Mr. Nasdaq's Wild Ride

In case you missed it, volatility has returned to equity markets as 2022, with the Nasdaq Composite in correction territory (down over 10% off the prior high) and the S&P nearing similar levels. Markets were erratic on Monday, January 24th, with the Nasdaq plunging around 5%, only to recover mid-day and close the day in positive territory. With no major news triggering the reversal, we can look to technical market indicators for some insight into why the markets fell so hard and recovered so quickly.

Before we dive into the technical view, however, we should remind ourselves why markets fluctuate at all. Simply put, the stock market is a pricing mechanism for future earnings of the underlying companies. Companies and analysts make forecasts for future earnings based on both macro level and company-specific variables, which are constantly changing. Any uncertainty in these variables makes for a wider range of potential earnings outcomes and causes more significant stock market fluctuations.

Right now, there is a good deal of uncertainty, starting at the top with the Federal Reserve. We know the Fed will be raising rates, but the market is in the dark about how steep the rate hikes will be, and how many we will get this year. That creates uncertainty for the economy at the macro level, and for any company issuing debt. The second major risk, and the reason the Fed is raising rates in the first place, is persistent inflation. Fourth quarter 2021 earnings calls are taking place for most companies this week and next, and analysts will be closely listening for any mention of inflation impacting forward guidance. Therefore, even strong Q4 earnings could be met with additional selling since markets are forward-looking in nature. Finally, there are additional major risks in the form of rising Ukraine-Russia tensions, and the ongoing COVID pandemic, with news of yet another variant breaking this week.

Now that we understand the risk factors on the table and the high degree of uncertainty associated with them, we can look at the technical indicators of the market. As we mentioned in our **2022 Outlook**, the Tech-heavy Nasdaq has become the dominant force in determining overall market direction. While the S&P 500 hit new all-time highs in the first week of January, the Nasdaq could not surpass its November peak, and fell below the 50-day moving average support level.

A major holding in most of our Hanlon proprietary Tactical Models is our Tactical Dividend and Momentum Fund (ticker HTDIX), where weeks ago we began raising cash from vulnerable sectors, namely Communications Services, Consumer Discretionary, and Technology. Around two weeks ago we continued to trim exposure from most equity sectors, as we noted in our Weekly Update that the next support level, the 200-day moving average on the S&P 500 Index, needed to hold to prevent further downward pressure. When 200-day was breached on January 18th, we further increased cash exposure in our Tactical Models. Hanlon Tactical models are presently heavily invested in cash, with just 20% equity exposure in our Tactical Growth and 13% in our Tactical Managed Income brokerage clients' models.

With an understanding of the macro-level risks on the table, and awareness of the technical support levels that have been broken, now the question is, "how long will this selloff persist?" Monday's selling did have some semblance of a short-term capitulation day, with data indicating retail investors gave up early in the day, and institutional buyers swept in when markets reached oversold conditions. The intraday bottom did coincide with some longer-term support levels, such as the 200-week moving average on the Nasdaq and the prior trading range from back in spring of 2021, before markets broke out in the summer. That said, none of the risk variables have been resolved yet, and therefore we recommend a continued cautious approach. Investors should listen closely to the next slate of earnings calls, with big tech on deck, to see how prominently inflation impacts their forward earnings guidance. We also would tread cautiously leading up to the March Federal Reserve meeting, as the market currently prices in an 88% probability of a 25-basis point rate hike, but we believe is underestimating the potential for a 50-basis point hike, at just 5%, per data from CME Group.

After 2021's smooth uptrend, a bout of volatility was bound to happen. Rest assured, we will continue to closely monitor the markets and assess the risks, remaining flexible to protect our clients' capital amidst a highly uncertain backdrop.

Thank you, as always, for the opportunity to let us serve you.

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