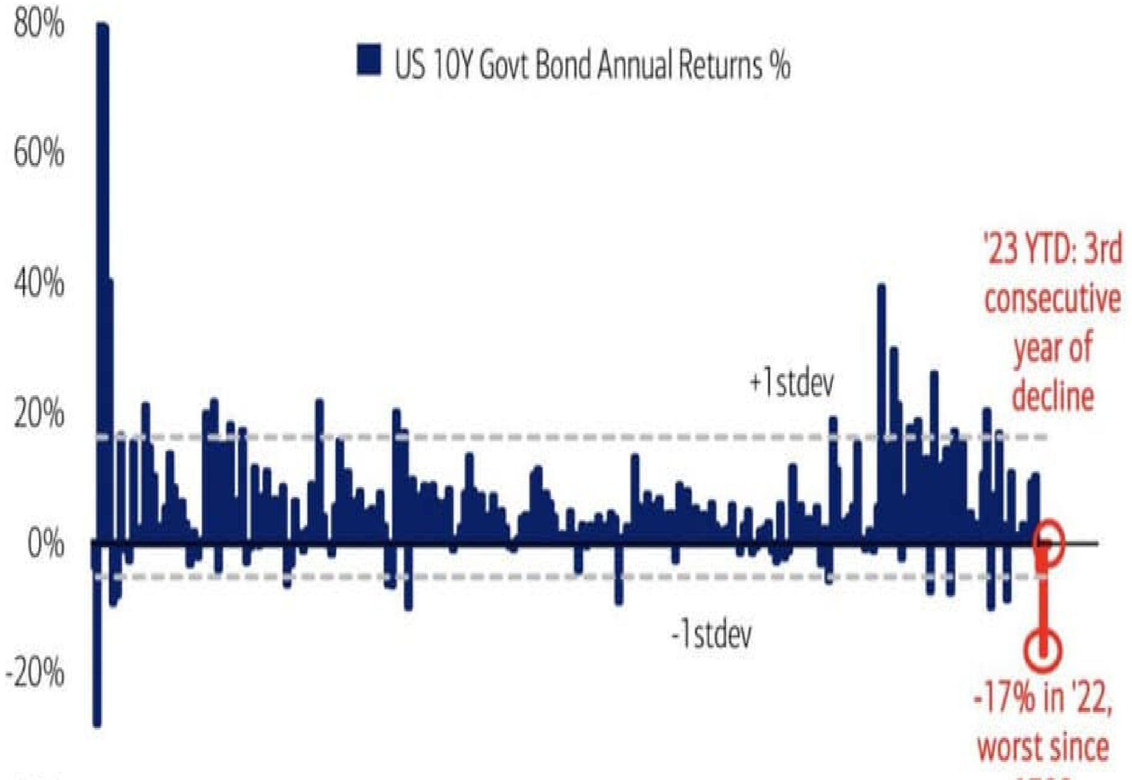

Tweet of the Day

Lance Roberts @LanceRoberts · 12m

Last four Septembers for the S&P:
2020: -3.92%
2021: -4.76%
2022: -9.34%
2023: -5.19% (thru 9/26)

Last three Q4s:
2020: +11.69%
2021: +10.65%
2022: +7.08%
2023: ?
(@bespokeinvest)

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Post Views: 1

2023/09/28

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