Risk-On

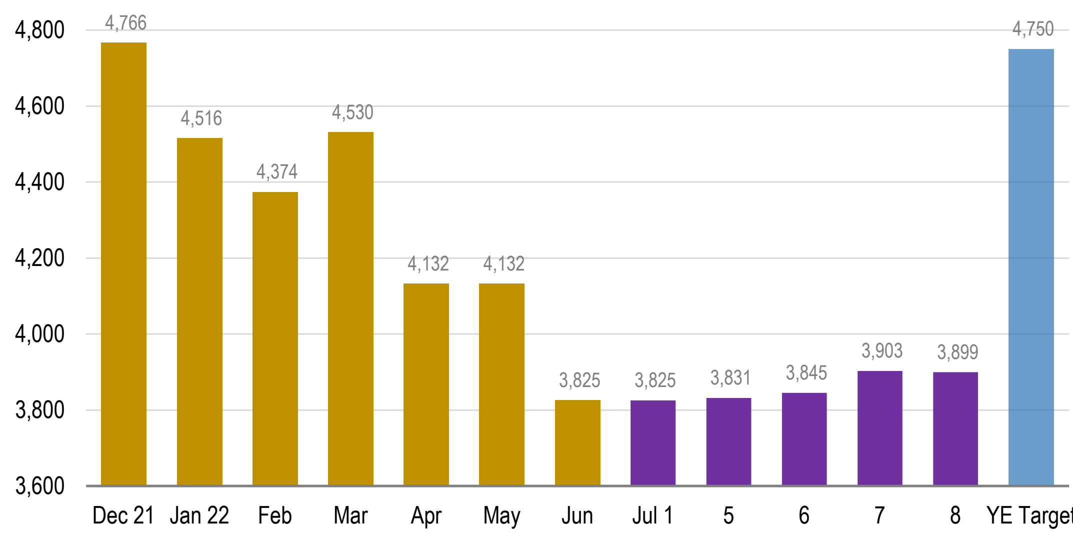
Weekender

July 8, 2022

Good morning and welcome to the Weekender for Saturday, July 8, 2022. For the week, US equity markets, as measured by the S&P 500, were higher by 1.9%. In general, it was a week characterized by the re-emergence of a risk-on mentality. The positive side of recession, lower rates in the future, was the dominant narrative driving the positive week. More broadly, 2022's equity and bond market declines are being driven by a surge in interest rates as central banks around the world take a whack at the worst inflation in forty years. But if inflation comes in line, the Fed will need to shift its stance from contraction to accommodation fairly quickly. This perspective drove the market higher this week.

S&P 500 Daily Levels

December 2021 - July 8, 2022



Economists, analysts, and market pundits constantly look back through history in search of similar periods from which to draw useful insights and accurate predictions. The current economic environment has no historical precedent. None.

Current inflation is driven by a cascade of foolish fiscal and monetary responses to pandemic-related economic shutdowns. In hindsight, policy makers did not understand the economy well enough to provide a surgical response to pandemic-related economic phenomena. Instead of a scalpel, bureaucrats used a bevy of blunt macro instruments that brought with them unintended yet foreseeable consequences. We are now left with an economy desperately searching for a new equilibrium.

On the positive side, the US economy has a robust labor market which creates a floor on demand in the face of economic uncertainty. Supply-driven shortages create a floor on prices for many goods. Unable to solve the supply-related shortages due to global supply chain problems, policy makers are working to slow demand by raising interest rates. Government stimulus payments, which were a primary cause of the inflationary problems, have dried up. So all we need to do is allow the economy to recalibrate and find its center. A different center than before the pandemic.

As a salve for future inflation, commodity prices are falling, although still higher than where they were a year ago, which will keep inflation at front of mind for a year or so. But a year from now year-to-date inflation comparisons are more likely to be negative than positive. Wholesale inventories continue to build to unprecedented levels, suggesting shortage will shortly turn to surplus. A sellers-market will yield to a buyer's advantage. The Fed is keenly aware of this but is trapped by the magnitude of their error at being far too late to take up the cause of inflation. The net effect will likely be a couple more rate hikes, followed by a period of data gathering and reflection. In the first quarter of next year rates will begin to fall.

Higher rates through the end of this year will certainly slow the economy. Higher mortgage rates have already begun slowing the residential real estate market to a crawl. Autos would also be in decline if there were any new cars available. But beyond products that usually require credit for purchases, higher interest rates have only marginal direct effect on consumption.

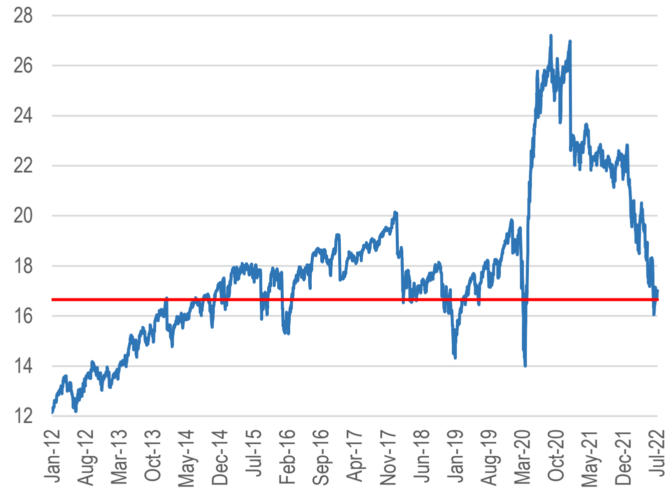
Market Narrative

US stocks posted their worst first-half of a year since 1970. On a year-to-date basis, the S&P 500 is lower by 18.2%. Normally, such a powerful drop is precipitated by something dramatic. A recession, for example. Not this time. Instead, equity markets have had their worst first-half performance in fifty years because government-sponsored inflation forced markets to give back the ill-gotten gains of the pandemic.

Removing the pandemic excess from the calculation, the average forward PE ratio for the S&P 500 over the period from January 2, 2012 – January 2, 2020 was 16.7 (the red line). It seems reasonable that in 2022, the S&P 500 has done nothing more than give up the pandemic era froth. On a valuation basis, using forward PE ratios, it's back to trend.

S&P 500 Projected PE Ratio

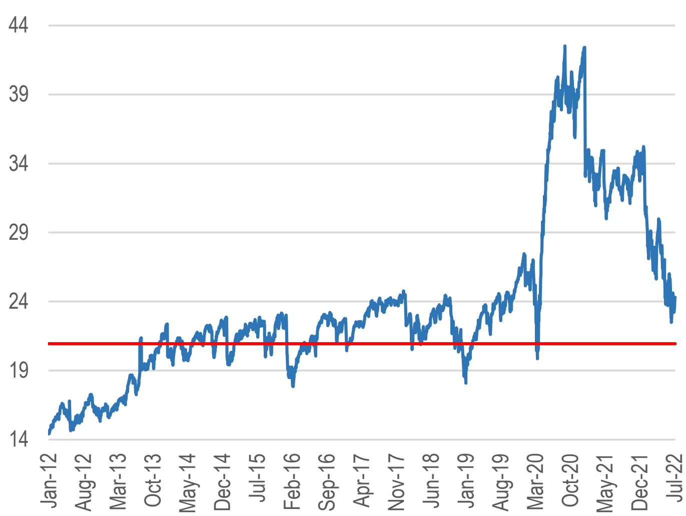
January 2, 2012 - July 8, 2022



Looking at the tech-heavy Nasdaq, a similar analysis suggests its valuation is still above its pre-pandemic average, if only by a little. For the tech sector, this may be a particular problem since higher interest rates tend to affect technology shares more than others.

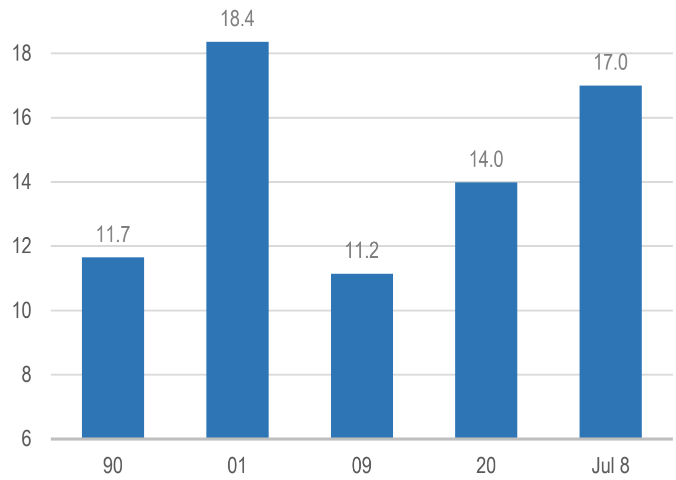
NASDAQ Projected PE Ratios

January 2, 2012 - July 8, 2022



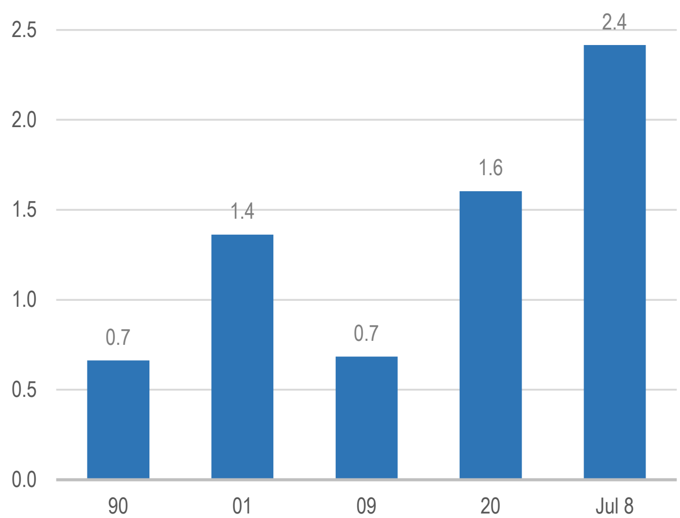
When comparing the projected PE ratios at the market bottoms of the last few recessions, current equity valuations seem stretched.

Projected PE Ratios at Market Bottoms
Recession Years on X-Axis



More worrying is the comparison of price-to-sales ratios for the same periods. Current equities seem significantly more dear. The difference? Companies with negative earnings fall out of the PE calculations but not price-to-sales. There are significantly more money losing companies in the market during this potential recession than during any other period.

Projected Price-to-Sales Ratio at Market Bottoms
Recession Years on X-Axis



A series of reliable talisman suggest Europe is in and the United States is approaching a degree of economic contraction. By historical comparison, corporate profits typically fall by 25% during recession. Current profit estimates for next year suggest profit growth of 10.4%. Not contraction. An unusually strong labor market in the United States may suggest we are in for a mild recession instead of a deep one. If so, the requisite reduction in earnings may be shallower than during a typical recession. But it won't be 10.4% growth.

We believe that a reduction in earnings is not being discounted by financial markets but should be. Consequently, we continue to believe investors should focus on strong balance sheets, pricing power, and unit sale growth.

While last week was full of economic data, there was more smoke than fire. Factory orders came in much stronger than expected and caused a bit of confusion given the economic contraction suggested by last week's PMI data. Weekly mortgage applications continued to fall as higher interest rates secured the lid on a hot housing market. Another version of PMI data, this set from Standard and Poor's, showed a US economy stronger than previously expected. These data conflicted somewhat with the Institute of Supply Management's PMI data release last week.

From the labor market data all lights are green and that's not necessarily a good thing. Job openings are plentiful and companies are hiring. The Federal Reserve released its meeting minutes where they suggested a readiness to do whatever it takes to combat inflation. As mentioned before, up to this point, inflation has been doing a lot of the demand destruction work for the Fed. But with a labor market that continues to strengthen in the face of inflation-related demand destruction, the Fed may be forced to push harder than they expected or wanted.

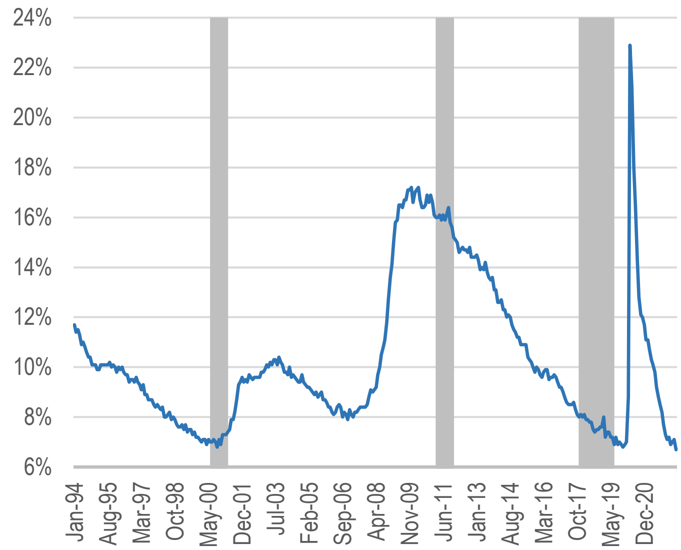
Our view continues to be that the Fed will push hard with higher target interest rates and a shrinking balance sheet. In doing so, they are likely to break something, pushing the economy into a mild recession. A strong labor market where job openings outnumber the unemployed by double implies any pending recession will not be catastrophic for either the economy or the markets. Our view could be upset by a policy mistake. The Fed was late to the inflation party. If they are late lowering rates once inflation has been tamed, our view of the future may change.

US payroll data was released Friday for the month of June. The number of jobs added, 372,000, in the month of June was far higher than most economists expected, suggesting the US labor market remains strong, despite widespread talk about a looming economic recession. Unpacking the headline jobs number provides better insight.

The labor force participation rate, which measures the percent of the potential labor force that is actively employed or looking for work, fell slightly. That's abnormal. Usually a robust add in jobs would push sidelined workers into the labor force resulting in an increase in the participation rate.

A broader measure of employment, called U6, which measures those that are unemployed, part-time, and marginally attached to the labor market, fell to 6.7%. The lowest reading since data began to be collected.

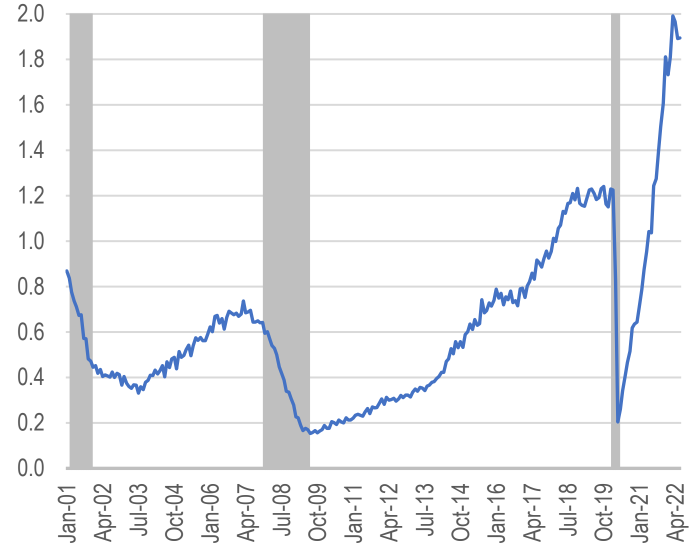
U-6 Unemployement Rate
January 1994 - June 2022



As partial confirmation of a tight labor market, the number of job openings, continues to outstrip the number of unemployed in the United States by a large margin. In fact, the ratio of job openings to the number of unemployed is close to its highest level on record and much higher than any previous periods when the US economy was at full employment.

Another data point deep within the employment report is wages. In the June labor report, wages increased by 5.1% compared to last year, a drop from May's 5.3% print which suggests wage inflation has peaked. In May, the consumer price index rose aby 8.6% suggesting consumers are losing spending power. CPI data for the month of June will be released next week.

Job Openings / Number of Unemployed
January 2001 - June 2022

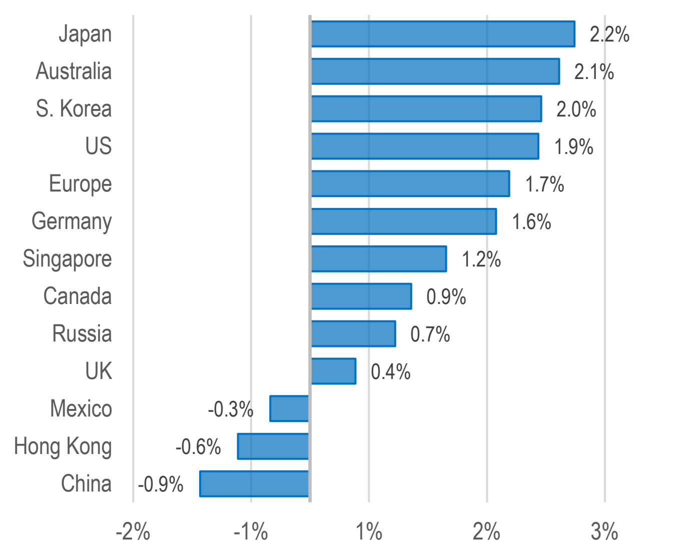


Countries

Among countries, Japan was the best performer. Equity market rallies were fairly broad-based on the back of a precipitous fall in oil prices, which by the end of Friday trading were at $104.79 per barrel.

From an economic standpoint, Europe seems destined for a powerful recession. US economic growth will certainly slow to an extent that it will feel like a recession. However, given the strength of the labor market it's possible that a "recession" label is never applied. Consequently, we believe it's more useful to focus on numbers than labels.

Country Returns
July 5 - 8, 2022

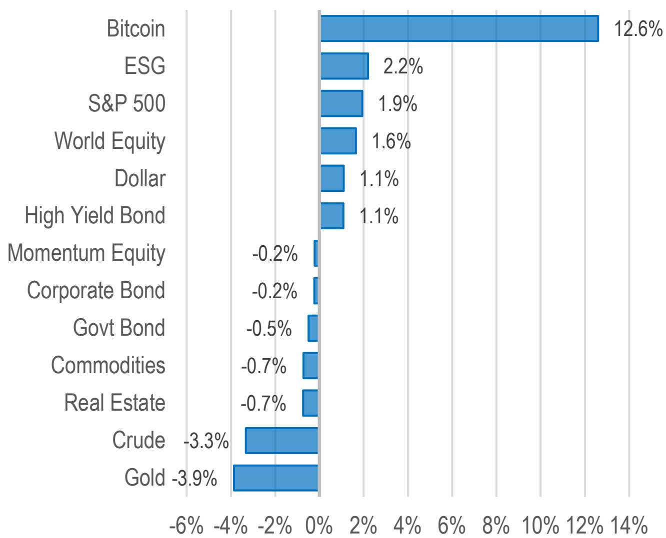


Instruments

Nothing says "risk on" more than Bitcoin. The cryptocurrency was higher by 12.6% last week. A rise that many believe is nothing more than a dead cat bounce. Crypto system failures chronicled over the past few months have caused some true believers to doubt their faith. Regulators have also taken notice. We expect a comprehensive regulatory proposal for cryptocurrencies to be drafted by the end of 2022. Central to this proposal will be a categorization of cryptocurrencies as a security and not a currency. This will result in constraints on creation, selling, and management of all cryptocurrencies in the United States. It will also require a benchmark of value to be established. Prepare for a terrestrial landing for all cryptos soon.

Instrument Returns

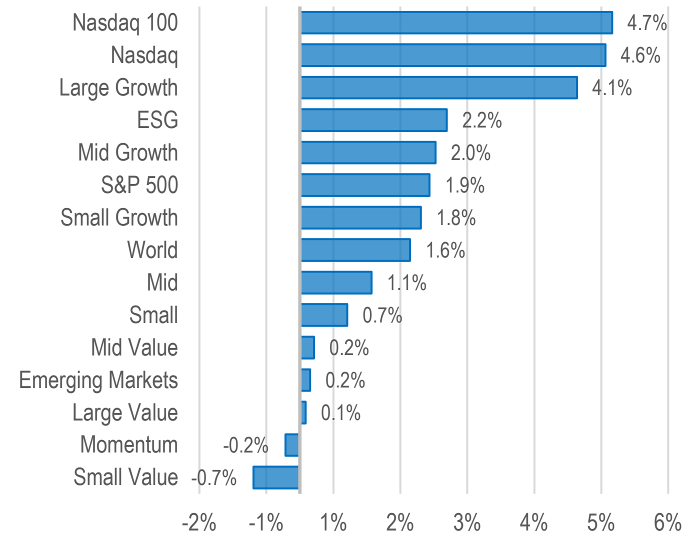
July 5 - 8, 2022



In a sign of the pervasive risk-on gains over the week, the best performing equity instruments were the highest risk, namely large capitalization technology and growth. The worst performers were value. Interestingly, momentum, usually associated with growth stocks was a poor performer. This is because the stocks that qualify as momentum stocks change as market drivers and momentum itself changes. At the beginning of the year, many momentum ETFs swapped technology for financials. Financials have underperformed. So goes momentum.

Equity Instrument Returns

July 5 - 8, 2022

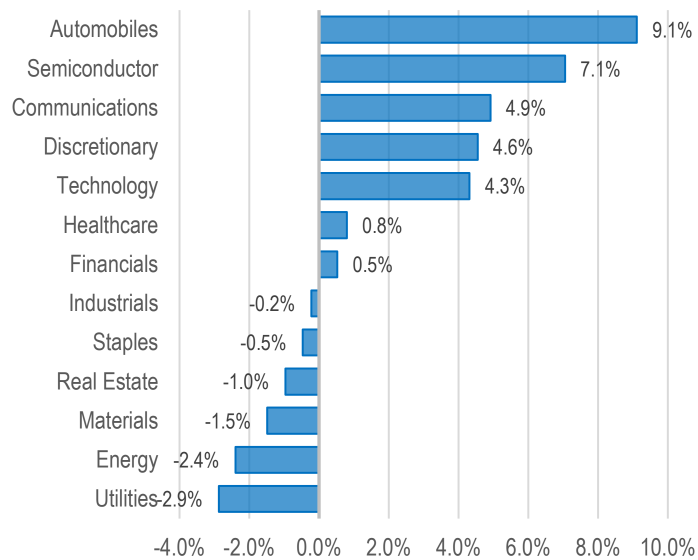


Sectors

Sector returns showed the same risk-on behavior exhibited by the broader markets.

Sector Returns

July 5 - 8, 2022



Automobiles were the best performing sector over the week. Tesla was higher, despite disappointing sales data and announcements that it would idle some of its manufacturing plants in Germany, China, and the US as sales growth slows and components continue to be scarce. Even so, Tesla remains the largest electric car producer in the world. In the second quarter, Tesla delivered 254,695 cars, lower by 18% from the first quarter, although higher by 26.5% compared to a year ago. In the first half, Tesla produced 564,743 electric vehicles.

Looking abroad, BYD, a Chinese auto producer backed by Warren Buffet's Berkshire Hathaway, produced 638,157 vehicles. But only half of them were fully electric. The other half were hybrid. Even so, domestic brands are gaining an edge over foreign manufacturers in China's EV world. Chinese brands account for 79% of EV sales in the Middle Kingdom, so far, in 2022. A similar phenomena is likely to emerge in Europe.

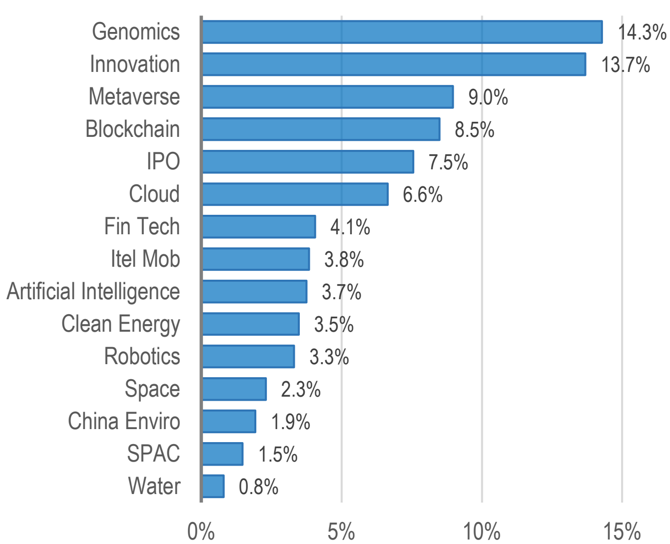
Meanwhile, Tesla announced that it will allow non-Tesla vehicles access to its supercharger network in the US by the end of the year. The decision to open their network, long considered a competitive advantage for Tesla, was driven by the White House. Biden's infrastructure plan opens up $5 billion in funding for national EV infrastructure. The company opened its European supercharger network in 2021 for the same reason.

While the EV data is interesting, it's not particularly critical at the moment because it's impossible to actually buy an EV. Supply chains continue to be constrained and demand for EVs is significantly outstripping availability.

Themes

Risk-on environments are catnip to investment themes. Theme gains were indicative of a week where companies that lose money rose by 10.1% while the S&P 500 was higher by 1.9%.

Theme Returns
July 5 - 8, 2022



Conclusion

That's it for this weekender. Next week we will publish the Weekender in two formats, print and video. We will also publish our House View for the second half of 2022 and 2023.

Have a great week.