Quarterly Market Review and Outlook

2022 Q2 Market Re-Cap

If you thought that 2020 was infuriating, then 2022 just said hold my drink. So far 2022 is a year of worsts. The worst bond market in half a century. The worst 1st half for the U.S. stock market in half a century. The worst inflation in half a century. For many people it is enough to pull your hair out.

We won't nitpick the fine details other than to say, "hold your nose". Depending upon which index you are tracking, U.S. stocks are down between 20%-30%.[i] For the first time in a very long time, the global stock market has performance a little better than U.S. stocks, but are still down 17% for the year.[ii]

While the stock market has been bad, the bond market on a relative basis has been worse. Consider that the worst calendar year for the U.S. bond market since 1976 was -2.92%.[iii] For the first half of 2022, the U.S. bond market has declined 10%![iv] This means if the bond market produced a 0% total return for the balance of the year, then 2022 would represent the worst bond market in 50 years x3.5!

2022 Q3 Outlook & Beyond

Rock & A Hard Place: Recession or Inflation

We won't dwell on the inflation data other than to reiterate that inflation is running a pace not seen in four decades. Certainly, part of the challenge stems directly from, in our opinion, the Federal Reserve's slow response to the early signs of inflation in 2021. Perhaps if the Fed hadn't persisted on the notion that inflation was only "transitory" and slowly increased interest rates, then the pace of the hikes today would not be as steep. However, the sole blame should not rest in the Federal Reserve's lap. A significant portion of the blame rests in the historic flow of money in the aftermath of COVID as well as, in our opinion, policy mistakes in Washington, DC. Many will point to continued supply chain challenges and the Ukrainian conflict, and while those do have an impact, inflation was increasing prior to Russia's invasion of the Ukraine and supply chain challenges have existed since COVID.

The issue is whether the Federal Reserve can tame inflation back to their self-imposed level of 2-3% without pushing the U.S. economy into recession.

First, we'd remind everyone that Q1 2022 GDP were negative. The follow up revisions to the initial GDP report has confirmed that the U.S. economy contracted in the 1st Quarter after factoring in inflation. Further, we consistently track the Atlanta Federal Reserve's GDPNow indicator. Unfortunately, their latest data projects a worsening situation as the 2nd Quarter is projected to contract by around 2%.[v] The traditional definition of a recession is two consecutive quarters of negative GDP growth. Therefore, by the traditional definition, we are already in recession.

Second, a silver lining is that we would typically expect to see rising unemployment numbers as the economy falters. There is some evidence in firing freezes and layoffs in certain sectors, but generally speaking unemployment is not the problem as employers can't seem to find enough employees to meet their needs. In March 2022, job openings were at a record high of 11,855,000.[vi] There was a slight decline in April, but there were still 11,400,000 job openings.[vii] This is not the type of unemployment data that we'd traditionally expect from an economy in recession. Employers want to hire people, but can't seem to find people willing to work.

We see the prospects of the U.S. economy avoiding an actual recession, not just the traditional definition of one, within the next 12 months as slim. The Federal Reserve is hell bent on bringing down inflation by raising interest rates, which should slow economic expansion. We do not envision the Ukrainian conflict ending soon. We do not see much of a chance that China will increase productivity due to their zero-COVID policy. Nor do we have any real hope that policy changes will take place in Washington, DC that could positively impact economic productivity or expansion.

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Financial Market Situation

As we discussed above, 2022 has been, so far, a year of worsts.

In the short term, we would not be surprised to see downward pressure on stocks as data confirms the impact of inflation on Americans and by extension the U.S. economy. Companies will begin to report 2nd quarter numbers shortly. Just as we've seen this year, any company missing estimates or issuing bleak forward guidance will see their stock price get punished. Investors will simply have little tolerance for missing on targets in the current landscape.

In our opinion, it is a fool's errand to time or predict the bottom of a market decline. However, it is prudent to examine history as a guide to obtain a sense of where value could begin to emerge. Currently, we'd suggest that the overall U.S. stock market is probably about fairly valued. As bond interest rates increase, they serve as competition to stocks. The concept is straightforward. If one can obtain a relatively low risk interest rate of 3-4% in bonds, for example, then in order to take the risk of owning stocks the rewards need to far exceed the yields offered in bonds. Hopefully, bond interest rates are closer to topping out than not, which could start to build a bit of a foundation for stock valuations.

Second, P/E ratios for stocks have fallen since the beginning of the year. By one measure, stocks are still overvalued.[viii] By another P/E measure, there is some value present in the stock market.[ix] Again, this confirms that markets are overall valued fairly.

Third, if markets fall much more and bond yields do not increase tremendously, then we'd suggest that the potential for a real buying opportunity has emerged. Many have heard us say this before, we make money when we buy, not when we sell. At some point, the risk of not buying stocks will be greater than buying.

Finally, we'd offer another silver lining in the form of the bond market. As we mentioned, as the Federal Reserve raises bond yields, they serve as more attractive competition for stocks. Just as with stocks, there should come a point when holding longer maturity/duration bonds will offer value.

To be clear, we are not advocating for a dramatic increase in stock or longer maturity bond exposure at this point. This should be evidence by the elevated money market positions in most client accounts. Just know that we believe that we are closer to this point than where we were at the beginning of the year.

Political Landscape

We don't think that it is a stretch to say that the political climate in the U.S. is toxic. Not matter where you fall on the political spectrum, civility, reasonableness or compromise is in short supply. Thus, our comment from earlier that we have little hope of true economic support from our elected officials in Washington, DC.

Further, we would caution people against the thought that Congressional change from mid-term elections will dramatically alter the political landscape one way or the other. The reality is that the builders of our government, purposely made it difficult for one branch of the Federal government to have overwhelming power over the other branches. Thus, while a different political party may control Congress by early 2023, we would not expect a tremendous amount of change politically.

Ideally, the politicians and bureaucrats in Washington, DC would recognize and accept that they tend to hinder economic growth than spur economic growth. It would be better, in our opinion, if they would simply get out of the way and let businesses prudently figure out when and where to take risks.

Summary

It is certainly not our intention that this newsletter comes off as bleak or pessimistic. We genuinely believe that we are realistic, and even optimistic, people. However, we also believe that we need to share our thoughts and opinions with our clients and not sugar coat what seems obvious to us.

While the short-term may look bleak, the longer term picture offers some silver linings. Several of our favored economists tend to concur.

Kiplinger: "Inflation 6.7% at end '22".[x]

First Trust: "Even more unlikely is the notion that the U.S. is on the cutting edge of a recession like the one in 2008-09."[xi]

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First Trust: Average S&P 500 Intra-year pullback during mid-term election year is 16.3%. Average return 1 year after low date is 37.2%.[xii]

Bob Brinker: "Based on our expectation that a slower economic growth track will reduce pressure on long-term interest rates, we continue to favor our 18 to 20 times forward operating earnings price/earnings multiple range, which should enable the S&P 500 to challenge the 5000 level during the first-half of 2023."[xiii]

Finally, we continue to be unwilling to beat against the long-term potential of the U.S. economy and innovative companies within the U.S. Recessions and bear markets are scary, but neither the U.S. economy or stock market has any history of not eventually recovering and reaching new heights.

In the interim, we will continue to play defense by holding stocks of companies that have tremendous positive cash flow, strong balance sheets, have a long history of paying and increasing dividends and/or provide a product or service that is essential for the vast majority of people. These are the companies that better weather the storm. Additionally, we hold bonds that are less interest rate and inflation sensitive.

Finally, and most importantly, we will continue to review client accounts to ensure that they are properly and prudently positioned relative to your financial goals and objectives. We can't control the stock market, the economy or who is in Washington, DC, but we can adjust where appropriate.

As always, we thank you for your continued trust and confidence. Our relationships with you mean a great deal to us. If you have any questions that you would like to discuss, please do not hesitate to contact us.

We hope that you and your family have a wonderful summer!

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[i] https://finance.yahoo.com/

[ii] https://www.morningstar.com/etfs/xnas/acwx/performance

[iii] https://www.bogleheads.org/wiki/Bloomberg_Barclays_US_Aggregate_Bond_Index#cite_note-11

[iv] https://www.morningstar.com/etfs/arcx/agg/performance

[v] https://www.atlantafed.org/cqer/research/gdpnow.aspx

[vi] https://www.bls.gov/news.release/jltst.nr0.htm

[vii] https://www.bls.gov/news.release/jltst.nr0.htm

[viii] https://www.multpl.com/shiller-pe

[ix] https://www.multpl.com/s-p-500-pe-ratio

[x] "The Kiplinger Letter". Volume 99, Number 23. June 9, 2022. 1100 13th Street NW, Washington, DC 20005. Kiplinger.com.

[xi] First Trust. "Monday Morning Outlook". June 27, 2022. www.ftportfolios.com.

[xii] First Trust. "Midterm Election Year Intra-Year Pullback". www.ftportfolios.com.

[xiii] "Bob Brinker's Marketimer". Volume 37, Number 7. July 2022. www.bobbrinker.com.

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