

## Rotate, don't retreat!

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It's that time of year again when investors may be curious as to whether the adage, "sell in May and go away" should be implemented in the current market environment. This aphorism is based on the seasonality of stock market gains in the first several months of the year up to April, and the historically weaker performance of the market that follows, from May to October. According to a recent analysis by Bank of America, the S&P 500 has seen the lowest average and median returns in May through October compared to any other six-month period since 1928.

There is no consensus, however, as to why there have been weaker gains during May through October. Theories range from traders going on summer vacations to seasonal factors in farming, back in the days when the economy was more agriculturally focused. However, today's economy is driven by technological progress rather than agriculture. Coincidentally, some of the worst stock market crashes have also occurred between May and October, which brings down the average returns for that period. The month of October, for example, is when some of the two well-known market meltdowns, Black Monday in 1987 and the 2008 financial crisis, took place. However, the lack of consensus along with some outlier events sets a compelling argument for long-term investors to consider rotating instead of retreating from the stock market.

Concerns about the possibility of a global recession or a debt ceiling debacle in the US where members of Congress are struggling to agree on the government's legal borrowing limit, might make an argument for selling in May. Bullish investors continue to hope for an economic soft landing and eventual interest rate cuts by the Federal Reserve that would justify high equity valuations. On the other hand, bearish investors are looking at data indicating that the odds of a recession are rising and that there are threats to market liquidity due to multiple bank failures. Given these divergent views, the overarching determinant should be time in the market rather than timing the market. Getting out of the market at the right time is hard enough, but then on top of that, investors will have to reinvest before missing out on the recovery for the selloff decision to really pay off. JPMorgan Asset Management found that investors who were absent during the S&P 500's 10 best days in the past two decades (through 2022), received half the gains of those that stayed in the market for the entire period.

Earlier in the month, the Federal Reserve increased interest rates by 0.25%, a hike that was both well-telegraphed and widely anticipated. The Committee statement and post-meeting press conference by Chairman Powell also had enough for both bulls and bears to stay entrenched in their respective positions. The comment that the Federal Reserve is getting close to a final rate hike or may have gotten there already, signals rate stabilisation, which is a positive for equities, especially for longer-duration growth sectors. However, the fact that the Federal Reserve will not drop their tools before reaching the 2% goal of inflation, suggesting higher rates for longer, is a negative for equities. To emphasize this point, Chairman Powell referenced the 2% inflation goal more than ten times in his speech. The approach of the Committee going forward would be to consider the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity, inflation, and economic and financial developments. This new approach suggests that the next stage of the hiking cycle may be slower and more data-driven.

According to a Chief Strategist at CFRA Research, since 1990, while the overall market recorded an advance of 2.2% during the challenging May-October period, the defensive S&P 500 sectors recorded average price gains of



4.5%. More recently, although an exception due to the pandemic, the S&P 500 was up more than 12% from May to October in 2020 and up more than 10% during the same period in 2021.

Investors should consider rotating into defensive sectors such as Consumer Staples, Energy, Utilities and Healthcare over Technology and Consumer Discretionary sectors. The latter, which are considered cyclical growth sectors have strong and often underestimated links to the overall health of the economy and so would lag if the economy slows. The equity market is overly optimistic by expecting rate cuts this year, something that is unlikely to happen unless the economy shifts into a deep recession, at which point rate cuts will not help risky assets. A much more sanguine approach would be to rotate portfolios into a defensive tilt position.

The Federal Reserve has a view that inflation is eventually going to come down, but that it will take some time. In that scenario, if the forecasts are broadly right, it would not be appropriate to cut rates. Chairman Powell also observed that inflation has not moved much and indicated that demand has to weaken and labour market conditions need to soften for inflation to move in the right direction. Therefore, focusing on industry sectors which are less correlated to the economic activity (positive or negative), the defensive or non-cyclical sectors will be valuable. Within these industry sectors, macro environment has relatively less influence, leaving more volatility in these sectors explained only by fundamentals. The Federal Reserve does not want the economy breaking out higher or lower, as this adds volatility and would limit the returns of the most sensitive sectors, the cyclicals.

Cyclicals, such as Autos, Materials, and Semis benefit from stabilisation of economic activity, while industries like Pharma, Beverage & Tobacco, Food Staples, and Utilities face headwinds. However, increasing economic activity contradicts the Federal Reserve's goal of delivering below-trend growth. Too strong economic activity may even be negative for the market as inflation would remain stubbornly high. This dichotomy creates an opportunity not for investors to retreat but to rotate their portfolio sector allocations.

#### *Sources*

*Morgan Stanley Investment Management Research & Bloomberg Economics*

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