Carrying the Water

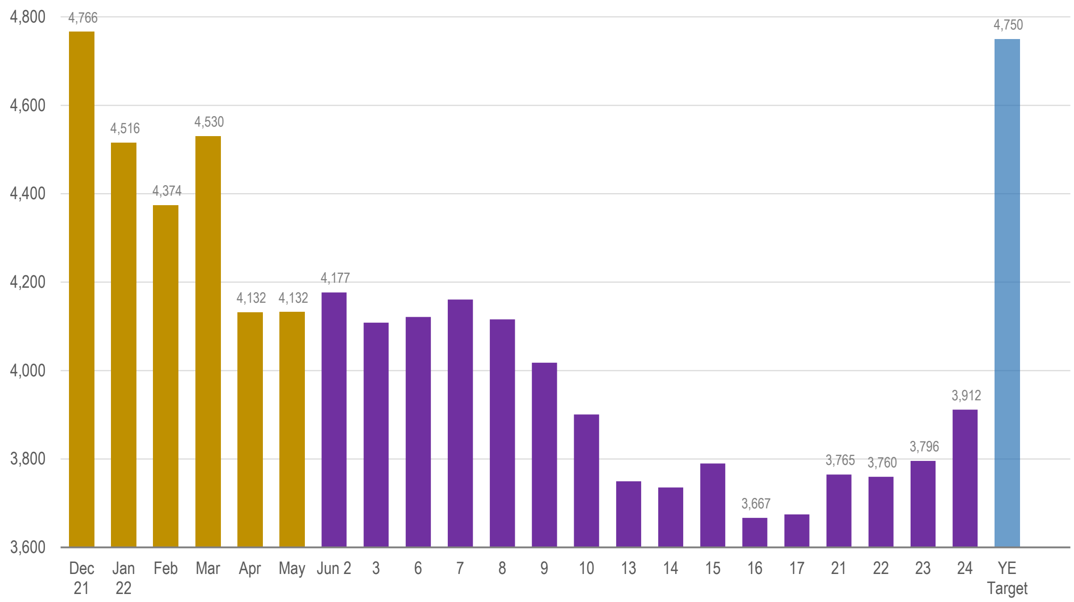
Weekender

June 25, 2022

Good morning and welcome to the weekender for Saturday, June 25, 2022. It was a holiday-shortened week with markets closed Monday for Juneteenth. US equity markets, as measured by the S&P 500, were higher by 6.4%. An admirable performance.

S&P 500 Daily Levels

December 2021 - June 24, 2022



Testifying before congress, Federal Reserve Chair, Jerome Powell, confessed that navigating the US economy to a soft landing was going to be "very challenging". His testimony was actually good for the market. Investors were overly pessimistic about higher inflation and interest rates. As part of Powell's message to the US Congress, he stressed that the Fed is committed to returning inflation to the Fed's 2% target as quickly as reasonable. Such an outcome will require copious amounts of luck and pain. Most certainly one will give way to the other.

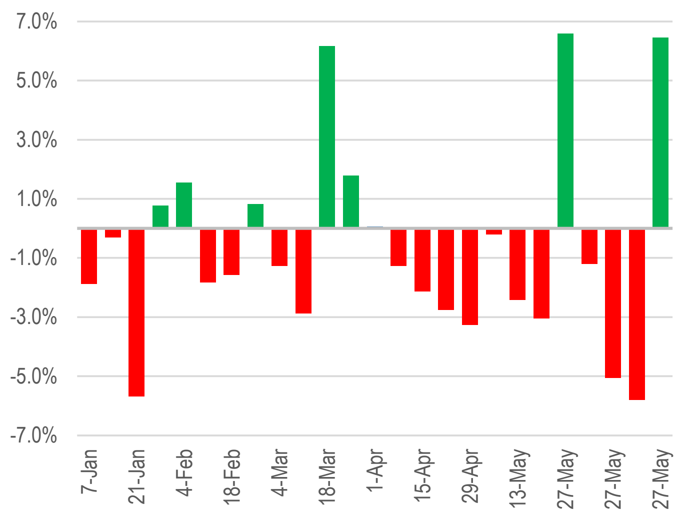
Bank of America reported that their private investment clients were holding 12.6% of their total assets in cash. Institutional investors are likewise flush with cash and last week they deployed a large chunk of sidelined cash into equity markets, which was part of the reason for this week's gains. In addition, as we close in on a gut-wrenching second quarter and first half of 2022, a lot of money managers are rebalancing their portfolios to keep in line with their performance benchmarks.

As we mentioned in last week's Weekender, we believe inflation is peaking, the economy is sputtering, and valuations on some investment instruments are just too attractive to ignore creating once-in-a-decade buying opportunities. We expect the energy sector to yield market leadership to sectors that have been heavily discounted, like semiconductors, some technology, and automobiles.

Looking at weekly returns since the beginning of the year, it seems like markets needed a little relief from the weekly drubbing they had been receiving. But its worth noting the even though there has been a strong downward bias to the S&P 500, when there is a positive week, it tends to be dramatic.

S&P 500 Weekly Returns

January 7 - June 24, 2022

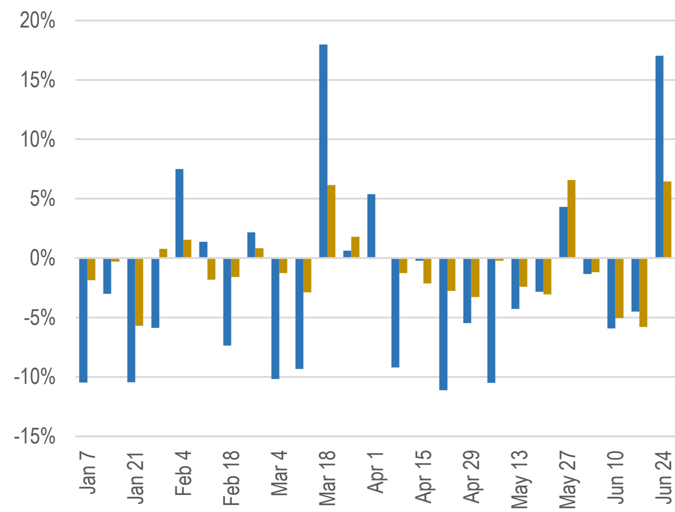


In the next column is a graph of the weekly returns, in percent, for the S&P 500, the gold bars, and a subset that includes only companies that are unprofitable, the blue line. Over the last week, king to the high-risk idea companies that have suffered so much from the beginning of the year.

We believe it is important to not read too much into the broader market from last week's advance. While last week's gains certainly showed the signs of bottom feeding in key areas. It was also characterized by a degree of defensive positioning as commodity prices declined. Earnings estimates began to fall this week. But its only the first inning.

S&P 500 Weekly Returns (Gold) and Losers (Blue)

January 2, 2019 - June 24, 2022

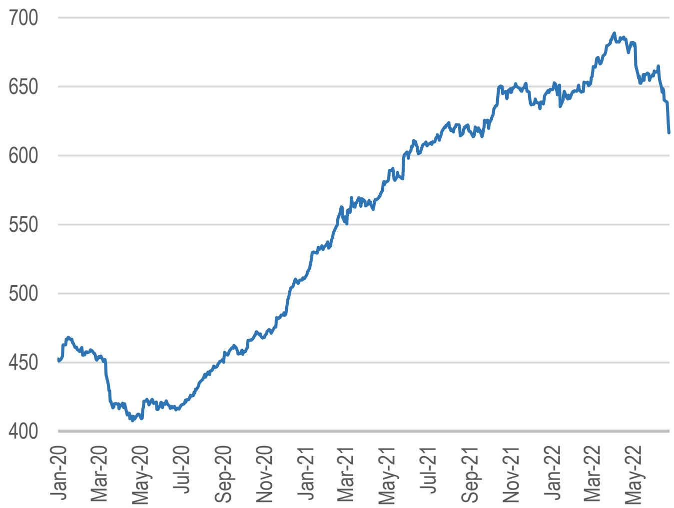


Market Narrative

The footpath to recession crosses stagflation on its way. We are currently experiencing stagflation which will transition to a full recession when product shortages give way to product surplus. How will we know when we get there? Look no further than your local recreational vehicle lot. It's probably stuffed full. Thor Industries, a large producer of multiple lines of RVs, announced record earnings and a terrible forward outlook. We expect this type of bipolar result to be common in second quarter earnings releases and prevalent in those of the third quarter.

We have been discussing the idea that inflation is doing a lot of the heavy lifting for the Fed by constraining demand and slowing the economy. We believe inflation is peaking. This will create a fog of uncertainty giving the Fed a chance to step off their hardline approach to raising rates by last quarter of 2022. Higher mortgage rates are clobbering the housing markets already. More rate hikes will roll it over completely. But don't expect any significant financial system damage. The labor market, although tight, is beginning to soften and layoffs will emerge as a dominant mantra by corporations by the end of the year, shifting the balance of power back to employers. Commodity markets, still high from their pre-pandemic levels, are falling hard from their peaks.

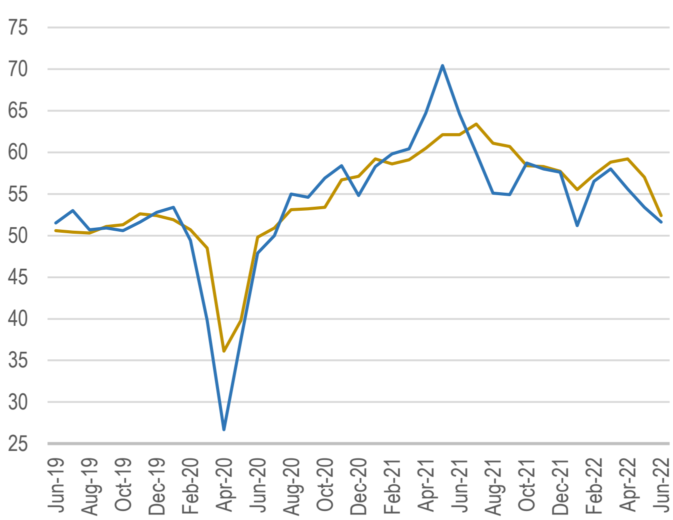
CRB Raw Commodity Index
January 2, 2020 - June 24, 2022



The Purchasing Manger's Index, PMI, which is a remarkably good indicator of recession, measures the health of an economy. US PMI data undershot estimates, suggesting the economy is softening faster than expected. PMI readings above 50 are indicative of an economy that is growing while prints below 50 suggest contraction.

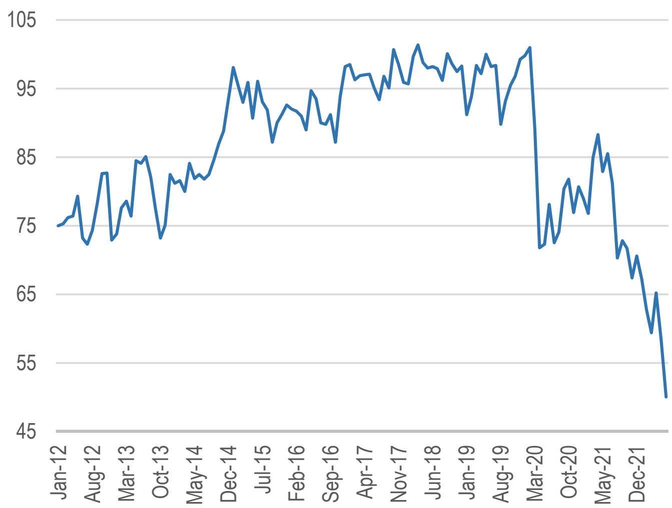
Both the services (blue) and manufacturing (gold) PMIs in the US are falling rapidly as inventories are rebuilt and proximate demand satisfied. A combination of PMI data, regional manufacturing results, industrial production, leading index, and consumer sentiment confirm that global economies are softening. Europe is farthest down the recession path, followed by the US. Asia could miss a recession all together, but it will be close.

US PMI Services (Blue) and Manufacturing (Gold)
January 2019 - June 2022



Speaking of consumer sentiment. The final readings for June were released and data came in as we telegraphed a few weeks ago. Sentiment hit an all-time low. Factors driving sentiment lower are myriad. Wage gains are half the rate of inflation. The wealth effect, driven mostly by the stock market and housing, stalled early this year and is now moving in reverse. Political divides continue to make the future less certain. None of these issues are facing a likely remedy. If the labor market stalls, as we expect, all these factors together will form an incredible headwind for consumption.

Consumer Sentiment
January 2012 - June 2022



During the past decade's artificially low interest rate, the fixed income market has been an unreliable signal. Those days may be ending. As rates are permitted to find their own levels sans overt government pressure, they are telling an interesting story. We believe as the Fed is necessarily distracted by their inflation fight, the fixed income market's role as economic oracle will again be useful.

This is a graph of the US Government 10-Year bond yield, the blue line, and the forward dividend yield of the S&P 500. In a hunt for yield, equity is no longer an option. After a decade of worthless government bond yields, where equity was the only reasonable investment vehicle, the bond is back.

US 10-Year Bond Yield (Blue) and S&P 500 Dividend Yield (Gold)

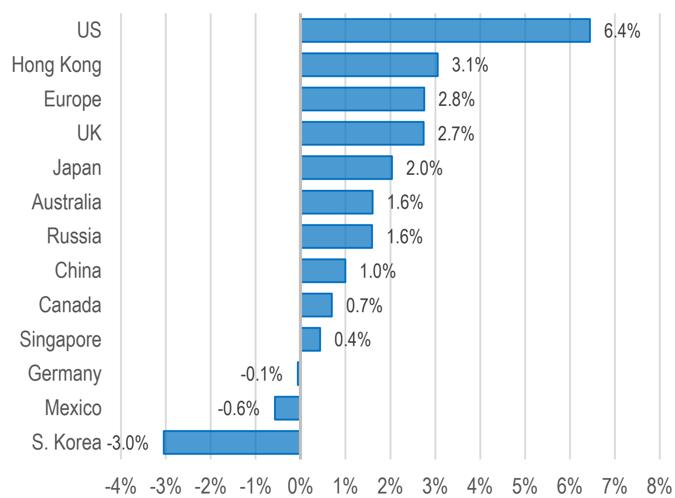
January 2, 2019 - June 24, 2022

Countries

Among countries, the United States was the best performer. This highlights the dominant investment narrative of the week. Areas that were the most beaten up were the best performers, and vice versa. For example, US growth and technology names and indices have been the worst performers on a year-to-date basis. Last week they were the stars. Most globally investable markets were higher.

Country Returns

June 20 - 24, 2022

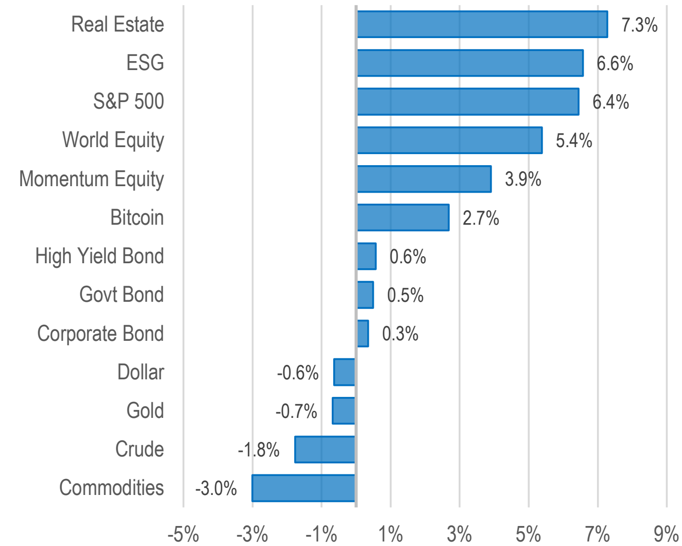


Instruments

Commodities were the worst performing investment instrument. Heightened recession fears and related demand destruction played into the emerging narrative that world product markets may shift from shortage to surplus fairly soon which would loosen up raw commodity demand.

Instrument Returns

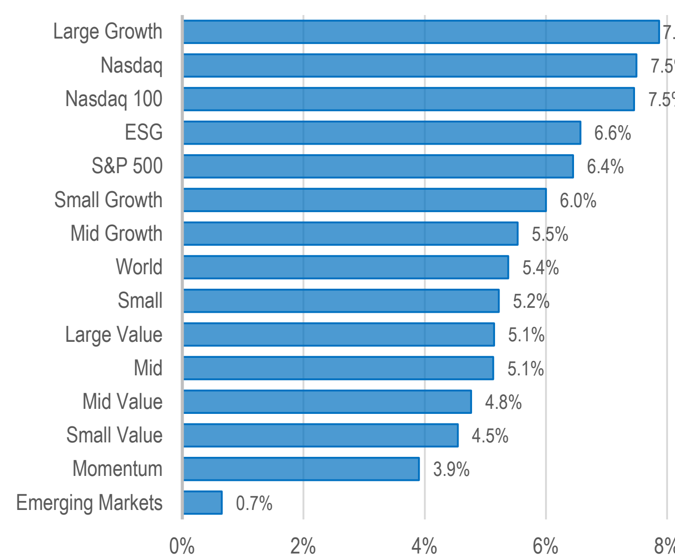
June 20 - 24, 2022



Real estate was the best performing instrument as mortgage rates fell on the back of a general loosening across the interest rate complex. Now that a recession seems a foregone conclusion, markets are looking forward a period when inflation and interest rates will be falling. Bonds were only marginally higher as rates softened a bit.

Equity Instrument Returns

June 20 - 24, 2022



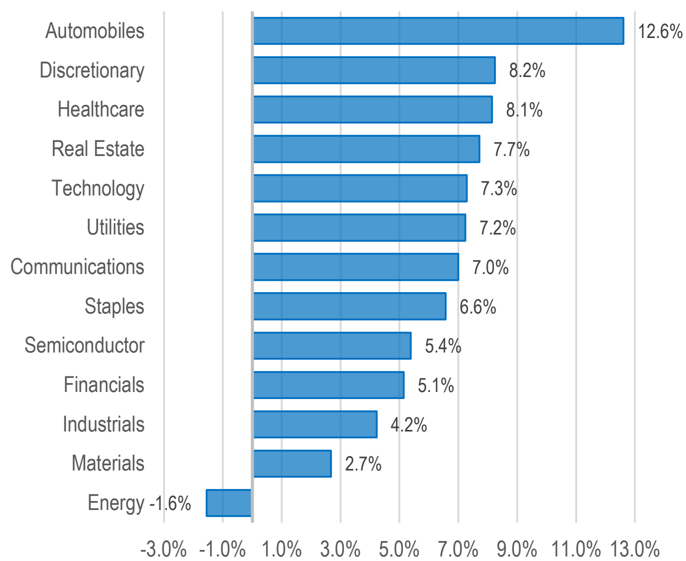
Among equity instruments, more specifically, markets were driven by the rebound in large growth names and technology.

Sectors

Energy was the only sector lower, in sympathy to lower crude oil prices. Crude oil fell with most other commodities as talk of recessionary demand destruction predestines a loosening of the tight supply dynamic that has been driving prices higher.

Automobiles were the best performer among sectors. Most of that was driven by a recovery in Tesla shares. Risk sectors rose with protective sectors.

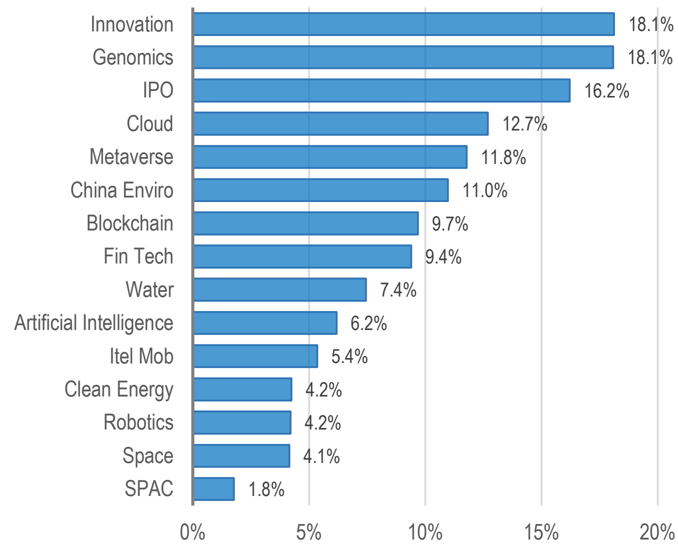
Sector Returns
June 20 - 24, 2022



Themes

Cathie Wood had her week in markets. Two themes for which her funds are a proxy led the leader board, innovation and genomics.

Theme Returns
June 20 - 24, 2022



Conclusion

That's it for this weekender. Next week we will not have a Weekender in honor of the US Independence Day holiday on July 4. The weekender following, published on July 9, will be a bit long and will focus on charting the path to and through a pending recession.

Have a great week.