

# EQUITY MARKET UPDATE

As of 06/30/22 | Volume 11, Issue 6 | FFTAM.com

Stocks plunged in June. There was nowhere to hide as all economic sectors fell. The four factors influencing the economy and the market—COVID-19, the war in Ukraine, inflation, and the Fed’s response to inflation—remained firmly in place. A hotter than expected inflation report, along with a 0.75% interest rate hike from the Fed, worried traders about the possibility of an upcoming recession. Economic data showed the US economy remains on firm footing although momentum is slipping. With growth concerns running rampant, investors will turn their attention to upcoming earnings releases to check the pulse of corporate executives.

## US Stocks Suffer Worst 1<sup>st</sup> Half Period Since 1970

The S&P 500 fell 8.39% in June. Losses were widespread as all 11 economic sectors declined in value. Another sign of the deep selling was no single company accounted for more than 4% of the drawdown. Energy was the biggest loser in June (-16.91%), followed by materials (-13.84%) and financials (-10.90%). The best performing areas were staples (-2.50%), healthcare (-2.66%), and utilities (-4.98%). These numbers are symbolic of investors pricing-in the possibility of an upcoming recession. In 2022, the S&P 500 is down 19.97% with only energy experiencing a positive return. Volatility has been high all year with the index losing 2% or more on 14 separate trading days.

The Dow Jones Industrial Average dropped 6.71% for the month. A higher allocation to staples and big pharma aided results versus the S&P 500. The Dow also has a lower allocation to technology. Year-to-date, the Dow is down 15.31%.

The NASDAQ sank another 8.71% in June. The index was crushed as investors continue to flee from companies that are unprofitable and poorly capitalized. The index has fallen every month except February so far in 2022. Year-to-date, the NASDAQ is the worst performing major index with a total return of -29.51% as investors shy away from high valuation companies as interest rates rise. The index has also been hurt by disappointing earnings announcements from Meta Platforms, Netflix, PayPal, Alphabet, and Amazon.

Middle-to-small-sized companies fared worse than the large cap indexes last month with the S&P 400 Mid Cap Index falling 9.78%, while the S&P 600 Small Cap Index was down 8.71%. A higher allocation to financials and industrials hurt these indexes. So far in 2022, this area has slightly beaten its large cap peers with the S&P 400 Mid Cap Index dropping 19.57%, while the S&P 600 Small Cap Index is down 18.97%.

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## International Markets Fall on Inflation Concerns and China Reopens

The war in Ukraine continues to be the major source of price spikes in Europe. Inflation in the Eurozone reached a new record high of 8.6%. The acceleration came from large increases in the price of energy (+41.9%) and food (+8.9%). Core inflation that removes the effects of food and energy slipped to 3.7% from 3.8%. This marked the first decline in core inflation since January. Businesses are unable to pass along the full extent of inflation, so profits are being squeezed. For example, Germany reported producer price inflation of 33.6%, the highest since 1949. Obviously, consumer prices cannot rise that quickly without crushing demand. The inflation is pressuring economic growth. Eurozone Manufacturing PMI slipped for a fifth straight month to 52.1, while Services PMI decelerated for a second month to 53. Both readings signal expansion, but the momentum is waning.

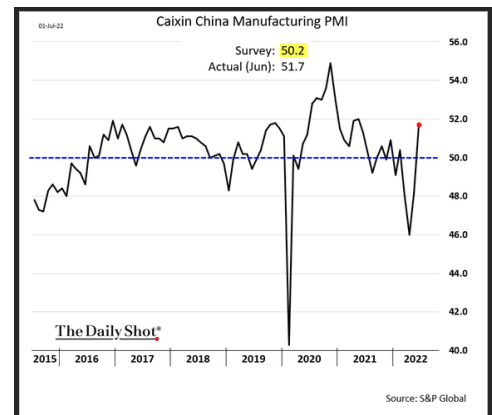
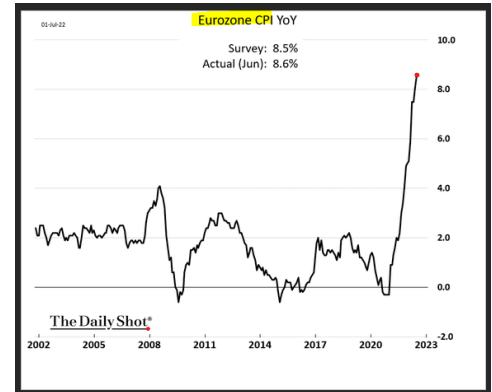
As I have discussed in the past, the European Union gets 35% of its total energy needs from Russia, so prices have skyrocketed as the region scrambles to find new sources. They have struck deals with the US, UAE, and Qatar. They are also negotiating with Canada for future LNG supplies. Unfortunately, none of these solutions provide an immediate fix, so Europeans face several years of elevated prices to wean itself off Russian energy.

Persistently high inflation has pressured the ECB to begin raising interest rates at their July 21st meeting. This will be their first interest rate hike in over a decade. They must proceed with caution since interest rate spreads between Italian and German bonds have widened. Unlike the Fed, the ECB faces the unique challenge of rate hikes disproportionately hurting highly indebted countries in Southern Europe. ECB Chairwoman Christine Lagarde said they are working on a proposal to invest the roll-off from their bond portfolio into government bonds from weaker countries to hold down spreads.

After three months of strict lockdowns to combat the spread of COVID-19, President Xi began to ease mobility restrictions. The most drastic change involved international travel. China reduced the quarantine time for incoming travelers to seven days from 14 days. This should help the airline industry in China where international flights were running at just 2% of pre-pandemic levels.

The reopening aided economic results. China's Manufacturing PMI rose by the highest amount in 13 months to 51.7. This was the first expansionary reading since February. Industrial production rose 0.7% year-over-year, while retail sales contracted by a slimmer amount (-6.7%) than the previous month. Unemployment remains a challenge hitting a new record of 6.9%. Besides the reopening, investors expect further stimulus measures from the Chinese government in coming months to reaccelerate the economy.

With many challenges facing international markets, investors continued their selling. The MSCI EAFE Index lost 9.40%, while the MSCI Emerging Markets Index fell 7.15%. Year-to-date, the two indexes are down 19.23% and 17.57%, respectively.



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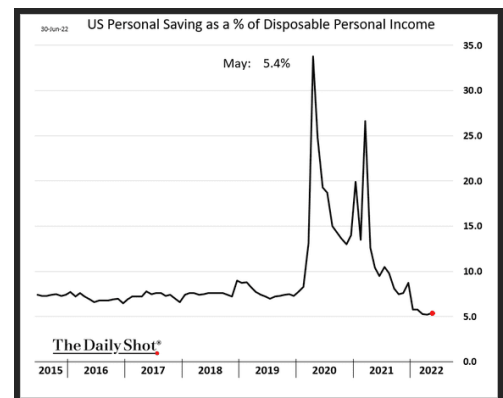
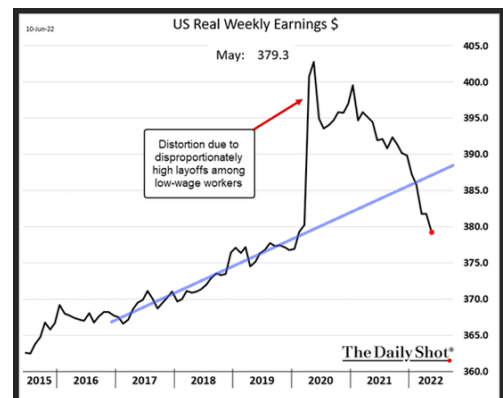
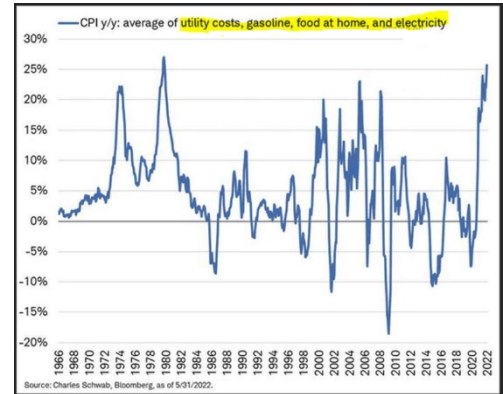
## US Economy Grows, But Momentum is Slipping

Inflation surprised to the upside with prices jumping 8.6% from one year ago, the hottest reading since December 1981. Like Europe, the biggest contributors were energy (+34.6%) and food (+11.9%), which both increased at their highest levels since 1979. Rising prices for homes and rent also worsened. Core inflation that removes food and energy prices rose by 6%, the second straight month it has eased. PCE data, the Fed's preferred measure of inflation, showed similar results with total prices climbing 6.3%, while prices ex-food and energy decelerated for a third consecutive month to 4.7%. The data presents a major challenge for the Fed. It shows that despite the strong labor market and higher wages, consumers are struggling to keep pace. Inflation adjusted income has declined in 9 of the last 10 months, while the savings rate has plunged to 5.4%, a 14-year low. Credit card balances have returned to the levels seen pre-COVID. With more of their paychecks going towards everyday essentials (food, shelter, and energy), consumers are running out of discretionary income. Consumer spending rose 0.2% last month, its smallest increase this year. Meanwhile, retail sales fell for the first time in five months. Credit and debit card usage indicated consumers have cut back on casual dining and full-service restaurants. It also showed a sharp decline in the number of visits to specialty retailers. Consumer confidence surveys are at all-time lows.

Business investment data is mixed. The ISM Manufacturing PMI slowed to 53, while new orders (49.2) contracted for the first time since 2020. Prices paid remained high with the producer price index (PPI) jumping 11% on a 12-month basis. The ISM Service PMI (55.3) was a little stronger than its manufacturing cousin. However, it has been decelerating for three months. Finally, housing starts and mortgage applications have fallen as the 30-year mortgage rate has doubled to 6% since the start of the year.

The Fed responded to the hotter than expected inflation data by raising interest rates by 0.75%, the biggest rate hike since 1994. They signaled more increases are on the way. The dot plots indicate Fed officials want interest rates to be between 3% and 3.5% by year-end. They are currently 1.75%. This is on top of their quantitative tightening program that involves shrinking the balance sheet by \$47.5 billion per month in June, July, and August with the amount doubling to \$95 billion each month starting in September. During his press conference, Chairman Powell was confronted by reporters about the possibility of recession. He said: "it is becoming more difficult to achieve a soft landing." Although a recession is not the Fed's goal, the possibility is increasing given the persistence in inflation that Mr. Powell said is largely beyond their control since it is due to lack of supply.

This put the focus back on Washington. President Biden continues to respond to higher fuel prices in contradicting ways. First, he asked Congress to suspend the federal gas tax to lower prices, which historically has led to increased consumption. He then ordered the Interior Department to cancel offshore drilling lease auctions in the Pacific and Atlantic oceans, while making it



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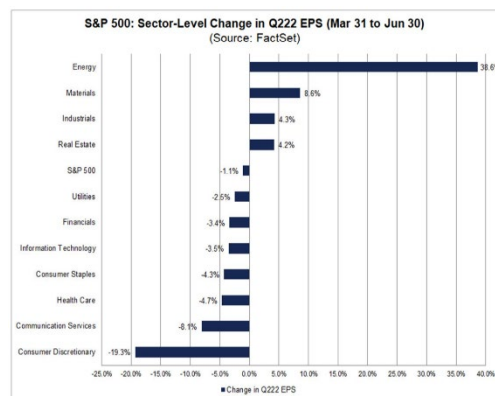
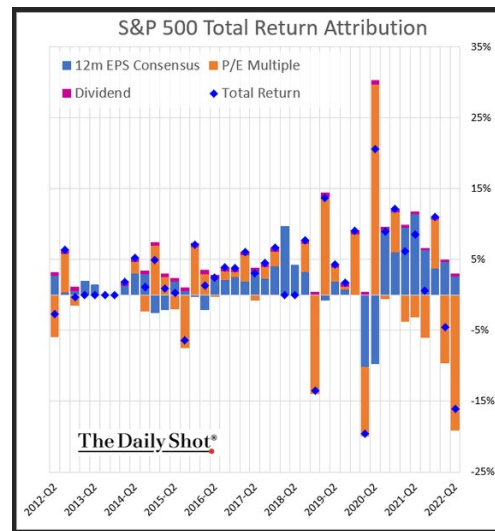
more difficult to obtain drilling permits on land that has already been leased but not developed. Meanwhile, Senate Minority Leader Mitch McConnell has threatened to prevent the bill that seeks to boost US production of semiconductors from coming to a vote unless the Democrats stop inserting components of the failed “Build Back Better” legislation into a budget reconciliation package. Senate Majority Leader Chuck Schumer has been privately negotiating with Senator Joe Manchin to pass a slimmed down version of “Build Back Better” before Congress goes on summer recess to provide a major legislative accomplishment for Democrats heading into the mid-term elections.

## Market Valuation Dives as Investors Become Skeptical of Earnings Forecasts

The recent sell-off has the S&P 500 trading at 15.88x 12-month estimated earnings. This is far below the 5-year and 10-year average multiple of 18.62x and 16.91x, respectively. It is also less than the pre-COVID PE ratio of 19.4x.

We are on the eve of another earnings season, and investors are on high alert. Wall Street expects year-over-year profit growth of 4.1% with top-line revenues advancing by 10.1%. This is far less than last quarter’s 9.2% increase in earnings, and it models a decline in operating profit margins as companies struggle to pass along the full effects of inflation. Analysts have been cutting numbers given the difficult macroeconomic environment. For example, today’s 4.1% earnings growth forecast is less than the 5.9% analysts were expecting just three months ago. Numbers have been reduced for seven sectors with the most aggressive cuts occurring within consumer discretionary, which has seen its earnings forecast chopped by 19.3% from three months ago. While analysts were decreasing profit estimates for the quarter that just concluded, they boosted their forecasts for the second half of the year. They now expect full year earnings growth of 10.2% with revenues increasing by 11.3%. These estimates are better today compared to three months ago. Investors are wary that double digit profit forecasts for the second half of the year are too aggressive, which is contributing to daily market volatility.

The market has finally gotten serious about the Fed and inflation by removing the premium valuation on stocks. Even though the current valuation appears attractive, it is based on aggressive profit growth estimates coming to fruition. The debate has intensified between economists that argue the economy is showing signs of peak growth and likely heading towards recession, while company specific analysts forecast continued prosperity for at least the next two years. This tells me three things. First, stocks are ripe for continued price volatility, especially among the higher valuation growth names. Second, the market has already priced-in the likelihood that several companies will miss earnings estimates and will guide their future numbers lower. Finally, the market is telling you if a recession occurs, it will likely be shallow and short-lived; therefore, interest rates will not return to 0%. This last point is important to keep in mind since it means we will not see PE ratios for the overall market expand back to the 20s; therefore, most of the future total return for stocks will come from earnings growth and dividends paid.



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## Our Outlook & Strategy

The biggest challenge for stocks in 2022 is central banks navigating how to remove emergency stimulus policies needed during the depths of the pandemic without significantly slowing growth. Russia's invasion of Ukraine complicates matters by pushing energy and food inflation even higher. The prospect of higher interest rates reduces the PE multiples investors are willing to assign to stocks. This places outsized stress on stocks trading at lofty valuations, especially those that cannot clear the earnings growth hurdles analysts have forecasted.

The best summary I have seen on how to navigate the upcoming environment is from Joe Zidle, Chief Investment Strategist at Blackstone. He said: "The path forward for investors will be more challenging as slower growth, higher inflation, and rising interest rates call for higher quality, greater selectivity, and a sharp focus on duration management for both equity and fixed income investors." This is historically a good environment for First Financial relative to the benchmark given our ownership of higher quality companies—those with consistent cash flows and less leverage.

We believe the recent decline presents many opportunities. Several of the companies we follow now trade at valuations only seen in the depths of recession. This is most clear when looking at the difference in valuation between defensive and economically sensitive stocks. The current disparity indicates investors believe a Fed mistake and a soon coming recession is a certainty. We believe the Fed is right to raise interest rates quickly to address inflation; however, it appears the market may be overestimating the number of rate hikes needed. Historically, stocks have bottomed when the Fed pivots from tightening interest rates to holding steady or cutting. Any indication that the Fed will not need to raise rates as high as the dot plots forecast will be viewed as a dovish signal and result in a rally for stocks, especially among cyclicals. Therefore, we are using this sell-off to invest excess cash, and we have been slowly trimming our defensive holdings in consumer staples and utilities to boost select positions in industrials and financials.

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