Second Quarter Comments

"Central Bankers know they have the super-power to rescue and save economies, but if they keep applying the accelerator, as has been the case, then the effects become pernicious and create more distortion than benefit. At some point it has to stop – say about 12 years ago. After saving the world in 2008, it might have been a better thing to let the normal business cycle resume in 2010 ".[1]

Bill Blain

"This knowledgeable audience needs no reminder that interest rates are the traffic signals of a market economy. Turn them all green, as the central bankers did for years on end, and fender benders will eventually clog the intersections"[2]

James Grant

"The notion of a central bank consistently chasing inflationary developments, running out of good policy options and, in the process, intensifying economic and financial volatility would not be uncommon in a developing country lacking institutional credibility and maturity. It is highly unusual, and particularly distressing, for the central bank that is at the center of the international monetary system."[3]

Mohamed El-Erian

"By training, if not also by temperament, [central bankers] are inclined to lay great stress on price stability, and their abhorrence of inflation is continually reinforced by contacts with one another and with like minded members of the private financial community. And yet, despite their antipathy to inflation and the powerful weapons they could wield against it, central bankers have failed so utterly in this mission in recent years. In this paradox lies the anguish of central banking."

Former Fed Chair Arthur Burns in September of 1979, and there isn't much new under the sun, apparently…

"The odds of a soft landing are pretty darn close to zero, and the reason is we're in an unprecedented environment and the Fed's overwhelming priority is inflation, inflation, inflation. Inflation is a lagging indicator and the fact they are looking for direction as to what to do for current monetary policy that works with a 12-18 month lag, that is almost a guarantee they'll overtighten and cause a recession."[4]

Stephen Kane

"As for the stock market, we have never before seen the Fed tighten policy into an official bear market. There is a first for everything and this is it. As for the economy, the bottom line is that since 1970, a 22%+

[1] The Morning Porridge, 5/24/22
[2] Presentation to the Fixed Income Analysts Society of New York 6/21/22
[3] The Bond Guru on Bloomberg, 6/15/22
[4] Stephen Kane, Co-CIO of Fixed Income, Trust Company of the West; Financial Times, 6/17/22

drawdown in the S&P 500 over a five-plus month time span has resulted in a recession "only" 100% of the time (five for five)."[5]

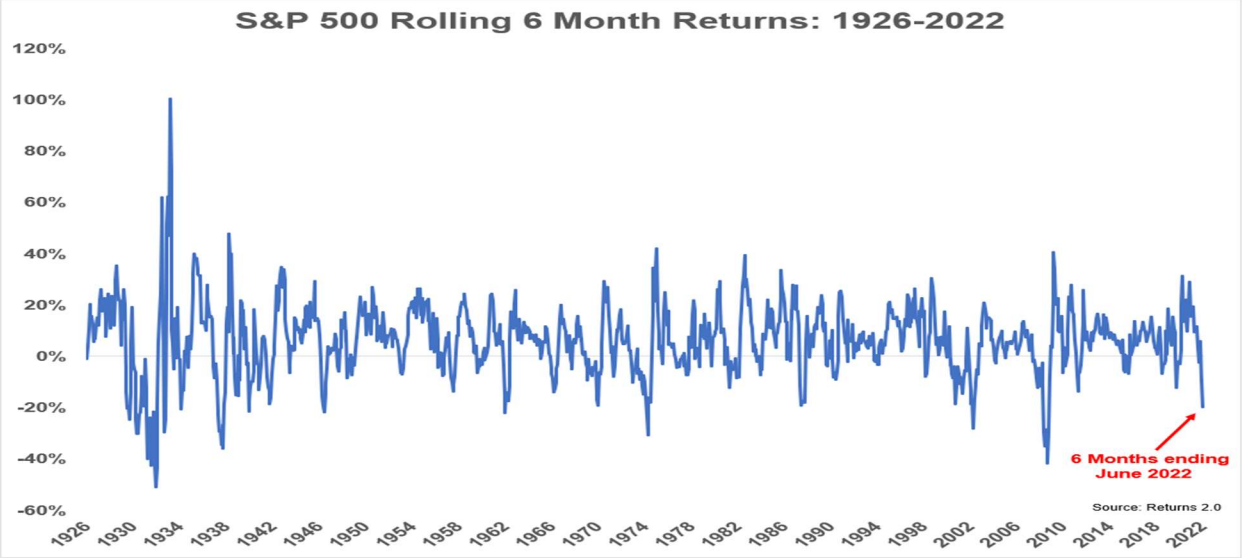
David Rosenberg

"*This is among – if not the most – complex, dynamic environments I've ever seen in my career. The confluence of shocks to the system to me is unprecedented"*[6]

John Waldron, President of Goldman Sachs

After (astounding Fun Fact) almost 40 years in investment management, I'm with John Waldron.

Reflective of all of which, and with all due respect to Dickens, and A Tale of Two Cities, for the financial markets in the second quarter, and the first half of 2022, it seemed like the worst of times. The S&P 500 stock index was off about 20% through June 30th, having bounced slightly from a 24% decline in mid-June. This represented a marked acceleration to the downside for the index, compared to the decline at March 30th of about 4.6%. The market has continued to react to a whole range of problems and concerns, chief among them the Fed which, having dawdled over addressing what to even the most casual observer was an escalating price environment, might belatedly tighten too fast and too far, sending the U.S. economy into a recession. That market reaction ranks as one of the worst performances for the S&P since 1970, and in the worst 3% of all 6- month returns since1926[7] :



…exceeded only by numbers delivered during the Great Depression, the 1937 crash, WWII, the 1970's Bear Market, the bursting of the Dotcom bubble and the Great Financial Crisis starting in 2008. All else equal, a rogue's gallery of financial disaster periods with which we'd rather not be compared!

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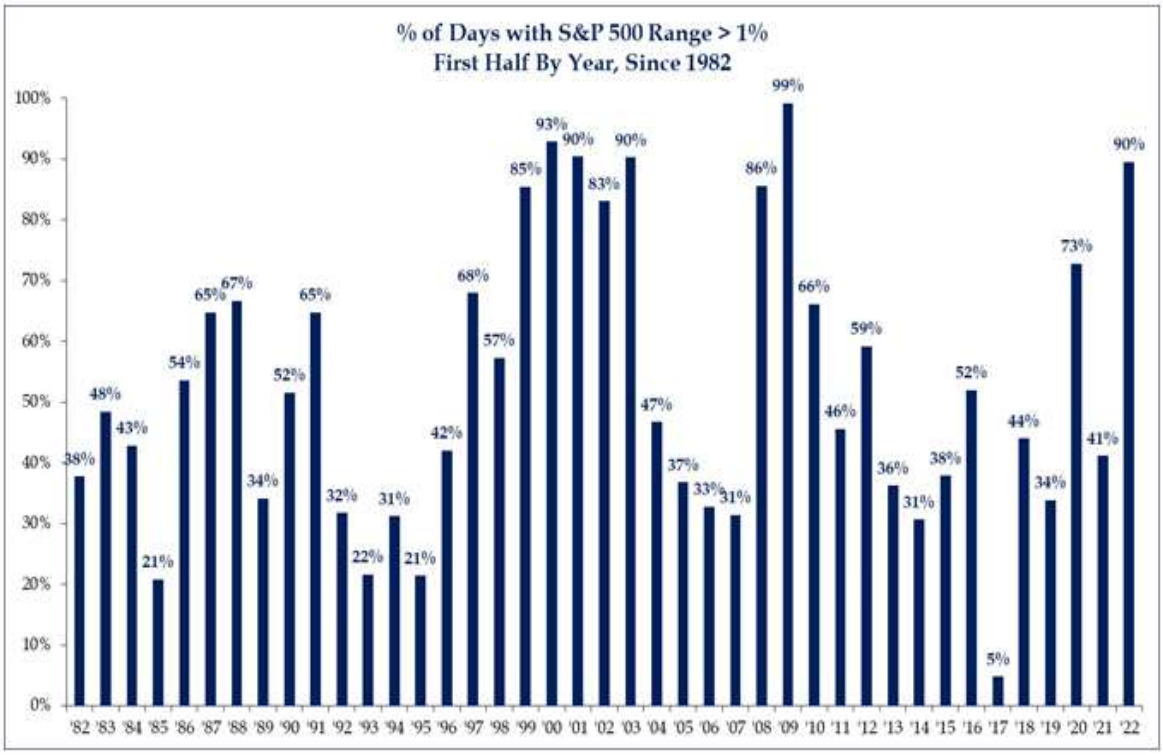
[5] Breakfast With Dave, 6/14/22
[6] Climbing on the "Unprecedented" bandwagon in a presentation to an investor conference, 6/2/22
[7] https://awealthofcommonsense.com/2022/07/the-worst-6-months-ever-for-financial-markets/

Similarly, the last six months ranks among the most volatile periods since 1982, and the most volatile since 2009[8] :



It will be observed that, beyond the S&P 500, the rout in financial assets was really quite broad, and not particularly discriminating as to type:

- The Dow Industrials Average was off about 15%
- The Tech- heavy NASDAQ was down about 29%
- Small Cap stocks, as measured by the Russell 2000 Index, were off about 24%
- The FTSE All-World ex US Index was off about 18.10%, and…
- The FTSE Emerging Market Index was off 21.5%
- Meanwhile, for good measure, since much of this action was due to fears about inflation, Fed policy, and higher rates, bonds continued to have some rough sailing too, with the most widely-followed bond index, the Bloomberg Barclay's Aggregate (intermediate term) Bond Index, off 9.93% through June 30th, while the benchmark and slightly longer-term 10 -year U.S. Treasury Bond was off about 10.6% for the same period. That's apparently the worst start of a year for bonds in 40 years.

…as in, practically no place to hide.

[8] Strategas - Daily Macro Brief, 7/1/22

For the second quarter in a row, and (updating the Strategas data in my last letter) for only the 20th quarter out of a total of 186 since 1976, both stocks and bonds declined, leaving lowly cash as the best-performing portfolio asset again.

Cries of "*Cash is Trash*!", so prevalent a year ago, don't seem to be echoing around the financial landscape as much anymore…

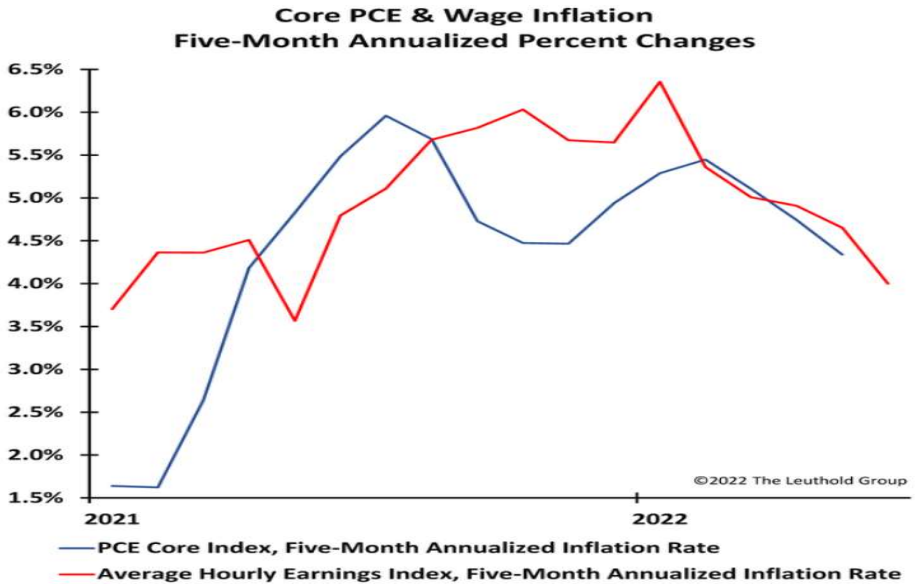
Dividend payers continued to outperform, although the relative performance there took a bit of a hit from a decline in Energy stocks (more on which below) in the second quarter. That said, a reasonable proxy for dividend-paying stocks, the Vanguard High Dividend Yield ETF, was off 8% through June 30th, so certainly still defensive enough. My old partner Elliott Farr used to quip that "*you can only get away with patting yourself on the back for delivering* a better negative number *for so long*" but Defense is what is needed in periods like these.

Inflation

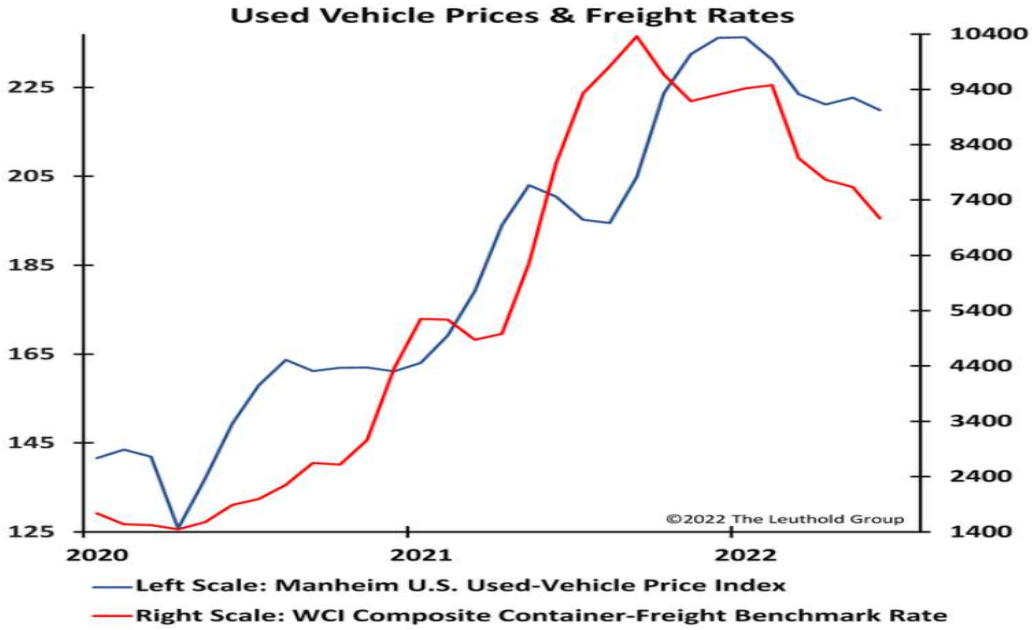
As to the inflation that seems to be responsible for much of this ruckus, the numbers have remained persistently higher, even as the Fed has finally begun to wade into the fight. In the last letter, I indicated that the Consumer Price Index for March printed at +8.5% year over year, and the Producer Price Index at +11.2%, with the Street hoping at the time that those numbers represented "peak inflation"; as of last week, the most recent readings were +9.1% and +11.3% respectively. For perspective, that compares to an average of about +1.9% for each in the decade through 2021.[9] So, the rate of change may have decelerated a little, but it's still pretty hard to see the Fed's 2% inflation target from here, and they've got their work cut out for them. That said, inflation measures are lagging indicators, and are reported with a lag too, and some of the background noise is starting to look at least a little better. Problems with supply chains generally, and China specifically, persist, and the disruptions emanating from the still ongoing Russia/Ukraine war are continuing to carom around global economies, but some cost inputs at least seem to be getting, if not better, at least less worse.

Core Personal Consumption Expenditures (PCE; "the Fed's favorite inflation indicator") and Wages are off their peaks, if certainly not back to their lows:

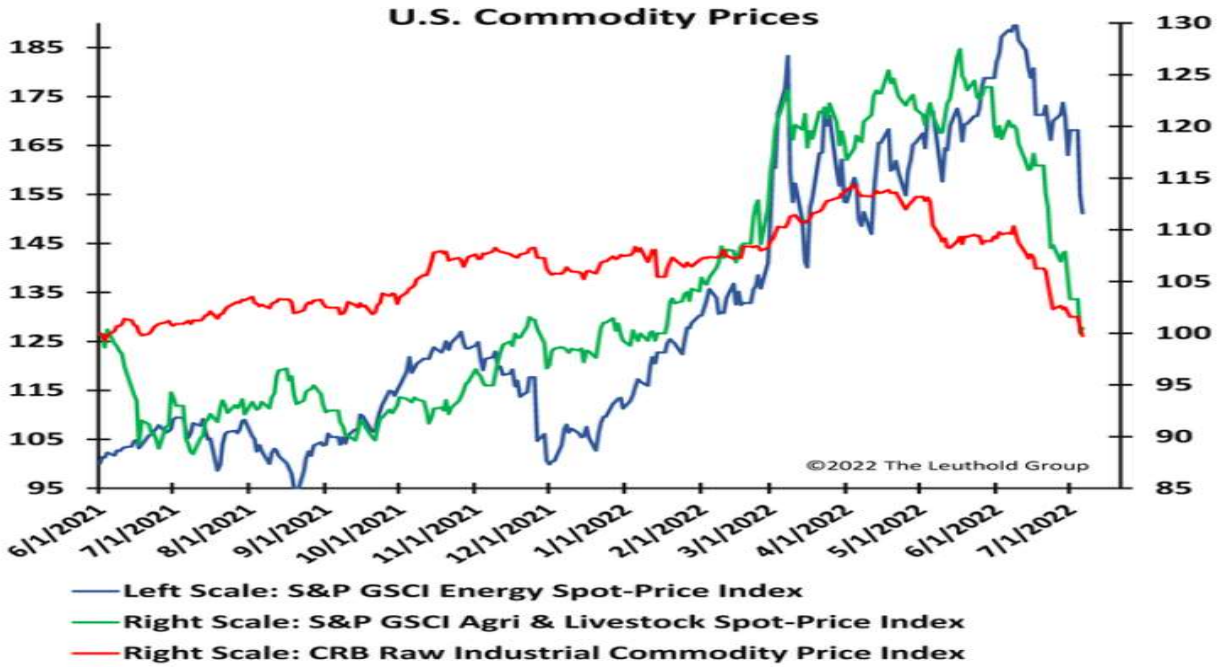
[9] Average Daily Grants, 9/26/22



…ditto Shipping Costs and Used Car Prices:



…and not least, Commodity Prices of all stripes- from Metals to Agricultural to Oil and Gas (blue line) are similarly off of the boil:



…although it remains to be seen how much of this is supply catching up with post-Covid demand, vs - demand "catching down" to supply levels. So far, "Shelter" and rent costs have remained stubbornly higher, but there's nothing like mortgage rates doubling in short order[10] to put a dent in home price appreciation. That doubling has already depressed housing demand, at any rate; existing Home Sales were off 5.4% year over year in June, vs. prior expectations of a drop of about 11%. So, it may be that we have just gone through the worst of the inflation spike, which would be welcome news at the grocery store, the gas pump, and everywhere else goods and services are purchased, both retail and wholesale. The problem is that even if the rate of inflation ceases to surge higher, there is nothing that says that it will be easily pushed lower again. Nor will the Fed be able to rest on its laurels if it manages to wrestle the CPI back to "only 5%" or the like, and then decides to call it a day. Not only is that still substantially above their 2% target, but (Non-Fun Fact Alert!) at that rate, the purchasing value of a dollar still drops by half in a little over 14 years. We therefore may be at or approaching peak inflation, but I suspect that we are nowhere near "peak Fed", and we should expect the Fed to continue to raise rates, and probably longer than the market currently expects. Absent which, they run the risk of losing whatever faith the market has left in their ability to fulfill one of their dual mandates, Price Stability…and that reputation may be more important to Chair Powell et al than the short-term market or economic risks associated with bearing down on inflation.

Energy

I spent a fair amount of time discussing Energy (as in, conventional Oil & Gas) in my last latter, so a follow-up might be in order. That sector of the market, where held in portfolios, provided outstanding relative and absolute performance not only in the first quarter of this year but also for the full year of 2021. During the most recent quarter, we seem to have hit the "pause" button, with oil prices backing

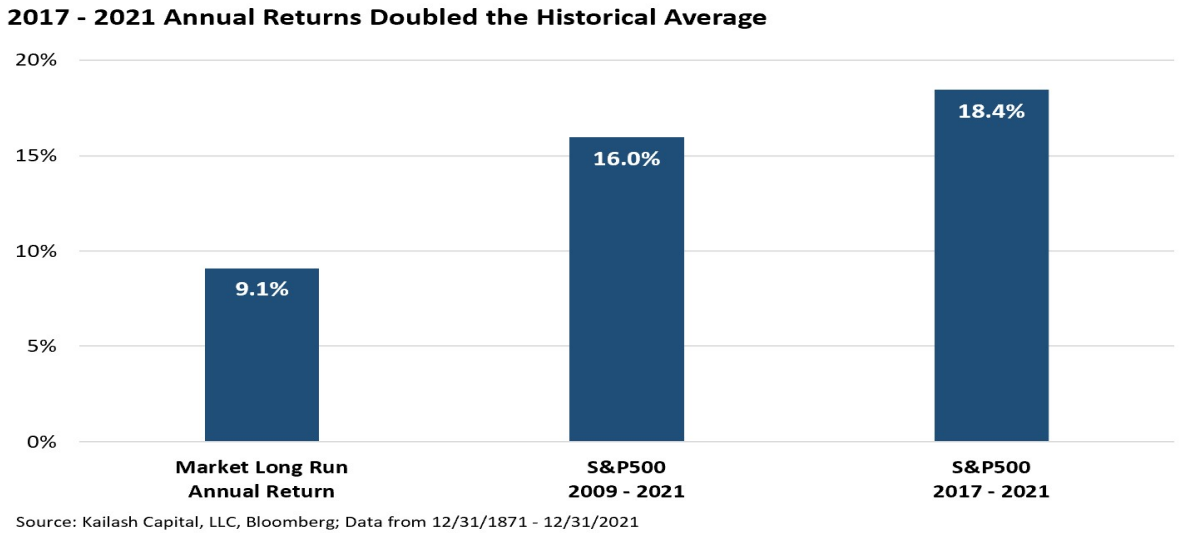
[10] (Per the St. Louis Fed, average 30-year mortgages in the U.S. have gone from 2.8% last September to 5.51% as of the last week); https://fred.stlouised.org/sewries/MORTGAGE3OUS

off from their highs (see the above commodities chart), and with associated stocks flagging a bit. There are assorted reasons why this could be in the case. One could be the strength in the dollar, as oil is traded internationally in dollars, making oil more expensive in local currencies. Another could be recession fears, and concerns that this could lead to a fall-off in demand. Yet another could simply be that, in the short run, those market traders who chase stock price "momentum" have moved on.

In the longer run, we believe that extreme international shortages, supply dislocations and demand imbalances will trigger even higher energy prices going forward…but all they need to do is stay in the current range to continue to reward holders with further share prices and dividend growth. Not a bad sector to own if we're in for an extended run of inflation either…

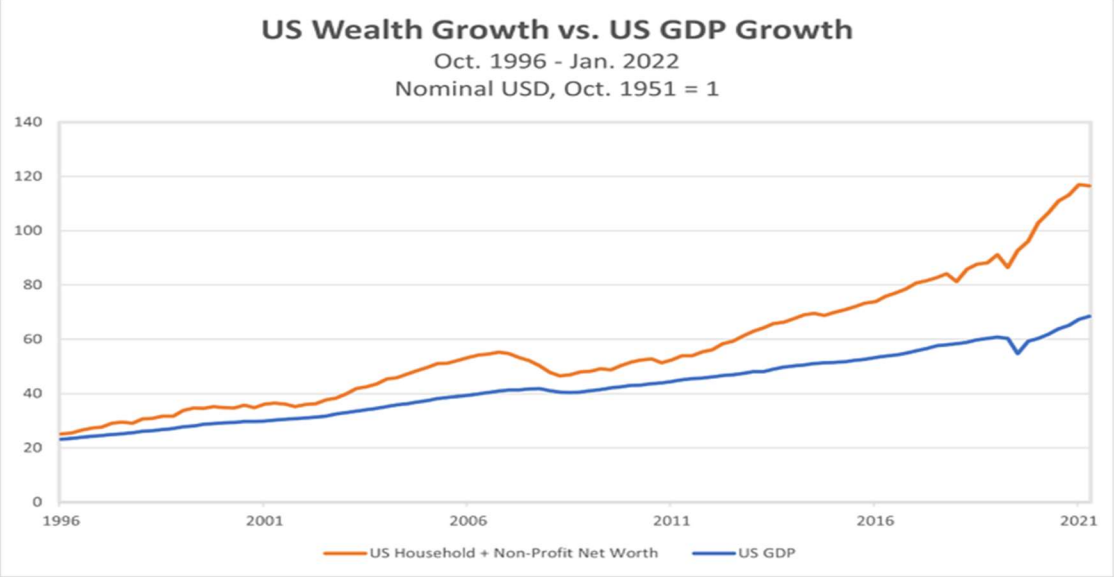
As to the current market environment:

As the following chart shows, the last 5 years, and really the 12 years since the bottom of the Great Financial Crisis (GFC), have enjoyed annual stock market returns well in excess of long-term averages:



And "long-term" means "since 1871" here. An awful lot has changed in that interim, of course, and perhaps expectations and results should be different/higher, but I think that it is well more than coincidence that this more recent period of above-historic returns started at the same time as the Fed's efforts to guide the economy out of the 2008-2009 Financial Crisis.

It might also be noted that while the spread between U.S. Wealth Growth and U.S. GDP Growth really started to widen starting in that post -GFC period too:



[11]

In the long run, it seems unlikely that wealth can grow faster than the economy as a whole from which it is derived, and a chart like this makes one think of Stein's Law:

If something can't go on forever, it will stop.[12]

One way to stop it, of course, would be to have the GDP line catch up with the wealth line, although that is not immediately likely, given a negative number for GDP in the first quarter, and with the same result, or at best flat, in the offing for the second quarter, after this goes to press (if the second quarter is negative, then two quarters in a row of negative GDP is at least a popular definition of recession right there). In the alternative, the wealth part "catches down" to GDP.

Or maybe both.

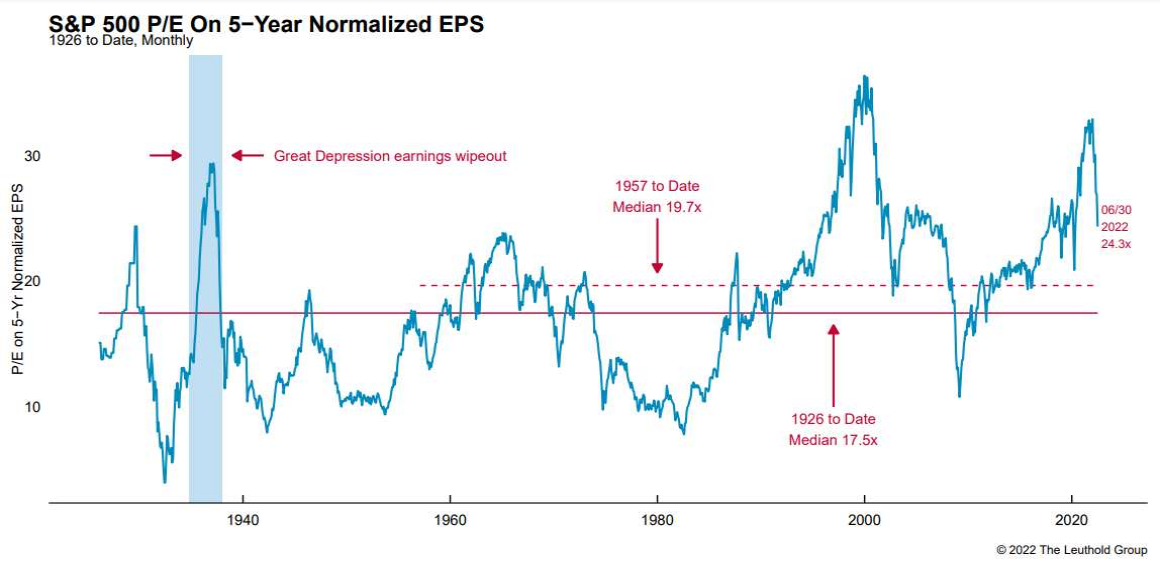
Starting from this very high point, we have endured a bear market drop of 20% in the S&P (and worse in other indexes), clearly in the "not fun" category, but for perspective, that merely takes us back to where we were last March on an index price basis. Meanwhile, Wall Street has plenty of strategists pointing out that recent market action has taken us back to historical average valuation levels based on forward earnings estimates, and so maybe "the bottom is in", but there are at least two concerns here:

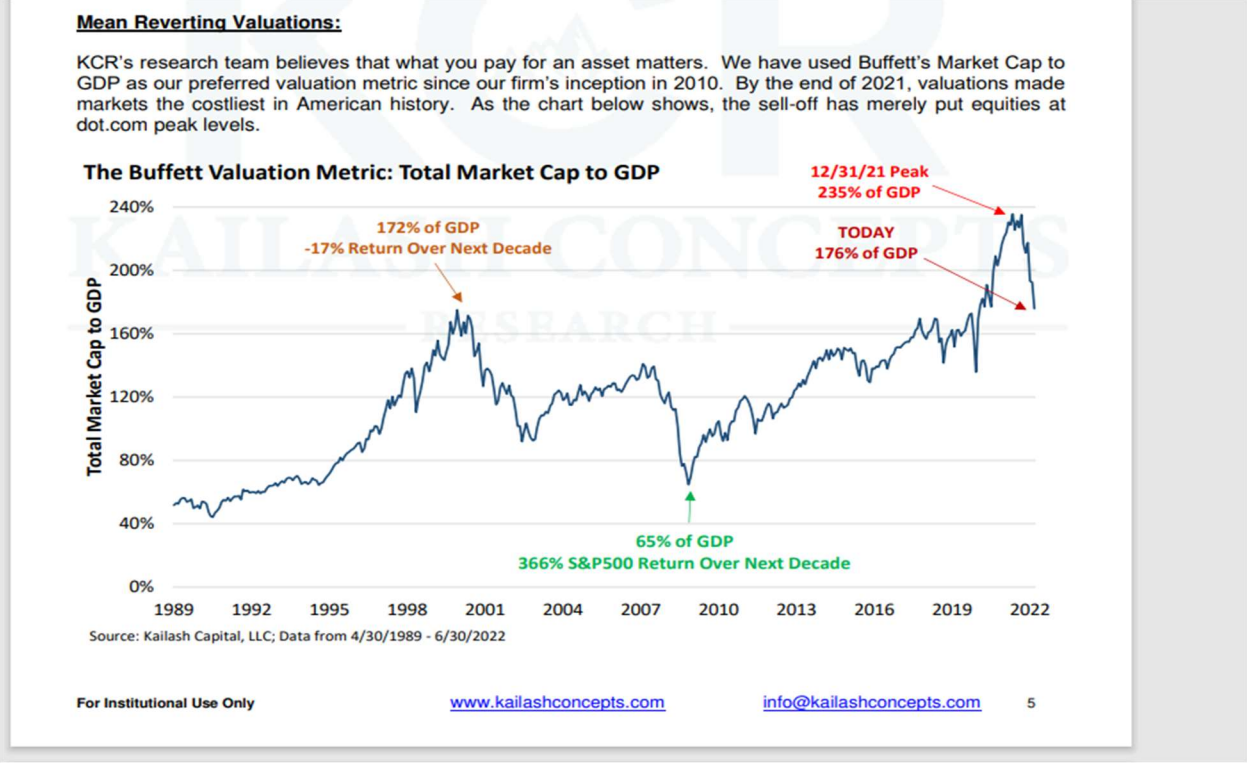
First, "forward earnings" is an *estimated* thing, and it remains to be seen whether earnings come in as hoped, particularly if the economy falters. So far, corporate executives remain reasonably positive in guidance for the full year of 2022 and beyond, and let's hope they are right, but the analyst community has been tempering their enthusiasm lately, and earnings estimates for the second half of the year are coming down. Whether that's just a slowing rate of growth or an outright contraction remains to be seen.

[11] http://forum.epsilontheory.com/session/sso?return_path=http://forum.epsilontheory.com/t/hollow-men-hollow-markets-hollow-world/1981

[12] Attributed to Herb Stein, Chair of the Council of Economic Advisors in the Nixon White House…

Second, and more fundamentally, if you are citing average or mean values or trends, they represent some mathematical combination of highs and lows. If, as the following two charts show, we are merely modestly off the highs, and really nowhere near the lows, then we might need to go through average or mean, heading lower, before we are at the end of this latest down cycle.





As the kids in the back seat might say, "*Are we there yet?*"

If we are in for a slowdown, but not a recession- that elusive thing called a "soft landing" - then maybe so. If a recession is in the cards however, then probably not, particularly with the above Buffett valuation metric having only declined to DotCom peak levels.

And I say this at least in part because at a real bear market bottom, investor sentiment is usually a lot worse. So far, investor morale still seems to be in pretty good shape, and there is no panic in the air yet; more "buy the dip" (maybe with a question mark now) than "get me out!".

What we do know is that stocks have gotten thumped since the turn of the year, resulting in stock price declines pretty much across the board. It depends on your starting point, of course, and stocks being on sale may still not make them cheap, but the current environment in the "market of stocks" is presenting us with opportunities that we have not seen in a while. It makes sense to begin to lean against the tide a bit, starting to take advantage, while acknowledging that stocks *could* well get cheaper, on their way to cheapest before this is over.

The Fed

As to the Fed, I think that the quotes section up front pretty well sums up where we are at the moment. I have no idea what they are going to do with rates, or when, or how far they will take this tightening cycle, or when they will stop. Since they continue to indicate that future actions will be "data dependent" -after this week's assumed 3/4 point increase of course – I have a sneaking suspicion that they don't really know either. What we can reasonably assert is that what happens next- with interest rates, the economy, and the stock and commodity markets- will certainly be significantly influenced by Fed policy and actions, and that in turn will depend on the economy.

The economy…is a mixed bag.

On the one hand, as noted, most corporate executives are upbeat enough about forward prospects, and it's hard to go looking for a recession in an economy that added over a million jobs last quarter, and where the unemployment rate has declined from 3.9% to 3.6% year to date. On the other hand, the once-again-inverted yield curve (2-year Treasuries yield more than 10-years, at 3.02% vs. 2.80%) is usually a pretty reliable forecaster of recessions (albeit 12 – 18 months out), as is the sort of market action we have seen so far this year. Meanwhile a whole lot of indicators, from Housing to Manufacturing and Services surveys to Hiring to Commodity Prices, to GDP to Leading Indicators to … well, practically, you- name -it, individually and collectively point to some sort of economic slowdown in process.

What we do know is that the last time we were dealing with inflation at these levels was in the late 1970's, also accompanied by an oil price shock. Fed Chair Paul Volker (a man to whom Powell has been comparing himself a lot recently) finally brought inflation to heel by raising the Federal Funds rate from about 4.7% in May of 1977 to 17.19% in July of 1981. Such an action would be inconceivable today, but that's what it took, along with back-to-back recessions in 1980 and 1981-82, to get the job done back then.

Another byproduct of this process was a price/earnings multiple of 8 (eight) on the S&P 500 in August of 1982[13]. In contrast, the S&P 500, after a 20% decline, still trades at about 17 X 2022 earnings estimates, and 15 X 2023 estimates, both of which are dependent on earnings numbers coming through as expected. Hence my caution above about cheaper vs. cheapest.

OK, my attempt to write a shorter summer letter having once again gotten away from me, I will end with a couple of quotes, for perspective. First, a comment from "Legendary Wall Street Trader", Jesse Livermore (1877-1940):

"There is nothing new in Wall Street. There can't be because speculation is as old as the hills. Whatever happens in the stock market today has happened before and will happen again".

Second a vignette periodically trotted out by my previously-cited mentor Elliott Farr:

A young guy buys a sporty new car, and decides to take it for a spin out in the country. Coming over a rise, he spies a farmer, wearing coveralls and an old hat, leaning on a fence, chewing on a piece of straw, and staring at the sky. He can't resist, so he pulls over and asks *"Hey old timer, think it's going to rain?".* The farmer ponders the question for a bit, and then replies *"Well, it always has…".*

Is this decline ever going to end? Well, they always have…

So:

Please do not obsess over the headlines, and stay as far away from financial TV as possible. Instead, enjoy the summer, go out with family and friends — now that we can again! — travel, make memories, and have fun. And if you want to talk about any of this, we are here, available, and keeping an eye on all of it on your behalf.

Pierce Archer
7/26/2022

[13] Data from David Rosenberg (Breakfast With David, 6/20/22) and Murray Stahl (The spin-off Report Compendium, 5/10/22)