CAPITAL INVESTMENT COUNSEL

The Columns

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This market is like a UFC cage match. In one corner we have the defending heavyweight champion: interest rates. The challenger is a young upstart called artificial intelligence. I feel inflation is defeated, but rates are (much) higher than they should be. High rates typically hurt the market, but AI is saying otherwise. The productivity gains that AI may bring are potentially spectacular and AI-related stocks are almost single-handedly dragging the market higher.

I love what AI may bring to our future, but stocks feel stretched in the short run. I spoke about a sell-off last month. Yes, we did have one, but it lasted about three days and dropped a whopping 2 percent. I'm not complaining, I still remember the relentless beatdown we all endured in 2022. Whether we sell off again or not, I think stocks may head higher over the next 18 months.

Stocks rose nearly 20 percent during November, December and January. The funny thing about markets is that sometimes strength can lead to more strength. Past similar scenarios in the S&P led to six-month gains of 7% and one-year gains of 12%. Markets were positive over 80% of the time. Thanks to Ryan Detrick for the historical numbers.

I like several things about this stat. First, there are 25 occurrences meaning that we have a pretty solid amount of history behind it. Second, the timing works out perfectly to how I see the election year playing out. We could pull back going into spring and then recover slowly through the summer. Finally, the rally's grand finale could roll out postelection (no matter who wins) and the market might hit that 12% historical return. FYI, if that plays out, that will put the S&P at 5700. That's twelve months you may not want to miss.

I'll remind you of two things:

1. Don't get too bearish. There's a fairly large amount of historical upside potentially waiting for stocks.
2. Have your buy candidates ready. Pullbacks will probably come. Be prepared to take advantage.

A five percent correction in the S&P would not be the end of the world and would take prices back to the rising 50-day moving average. That's where the market was in mid-January and was also the breakout level that led to new highs. A positive retest of that level could potentially provide the launching pad to another leg higher in late spring.

I view the market with two goals, what's working *now* but, more importantly, what might be working *next*. I've liked the bank stocks for some time, but the Fed's relentlessly high rates were challenging for the group. In the end, things worked out and the banks hit new highs.

Let's play a game. If I had offered you one of these three stocks to own last Halloween, which would you have chosen: Apple, Microsoft, or Wells Fargo? Let's be honest, you probably would have NOT chosen Feliz Wargo as we call it in our household, but Wells was the clear winner. Wells chalked up a 33% gain, versus 2% for Apple and 27% for Microsoft.

Potentially even better news is that both the financial and industrial sectors punched out new all-time highs. This is notable because this triggers a potential bullish scenario for the overall market. Sentiment Trader says that past occurrences led to the S&P being higher one year later 97% percent of the time. I like what this says about both stocks and the economy at large and it also dovetails nicely with the bullish stat we talked about earlier.

The bigger question is what stock or group might be the next Wells - the next sleeper sector that quietly outperforms the tech giants. My pick to watch is the small caps. They've bounced nicely since the regional bank crisis last spring, but higher rates still weigh on the group. Small caps peaked in November 2021 right when interest rates began rising. Unlike the Dow or S&P, small caps still have not hit a new high and sit 22% below the old high.

Why would small caps rally? I think credit conditions are easing again. Credit tightened last July and peaked last Halloween. This in turn drove a ferocious 23% small cap rally over 2 months. For some reason, credit tightened up again in mid-December and caused a 10% small cap sell off. Small caps have currently recovered 7% of the drop and may be poised to finally challenge the old highs. I feel small caps are under-owned and underrated, so let's see what happens next.

For small cap owners, the January CPI numbers were not what we wanted to see. Inflation ticked up but the small blip higher shouldn't meaningfully alter what comes next. Rate cuts are still coming according to the Fed but it's going to probably be June instead of March.

Good thing we'll get some potential clarity this coming Thursday in the form of the Fed's favored inflation measure: the personal consumption expenditures (PCE). I feel the PCE balances out the various categories better and is less volatile than the CPI. This might be the match that (finally) lights up the small caps' next leg higher. If you have any comments, feel free to contact me at heddins@capital-invest.com or call at 919-656-0836.

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