THE MID-YEAR RE-SET AND RECALIBRATION

Summer 2022 Newsletter

July 2022

Good riddance to June

The first half of 2022 is in the books. The S&P just completed its worst month since the Covid crash and the worst first half decline in 5 decades. The Bond Market had its worst start to the year, ever. Now that is saying something. Ever is a long time. It's simply been a brutal environment for investors.

Mid-Year Re-set

We stated in our 2022 Outlook letter that 2021 was a year of fake outs. The fake-out theme continued in the new year. Investors are understandably proceeding with caution into the second half of 2022. This correction has been quite different than the Covid crash, which brought sharper declines but in much faster fashion. The Spring of 2020 saw a crash down followed by a crash up. This 2022 correction has been less deep but much longer in time, in an excruciating way.

The path of least resistance in 2022 has been lower throughout the year with the outsized focus on the Fed-led global tightening cycle. The invasion of Ukraine has played a role too. It's still the case this Summer.

The Market is a discounting mechanism. It is forward-looking. The Market doesn't wait. It's in constant movement. Its eyes are fixated on the horizon, anticipating outcomes and pricing them in. The Market decline in 2022 has been fueled by soaring inflation and the Fed's aggressive tightening monetary policy. The result has been slowing growth and increased borrowing costs. The price of money rose. This effect hit both stocks and bonds, which made this correction so painful, leaving few places for investors to hide. Bonds did stage a bit of a rally to close out H1, providing a little relief.

Bubbles Burst

What a difference a year makes. In 2021, asset bubbles were everywhere. Cheap money was everywhere in response to Covid. That money plowed into assets which sent prices soaring. There was a sense of euphoria not seen since the Dot-com days. Stocks, cryptocurrencies, and housing caught a historic bid hitting price levels never before seen. The bubbles have since burst and the most speculative areas, which did the best at first, have fared the worst at last.

It's natural to key on those all-time highs as a reference point in which to return. That approach has flaws. Many of the securities that flew to those heights will take a long time to get back there, if ever. I always remind myself that Intel has yet to reach its bubble levels from the Dot-com days. 22 years later, the company is far more profitable. But the premium assigned to Tech stocks back then got burned off. It never returned for most. It took years for Tech stocks to reignite. And it was a new cast of characters that emerged. That could very well be the case for what lies ahead.

Sentiment is Sour

The Market tends to overshoot. It happens in both directions. Call it mean reversion. Emotions tend to distort decision-making. Overly euphoric or pessimistic environments typically cloud investor attitude and judgment. The Market generally stays euphoric longer than panic because making money tends to mask problems. Plus, fear is a stronger sensation than greed.

Case in point today: Sentiment is sour. Investor Sentiment has not been this bad since before the Dot-com days. That is a significant contrarian indicator, which is historically considered bullish. There are a lot of potential buyers again. It's so bad, it's good is the thinking. Investors definitely do not feel good right now.

As mentioned above, there have been few places for investors to hide and play defense this year. One of the only segments of the Market that gained in the first half was in commodities. Crude Oil went from $75 to well north of $100 a barrel. Natural Gas prices nearly tripled before falling back in recent weeks. Gasoline prices at the pump doubled from a year ago. Consumers have been simply squeezed with this phantom tax of inflation. A reprieve recently set in, as commodity prices fell. The Market has begun pricing in a recession ahead.

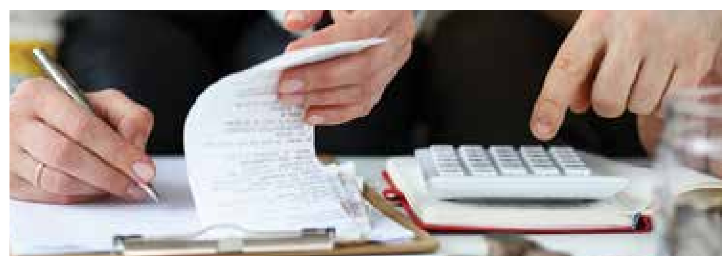
America is Open for Business

The re-opening of America gathered momentum so far in 2022. The American people were out and about with a vengeance. Pent-up demand saw travel explode in the Spring and into the Summer. Being locked down for 2 years will do that. Americans hit the road and the friendly skies in size. Bars and restaurants were busy, as were theme parks and concerts.

Consumer spending accounts for roughly 70% of US Gross Domestic Product. An active Consumer is great for the Economy. The problem is, the spending might not last. Soaring prices and higher interest rates are shrinking demand. It's very likely that budgets were busted early on in 2022 and wallet tightening will return when Summer is gone.

The Cost of Living Jumped

Inflation is not just about food and energy. Monthly rents have jumped too. It's generally a lagging phenomenon, being one of the last areas to rise with inflation. The cost of living is much higher today compared to a year ago. Rising interest rates impact car payments and credit cards too. Rates are still low by historical measures. But it's the direction of the move that matters most. 30-Year mortgages cleared 6%. That's the first time they've seen that level in a decade and a half. They were sub 3% a half a year ago and set record lows in the early days of Covid. The cheap money fueled the housing bubble. The bubble finally got pricked.



The Real Estate Market was white-hot with rising prices. All-cash offers well above asking became the norm. We've seen this before. The house price/income ratio reached its 2005 bubble peak this Spring. It's reversed since. With mortgage rates rising, affordability is tenuous. Refinances fell sharply. Mortgage applications fell 78% from a year ago. Here's an important calculation to think about: Every 1% move in mortgage rates requires a 10% adjustment in home prices to keep monthly payments unchanged. The fact is, a 6% mortgage buys a lot less house.

The Economy doesn't work when prices for goods and services increase at a faster rate than incomes. There's only so much the Fed can do. Their tools are designed to curb demand. The Fed can't control supplies. It can't produce more Oil or grow more food. It can't manufacture cars. It can't make electronic devices or toys. It clearly can't relieve the ever-present strains in the global supply chains. So, the Fed will continue to raise rates and tighten monetary policy. They plan to do it until inflation peaks.

Peak Inflation?

Commodity prices have fallen of late. Copper is down 30% from its 2022 highs. It's back to 2020 levels. The CRB index, which consists of 19 global commodities ranging from cotton and wheat to corn, cattle, and aluminum, has also started to roll over. These are all key inputs in our daily consumption. It's where inflation lives. These declines in commodity prices are another sign that inflation may just finally be peaking.

The price slide in raw materials is a true sign that inflationary pressure might be starting to ease. The Fed likes seeing this. Demand has been intentionally destroyed. This is very deflationary. The problem is, it could also be recessionary. That would be a hard landing rather than soft.

While we may be getting near a peak in inflation readings, especially with many commodities rolling over, we still have inflation higher than expectations through the end of the year. This is likely to continue to provide a conundrum for the Fed, especially as the Economy slows. Industrial Metals were down 26% in Q2 alone. That was the biggest drop since the Financial Crisis in 2008. Copper is the leader in those declines. It's said that Dr. Copper has a PhD in Economics. It's always a leader, on the way up and down.

The World Still Runs on Crude

The War in Ukraine made it crystal clear how dependent the Global Economy is on Crude Oil. The price of Oil soared to start the year, as supplies were threatened. West Texas Intermediate (WTI) cleared $120 per barrel in the Spring. US production has been held in check. Part of it is political. Part of it is economic. Washington isn't very good at economics. The simple fact is, the World needs stable and cost-effective energy supplies. There's no getting around that.

Crude prices have since fallen from the 2022 highs. The price decline was driven by demand destruction at the hands of the Fed. Crude is often the last one to slide. The Market has started pricing in a hard landing.

Economic Slowdown: Hard or Soft?

The Market is increasingly concerned about a hard landing scenario with the Fed tightening into the economic slowdown. Persistent inflation has been the driver of this aggressive, front-loaded rate hike cycle. The overnight interest rate is expected to peak near 3.5% by this time next year. It currently sits at 1.75%. Another 3/4-point hike is expected later this month. And that is just interest rate increases.

There's still the issue of the Fed's quantitative tightening (QT) campaign. After aggressively buying bonds and asset-backed securities, to the tune of a $9 Trillion balance sheet, the Fed has begun letting $47.5 Billion in securities roll off every month. That number is expected to jump to $95 Billion per month in September. Taking this liquidity out of the system reduces liquidity as the Federal Reserve is no longer a large buyer. It also has a phantom hike effect, as the price of money is no longer controlled at the frontend. This QT campaign of approximately $1 Trillion per year is estimated to equal an additional 25-50 basis point rate hike.

The Economy is slowing, that much is clear. The International Monetary Fund (IMF) predicted the US will narrowly avoid a recession in 2022 and 2023. But they did downgrade growth forecasts. The organization believes the front-loaded Fed tightening will help reduce inflation and protect real incomes, sustaining economic growth. The IMF clipped its 2022 growth forecast for the United States from 3.7% to 2.9%. It lowered its 2023 growth estimate from 2.3% to 1.7%. Standard & Poor's cut 2022 estimates too. Growth is slowing around the Globe. There's no question there. To what extent is the question. The Market and the Fed are paying close attention. The Market has gone a long way to price in a recession.

Around the World

Russia and Ukraine:

There's still a serious crisis in Ukraine. The war continues. It's not the primary driver for the Market, but it still matters. Sanctions on Russia have been swift and aggressive. NATO strength and resolve is unified. Russia is not backing down. The Ukrainian people aren't either. Resolution seems nowhere near.

Russia has defaulted on its foreign debt for the first time since the Bolshevik Revolution. That was a century ago. It's a largely symbolic move, given that the Kremlin has enough money to pay off the debt. It was barred from doing so due to the heavy Western sanctions. Moscow claims it's a false default. The Russian Government currently cannot borrow internationally. It doesn't need to. Surging Oil and Gas export revenues have grown even more plentiful since the invasion of Ukraine.

China and India have stepped in and bought roughly the same volume of Russian Oil that previously would have gone to the West. This was not part of the NATO calculus. The West is not happy with either, but is more surprised at India than China. Here's the thing: We can damage the Russians. But the Russians can also damage us.

Russia will shut down the Nord Stream 1 pipeline for its regular Summer maintenance activities. They just might not turn it back on. That absence would be felt. 40% of Europe's gas had come from Russia. Nord Stream is Europe's largest source of imported gas. It will be hard to replace. Prices have already skyrocketed. Natural Gas prices in Europe jumped 6X since the invasion of Ukraine. Europeans are already facing economic recession. Another energy crisis could be in the offing.

Don't Forget About China:

Shanghai declared victory over Covid. Early indicators point to China's Economy improving in June after the self-imposed lockdown. The city of Shanghai resumed in-person dining at restaurants and schools are returning to in-person classes. The Chinese Economy has struggled for much of the year while the rest of the World recovered. China is the #2 Economic Superpower. It's now playing catch-up.

The Chinese Government is providing economic support again. The combination of improved Covid trends and stimulus measures is starting to trigger early cycle recovery. A strengthening China will help loosen the supply chain strains. Freight rates from China to the West Coast are already down 50% from a year ago. But a recovering China will also create increased demand for Oil and other commodities, which could send prices back higher.

Importantly, China is committed to its Zero Covid policy. So basically, the re-opening can change in an instant back to lockdowns. That makes business activity beyond challenging. The Market is getting used to it.

21st Century Powers:

China is the clear long-term challenge for America and the West. There's little trust in both directions. A New Cold War rivalry is on. Planet Earth cannot afford for it to turn hot. Russia is not an economic power. But the Chinese-Russian alliance definitely complicates things for the United States.

China wants to dominate the Digital Age. That means Artificial Intelligence, Biotech, and Renewable Energy, among so much more. But the growing geopolitical issues popping up around the Globe continue to complicate its foreign policy. The War in Ukraine is clearly the primary issue that has great implications beyond. But threats and instability in Israel and Iran are brewing again. Europe has its own internal challenges, particularly with political instability in France and the UK. All is not well on Planet Earth.

Trade War Truce?

Chinese tariff relief appears to be back on the table at the White House. The Biden administration is seeking any and all levers to pull for inflation relief. Did the trade tariffs even work? Chinese exporters generally didn't lower prices to keep their goods competitive when the tariffs were first put on in 2018. US importers passed the duties on to American consumers. The American people paid the highest price for that. We have competing concerns at play, which is very significant. One is the need for the White House to be perceived as committed to fighting inflation. The other is the need for America to be very strong in standing up to China. Both are critically important. They're also highly politicized.

Chip prices surged during the pandemic amid heavy demand for stay-at-home stuff. Supply chains got strained. The semiconductor industry is beginning to see signs of easing as inventories build and companies prepare for a decline in consumer spending. There have also been efforts to re-shore more of the crucial supply chains to American soil. It will come at a higher cost, which is measured in Dollars. But considering the benefit for National Security, Dollars might not be the proper measurement for success here.

The Dollar has been super strong, reaching levels not seen in decades. It's close to parity with the Euro. That hasn't happened in 20 years. Rising rates and instability overseas have been the drivers. A strong Dollar is a double-edged sword. It helps to fight inflation because it makes imported goods less expensive. But that can also hurt growth. US exports have become more expensive and less attractive on the global stage. American companies received fewer Dollars for their sales. That hurts company profits. It's earnings that drive stock prices. If earnings decline, stocks follow suit.

Earnings Drive Stock Prices

Earnings Season is here again. It's the time of year when Corporate America reports its quarterly scorecard. It's the ultimate fact-finding mission for Wall Street. Here's the problem: Estimates might still be too high.

Analysts on the Street are considered to be like "deer in headlights" heading into this Earnings Season. Their estimates have barely budged. Earnings estimates need to be revised down to reflect the hit to growth from tightening financial conditions and subsequent economic slowdown. The Street is currently looking for S&P 500 earnings to grow 4.3% in Q2 compared to a year ago. That would represent the smallest expansion since Q4 2020. But the consensus estimates seem too high in the face of slowing growth and the tight Fed. We'll learn a lot in the coming weeks.

Since the Market is forward-looking, it already has eyes on next year. The consensus for 2023 S&P 500 earnings currently stands at just over $250 per share. That estimate is 2.5% higher from the start of the year. The increase is largely on the back of higher Oil prices leading to greater Energy profitability. Importantly, there have been no cuts to earnings estimates for all the other companies that face the impact of slowing demand.

Goldman Sachs put out a report that suggests if the Economy does contract, and falls into recession next year, the 13% median historical recession decline would bring 2023 EPS down to $200 per share. The analysis found that if the Economy avoids recession but profit margins and revenues for most sectors return to pre-Covid trends, EPS would come in at approximately $215. The Market has definitely priced in a slowdown. It doesn't seem to have priced in a slowdown like that.

Premium Pricing

The Stock Market has been recalibrating all year to account for the higher price of money, tighter monetary policy and economic slowdown. Stocks are valued by a number of measures, most commonly their relationship of Price to Earnings, otherwise known as the P/E ratio. Much like food, commodities and houses, which are valued by the pound, ounce or square foot, the numbers change based on supply and demand. Strong demand and cheap money always lead to higher multiples and higher prices. Euphoria leads to premium prices. But when access to money tightens, so do the multiples. Demand shrinks and prices generally fall. The Stock Market lost its premium. Wall Street is one of the few locations where buyers freak out with bargain sales. That's the environment we're currently in.

Second Half Playbook

We outlined in the 2022 Outlook that though we still see tremendous value long-term, we anticipated a tough go for Tech in the short-term. It got it, and then some. Early in the year, we pivoted from aggressive growth investments into more profitable and defensive areas. We bought Utilities for the first time in my career. It was a hiding place. We still think it is.

Looking under the hood of the Market, there's much to like paired with plenty of caution. Our job is to navigate through the problems. Credit conditions continue to deteriorate, with most indications pointing toward a post-peak inflation World. Inflation and higher rates tighten the financial system, making a much tougher environment for lower-quality assets. At this stage of the cycle, Energy and Materials start to weaken while defensive areas like Consumer Staples and Health Care outperform. Bonds start to outperform, as money flows into Treasuries

seeking safety in the slowdown. That has happened of late.

Tech bounced off the battered lows but is still under pressure. We like Tech long-term, but still see some challenges remaining in 2022. Our focus for H2 remains quality. Profitable companies with predictable revenues and safe dividends continue to drive our portfolios. We call them "Boring Blue Chips." They pay safe dividends and have a track record of raising them every year. Boring is good in this environment. We really like Consumer Staples and Health Care right now. They are less economically sensitive, with predictable qualities which we covet in this environment.

We still like Energy, both traditional and renewables. The war in Ukraine and limited production should keep a floor under Crude prices at around $100 for the foreseeable future. Energy companies are plenty profitable at $100 Oil. A breakdown in crude prices would suggest the Economy is recessing faster than thought. Gold is playing an important role in portfolios too. It has safe-haven status. Precious metals do well with inflation. Alternative asset classes are likely to play an important role for an investment portfolio in the years ahead.

We took a stab at putting money back to work in international markets early in the year. The invasion of Ukraine had us switch gears. We do find value overseas, as international stocks are generally much cheaper and pay larger dividends than those in the United States. But growth and stability are a challenge internationally. That has us sitting back and studying the area before redeploying capital in the regions outside our shores.

The Bond Market is a viable option again for investors. The big move in rates has been devastating for long-term Bond prices. But it created a nice opportunity for new money to find a stable source of income with higher yields. Like everything today, yields have been moving fast. But getting 3% for 2-Year Treasuries, 4%+ for quality Corporates and 3%+ for tax-free Municipal Bonds looks pretty good to us in this unstable environment.

Bull Case

Here's the Bull case, something the Fed and the Market would like to see: Food and Energy costs slide with other commodities, reducing pricing pressures on what we consume. Covid concerns ease enough that global supply chain strains get soothed. Chip supplies grow to meet demand. That would lead to an increased availability of goods which would allow for more consumer spending towards services. In that scenario, the labor shortage gets remedied as kids stay in school and people eagerly come back to work. All of this would ease inflationary pressures, allowing the Fed to slow, if not pause, the rate hikes while the Economy regains its footing.

Stocks could rally in this situation, but the earnings outlook will be key in this case. This is a very possible scenario. We'd like to see this play out too. But a lot has to go right for the sequence of events to take shape. Earnings Season is about to begin again, and Corporate America is dealing with all of these challenges presently. Profit growth will naturally slow as the Fed cools the Economy. It's not clear how slow economic output will be and what the Market has already priced in.

Bottom Formation is a Process

Everyone wants to know, are the lows in? We would like to know too. But we don't. The rally to close out Q2 looks familiar. The only relief in Q1 came in the second half of March, when the S&P 500 rallied 11% off its lows in just 11 trading days. Then the selling continued in April and much through Q2. The second half of June brought another rally. Bear Markets do that. We anticipate another Bear Market rally over the Summer, one that might be more powerful than any we've seen thus far in 2022. But we are not convinced the lows are in either. Bottom formation is a process. Stocks will stop going down after rates stop going up. That will happen when the slowdown subsides with anticipation of a return to growth.

Recalibration

For the rest of the Summer, we believe playing defense is still required until inflation cools to a tolerable level which allows the Fed to put the brakes on the aggressive tightening campaign. 2% inflation isn't returning anytime soon, perhaps not for the rest of the decade. But 8% won't likely stick either. It's our sense that sub 5 % inflation would be acceptable for the Market and the Fed as we near year-end. That could trigger a second-half rally, which takes the Stock Market back to higher levels.

The highs for the year are almost certainly in. Those were bubble-like levels. But there is meaningful upside potential from current levels. A definite risk is the Fed goes too far, creating a hard landing that sends America into recession. It can't be ruled out. There's also the midterm election in November, which will no doubt create some more turbulence. We will stay active.

With so many variables in play for the rest of 2022, we don't see how the path ahead remains anything but bumpy. But we are more than equipped to deal with it. We've been doing it all year.

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