

MARKET UPDATE

AUGUST 19, 2022

GOOD NEWS IS GOOD NEWS AGAIN

July was a month where good news was bad news, and bad news was good news. Strong economic data meant the Fed would need to be more aggressive with the policy rate. A weak company forecast meant the Fed may be able to slow down the pace of rate hikes. But recent weeks have shown that the three main drivers of markets may all be moving in the right direction. Inflation, Recession and Earnings. Let's look at all three:

Inflation: The rate of inflation was slower than expected in July, offering some hope that inflation is cooling down. The headline CPI dropped 0.6% from its June peak, coming in +8.5% year over year annualized. While still high, it was lower than expected, driven by an 8% drop in gas prices and only 1% rise in food prices. We may have seen a peak; the next few months will tell that tale. All signs point to a 50-basis point increase in the Fed Funds Rate when they meet again September 21st.

Recession: The economy is slowing. Productivity and manufacturing are down. However, there are some relatively strong pockets as well. Small business expectations are still positive, consumer sentiment readings have been improving, the unemployment rate stands at 3.5%, matching the pre-pandemic low and wages are growing at 10%+. Whether we are in a recession, or we will be in one next year, the key is how deep and how long it lasts. With strong jobs and high confidence, a deep recession seems the less likely scenario.

Earnings: In the last update, I wrote about the market pricing in the potential for negative earnings revisions. That never materialized. The number of S&P 500 companies reporting positive earnings surprises and the magnitude continued to rise over the past few weeks. Most S&P500 constituents have reported Q2 2022 earnings, and 70% have beat estimates, in-line with the 5-year average. Looking ahead, analysts expect earnings growth of 5.8% for Q3 2022 and 6.1% for Q4 2022. This should support the current 12-month 17.5 P/E ratio valuation.

We are keenly aware that interest rates are rising, and growth is slowing. We still believe that a hard-landing or deep recession seems less likely than the other scenarios. We have added quality to the portfolios. This strategy finds companies that pair a high return-on-equity with low debt-to-equity. We are taking down the large overweight to Value as it has worked very well. The Fixed Income allocations are also changing a bit. The low-duration strategy helped to protect portfolios from price declines during the second quarter when rates backed up dramatically. These changes on the margin we believe help to position us well in multiple scenarios. Our portfolios continue to hold short duration in Fixed Income and an overweight to US equities vs. International with a focus on quality earnings and sustainable growth.



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