Faithful

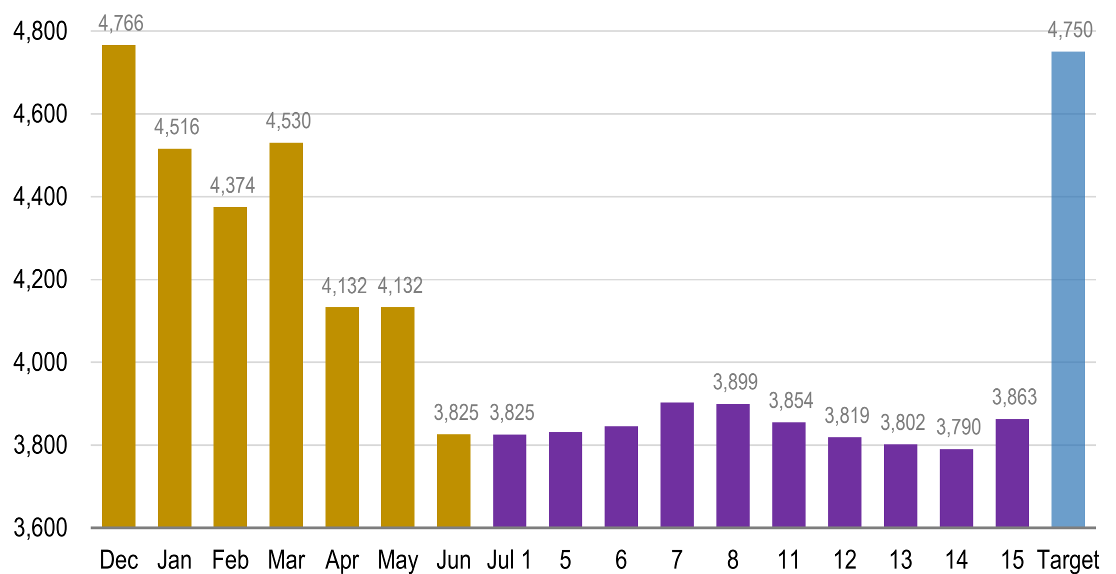
Weekender

July 16, 2022

A valiant week-ending rally in US equity markets was insufficient to push gains into the green for the week. At Friday's close the S&P 500 was lower for the week by -0.93%. The primary drivers were the same. Launching into the wind was inflation. On deck, earnings.

S&P 500 Daily Levels

December 2021 - July 15, 2022



Inflation for the month of June, as measured by the consumer price index, or CPI, came in at 9.1%, a forty-one year high. Primary drivers were soaring gasoline and food prices with stubbornly "upward-sticky" housing costs. Prices at the producer level, as registered by the producer price index, or PPI, were also higher than expected at 11.3%. But when food and energy was stripped out, the CPI was higher by 5.9% while the PPI was higher by 8.2%. Certainly, removing food and energy from inflation calculations constitutes "slight of hand". But it also provides an interesting perspective that leads us to conclude inflationary pressures are peaking.

But, peaking does not mean reversing. Even if the rate of change is slowing, when the annual comparisons roll forward one year from now, the degree of enduring inflation should be manageable, in the 4-5% range. Still double the Federal Reserve's target of 2%.

On deck, earnings are another story. Earnings season for the second quarter began this week. Only 75 of 3,075 reporting US companies have released earnings. Next week, almost 25% of US companies will report. Even so, if this week is a taste of what is to come, its going to be a stinker. Of the 33 companies in the S&P 500 that have reported, sales are up 7.8%, a respectable showing but still lower than inflation. Earnings are contracting at a rate of -9.9%. The stinker.

In this *Weekender* we will provide a summary of the inflation data and summarize market moves in countries, instruments, sectors and themes. Pleasure be sure to consult a qualified financial advisor prior to making financial decisions. Next week's weekender will tackle earnings.

Market Narrative

After the hot consumer price index data released at the beginning of the week, markets started to price in the "certainty" of a 1.0% rise in interest rates at the Federal Reserve's July meeting. By the end of the week a number of Fed members cast doubt on whether rates needed to be "super-sized" with a 1.0% rise. On Friday, data showed consumer expectations for long-term inflation had fallen to 2.8%, probably influenced by precipitous declines in Crude Oil and gasoline over the last fortnight.

Putting things into perspective, the upper bound of the Fed's current target interest rate is 1.75%, the gold line in the graph below. It is likely that before the fed is done, their target rate will rise to between 3.5% and 4.0%, the rose shaded area. This implies we probably have approximately two percentage points of tightening still to go. Even so, moving too far, too fast, could disrupt some of the economic cushions in place that give the Fed room to maneuver. These cushions include a strong labor market, robust consumer spending, and relatively stable corporate and consumer balance sheets, all of which usually deteriorate going into a recession.

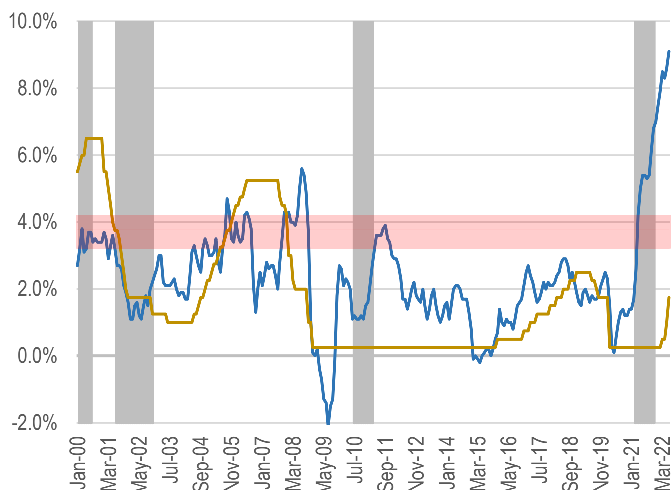
Labor market strength and resilience in our rate-hiking environment is a key attribute that, if it persists, may ensure the coming economic slowdown is mild. Consumer spending remains strong, although in real, inflation adjusted terms, its roughly flat. However, as shortages and stock-outs are remedied, its likely consumer spending will increase, as consumers satisfy pent-up demand. Balance sheets of corporations and individuals are relatively strong compared to the gate of previous recessions.

We expect these three cushions to provide a softer landing for the economy this time, as long as inflation can be tamed by demand destruction. But, constraining inflation to a 4-5% level may take a few quarters.

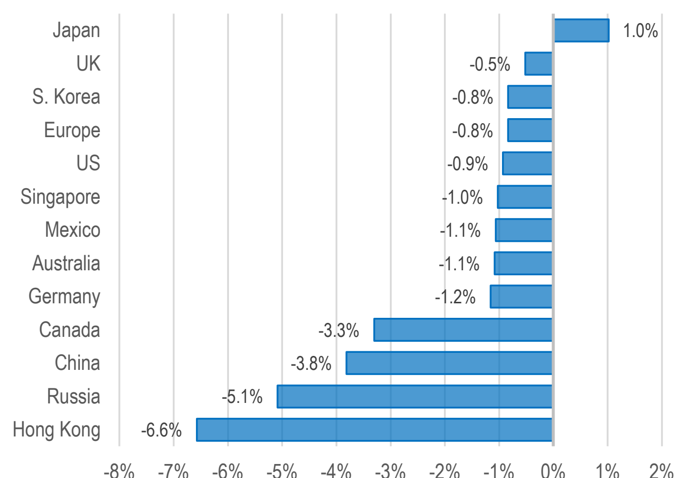
Countries

Despite powerful week ending recoveries in may global equity markets. Most markets ended the week lower. Hong Kong and China were notably soft after a resurrection of a few tender issues related to government crackdowns on powerful companies and

Fed Target Rate (Gold) and CPI Inflation (Blue)
January 2000 - July 16, 2022, Shaded Areas are Recession



Country Returns
July 11 - 15, 2022

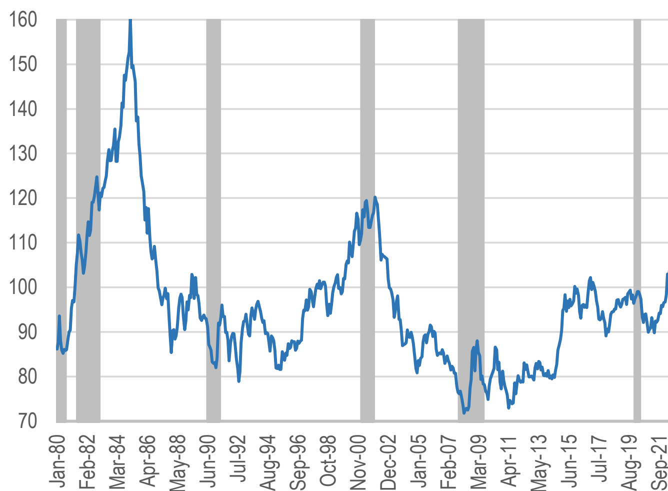


company leaders and an increase in COVID infections and threats of potential shut-downs. Russia was lower, because its Russia. Japan was the best performing market on the back of strong corporate expectations and the tailwind generated by a devalued yen compared to the US dollar.

An index of the dollar against other major currencies shows levels of strength not seen since the early 2000s.

Dollar Index

January 2, 1980 - July 15, 2022



Compared to the euro, the dollar is approaching parity, a place it also hasn't been since the early 2000s.

There are many knock on effects of a strong dollar. Foreign earnings, which account for 37% of the S&P 500 member profits are worth less as the dollar strengthens. A strong dollar also impacts commodity prices since most commodities are still denominated in dollars. Exports from the United States are harder to sell when the dollar is strong.

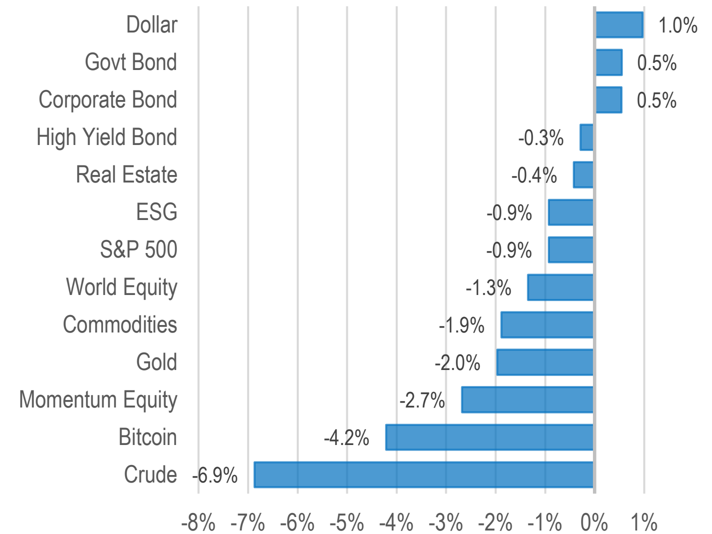
We believe the dollar will remain strong as long as the US maintains its position as the cleanest dirty shirt among nations. Europe's determined economic deterioration all but ensures dollar pre-eminence for the foreseeable future. Earnings weakness and non-operating currency-related charges are likely to be a leading topic of second quarter releases over the coming weeks.

Instruments

Crude oil was the worst performing investment instrument on the week. Commodities didn't fare well either, particularly influenced by demand destruction and dollar strength.

Instrument Returns

July 11 - 15, 2022

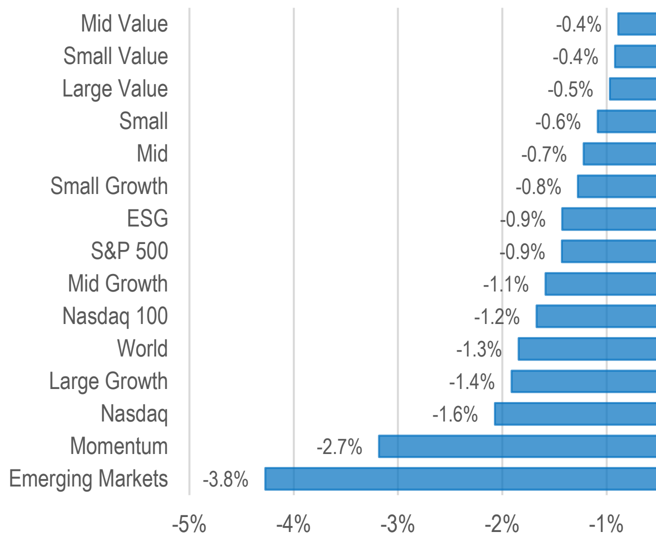


As the commodity boom pushed from 2021 shortages into 2022, strategists and economists embraced commodities as a "hard asset" that would be a useful investment tool for fighting inflation. At the beginning of the year, allocating into commodities seemed like a no brainer. However, as the Federal Reserve pushes harder in the face of inflation, resulting demand destruction will push commodity prices lower.

Commodities are great trades. As such, the best time to be long or short commodities is when asymmetric information is at hand or when market dysfunction is setting prices. Very few market players hold asymmetric information on commodities where prices are set by market forces and a particular buyer and seller has little influence on a commodity's price. Experience and history suggests that during periods of recession-led demand destruction, commodity risk beats reward.

Looking at equity instruments over the last week, they were all lower. Emerging markets fared the worst in an increasing high dollar environment. In a sea of losses, value categories fared much better than growth. Momentum and technology were punished.

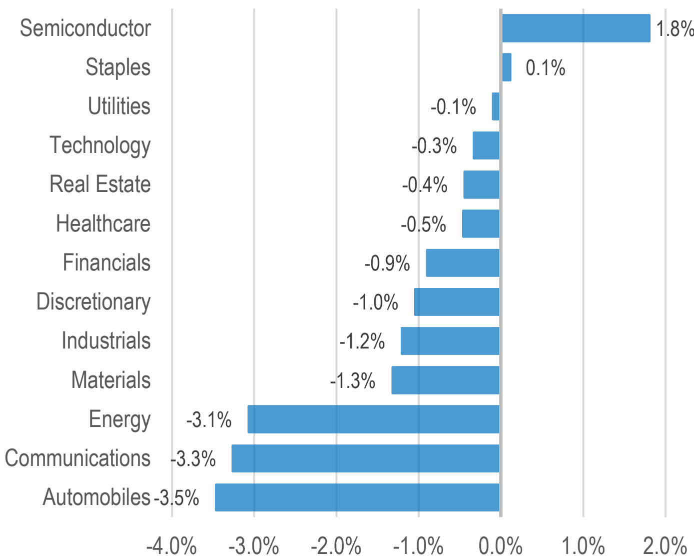
Equity Instrument Returns
July 11 - 15, 2022



Sectors

Among sectors, allocation toward the energy and materials is not warranted as commodity prices are expected to continue to fall into the end of the year.

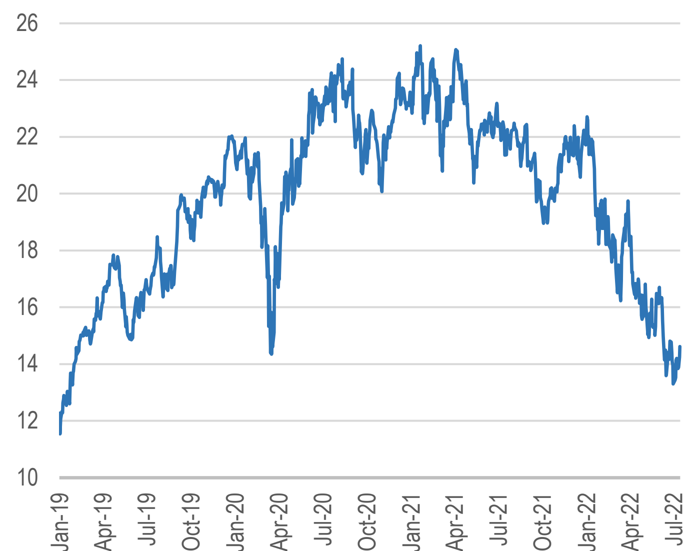
Sector Returns
July 11 - 15, 2022



Protection in consumer durables, healthcare and utilities are also too expensive. Some areas warrant overweight.

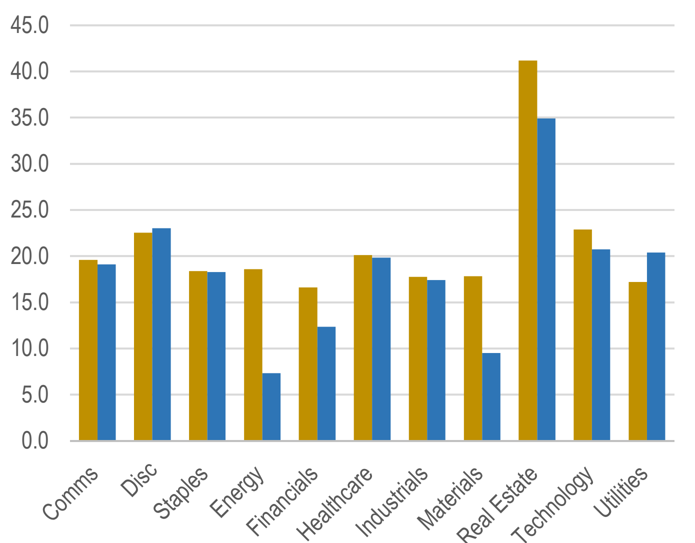
Semiconductors were the best performers by a large margin this week. Higher prices, and a sense that demand will outstrip supply for the foreseeable future, except for the commodity chips, pushed prices higher. That said, the Philadelphia semiconductor index is lower by 31.7% on a year-to-date basis. The pummeling has certainly pushed semiconductor stock valuations below medium-term averages and close to where semiconductor stocks were valued during the slump of 2019.

Philadelphia Semiconductor Index Projected PE Ratio
January 2, 2019 - July 15, 2022



Looking at the primary sectors, PE ratios based upon forward earnings estimates are mostly in-line with pre-pandemic levels. The exceptions are the commodity driven sectors of energy, and materials, where valuations anticipate a drop in commodity prices. Financials are also trading at a discount on expectations that a recession may lead to higher loan loss reserves. Real Estate valuations are soft in light of rising interest rates.

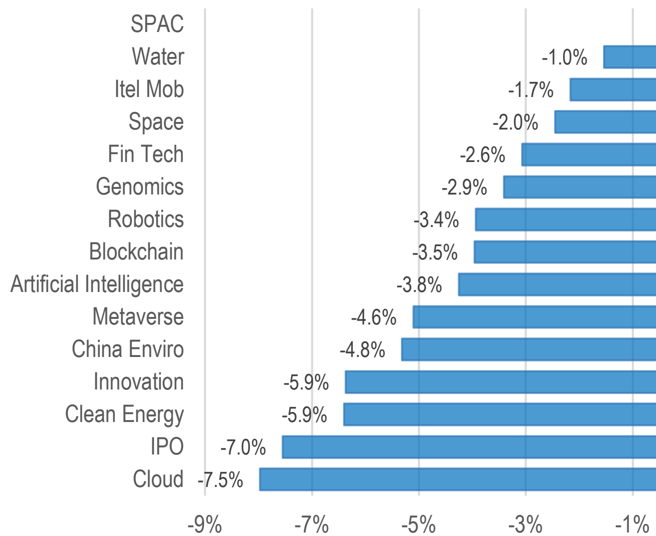
January 2, 2020 (Gold) and Current (Blue) Projected PE Ratios



Themes

All theme areas were lower on the week. Nothing dramatic can be cited as the cause, only a risk-off attitude.

Theme Returns
July 11 - 15, 2022



Conclusion

That's it for this *Weekeder.* But one last thought to consider. When one reaches a certain age, a restful full-night of sleep becomes illusive. To fill the sleepless moments, my wife and I regularly watch inspirational talks. This week we listed to a graduation speech given at a Franciscan university. At the end of the speech, the speaker shared a comment Mother Teresa made to her biographer, Navin Chawla. The simple quote has been gnawing at me all week. Do with it as you will. "We are called upon not to be successful, but to be faithful."

Have a great week