CAPITAL INVESTMENT COUNSEL

The Columns

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Lonnie Johnson is a renaissance man. He's a nuclear engineer and a rocket scientist at NASA but you're most familiar with one of his unconventional products. If you were a kid in the 80's or 90's, you likely used his most famous creation. Lonnie Johnson invented the Super Soaker water gun. There's nothing like a hot summer day and a Super Soaker. I know what you're thinking. What does the Super Soaker have to do with the stock market?

The Super Soaker came to mind last week while listening to Federal Reserve Chairman Jay Powell. The Fed's performance during the Covid crisis has been impressive. They provided stimulus early and often. I feel the Fed Stimulus has been a major driver behind the market's recovery. After five years on the sidelines, the Fed's QE stimulus program was resurrected in March. Last week, Powell committed to extending the program. His exact words were: *"we are going to be deploying our tools — **all of our tools** to their full extent in pursuit of that — of those goals, **however long it takes**."*

Fear reawakened in the markets last week. An uptick in Covid cases sparked talk of a second wave of infections. Yes, Covid provided the reason, but the market was due for a pullback. Over the four days ending June 15th, the market tumbled 8.5% and volatility spiked. The bears were licking their chops and waiting for the next leg down. The market responded with a 7% rally to bring us near the June highs. The bears are wondering what happened. I bring up the Super Soaker to remind you not to get too bearish. Picture Jay Powell poolside (or maybe not) holding a Super Soaker filled with dollar bills and stimulus.

The Fed used QE stimulus on and off from 2009 through 2015. QE's job was to provide training wheels for the economy. QE allowed the economy to gain momentum until it could ride on its own. With the Fed providing support in 2020, the economy and markets are receiving a good deal of bolstering and hand holding. Powell's "h*owever long it takes"* could be a long time if you're a market bear.

History provides potential clues for future market action. In May and June, history scored a win. With the VIX fear gauge at extremes, we wrote this in April: "*Results showed that as the VIX receded below 40, the market showed an average gain of 13%. The VIX currently sits at the all-important 40 level. If history holds true, from the Dow's current value of 23,700, the average gain from our study would place the Dow back at 26,700*." Volatility did recede below 40 and plummeted to 23. The Dow did its part as well with a massive upside rip. It even bettered our price target with a high of 27,500.

However, the rules of gravity still apply, and we've seen a pullback over the past few days. In reality, this pullback isn't a big surprise. The VIX dropped from 66 on March 30th to 23 on June 5th. In my experience, when volatility pulls back, market rallies can pause. The Dow did pull back from 27,500 to 24,800. Conveniently, 24,800 was the uptrend line for the latest rally. A break below that level could have brought in more selling. It felt terrible at the time, but the market appears to have started the recovery process off of Monday's lows. May's record retail sales numbers certainly helped drive prices higher. The US consumer appears to be alive and well.

It's encouraging to see a broad market rally as opposed to the narrow list of big cap tech that dominated the gains since March. In the latest surge, the equal weight S&P 500 (RSP) rallied 25% from May 14 to June 9. The tech heavy "normal" S&P only gained 17% over the same period. I'm not sure what to make of big tech. Charlie Biello recently pointed out that during the 2009 recession, the NASDAQ 100 dropped 42%. During the 2020 recession, the NASDAQ 100 rallied 16%. What? Sure, low interest rates are playing their part. With ultra-low rates, PE multiples can expand on big tech and drive prices higher.

I enjoy Jason Goepfert's work at Sentiment Trader, and he came up with this gem last week. The NASDAQ 100 has stayed above its short term 20 day moving average for 46 days. That's impressive but also maybe a signal that large tech is reaching an extreme in popularity as well as valuation. I don't see this as a call to be negative on tech. Rather, it emphasizes that there may be better bargains at large in the broader market.

The "Open Up" group is a basket of stocks that surge when investors are confident about the economy reopening. Open Up drove the big gains in the equal weight S&P this month. It consists of old school sectors like retail, financials, airlines, and shipping: the basic building blocks of the economy. When we see bad news on the Covid front, this group takes it on the chin. I'm encouraged to see the Open Up stocks start to stretch their legs. Through June 16, the overall market is flat on the month. In contrast, the transport stocks are up 4%, and the banks are up 3%. This may signal better things for the remainder of 2020. By the way, the Super Soaker netted Lonnie Johnson $73 million in royalties. If you have any comments, feel free to contact me at heddins@capital-invest.com or call me at 919-656-0836.

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