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Elston Insights

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Are we in for a year-end equity rally?

- Rate rises are on pause
- Equities are over-sold
- Short-covering has already taken place

One of the over-riding sentiments that has affected markets over the past couple of years has been a lack of certainty, whether in relation to the actions of central banks, the persistence of inflation or simply the general economic outlook. There's nothing that investors like less than uncertainty, so markets have accordingly been flighty in their response to anything that might be seen as having a bearing. One of the pivotal issues in the mix has been whether or not central banks would be able to raise interest rates at speed without prompting a recession, achieving the much-vaunted 'soft landing'. The conclusion remains to be seen – as things stand, the US looks the most likely candidate, in the EU it is a possibility and for the UK, recession appears to be underway, albeit moderately.

All of which would perhaps not prefigure a potential year-end rally in equity markets. But look closely, and it may just be that this is on the cards.

It has been our view for the past year or so that the US Federal Reserve would most likely reach a point with interest rates whereby it paused in order to take stock of the impact (or not) of the current level and would then at some point start ratcheting things back down. The pause came in September and although the accompanying narrative has been hawkish in order to head off consensus expectations of a decrease at the next meeting, the rate of inflation is moderating.

Equity market performance has been driven by the so-called Magnificent Seven, a group of tech stocks in the US that have shrugged off the adverse macroeconomic conditions to make excellent returns. But for the rest of the market, much of the pain of the constrained economic environment is already priced in, meaning that equities are currently quite fairly valued. From a technical point of view, equities have been oversold by jittery investors, and this means that broadly speaking there is ground to be regained.

For want of any clear-cut alternative opportunities, many of those jittery investors have built up a relatively substantial cash balance that will at some point need redeploying.

What might be considered the first phase of a rally – short-covering – has already taken place. This means that investors who have taken short positions in stocks for which they expected the price to fall move to buy back those same securities, normally triggered by expectations of a rise in value for the stock which they wish to avoid.

Combined with thinning trading volumes through the holiday season, and potential signals from the Federal Reserve as regards interest rate outlook for 2024, and a year-end rally could be on the cards. It would provide much needed relief after a few years – since December 2021 – of worrying newsflow and volatile markets.

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