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Is This What Capitulation Looks Like?

January 24, 2022 Market Update

The S&P 500 was down 5.7% last week and is now very close to a full 10% correction. NASDAQ lost 7.6% last week and is firmly in correction 15% below its November highs. The U.S. treasury market benefited from a haven bid as the 10-year note is now down close to 1.75% from nearly 1.90% last week. Commodities have been the best hedge to market volatility in January with WTI crude oil up 11% year to date, gold up approximately 50 bps, and copper up nearly 3%.

Despite earnings season in full bloom, the stock market's attention is elsewhere: the Federal Reserve, interest rates, and Russia-Ukraine are all dominating the outlook. When the market corrects, which is what we think this is, there is usually — but not always — a "capitulation" day. This is a day of broad selling in which even the highest quality and heretofore insulated stocks get knocked down at least a few percentage points.

The bad news is we haven't had a capitulation day yet. The good news is that we may have it today. It won't feel good, but it is the necessary step to the bottom in order to go higher. With fully 50% of the Russell 3000 index down 25% from its 52-week highs, we may be close enough to call a bottom. That doesn't mean we march right back up to the highs, but it does mean we may have reached peak fear. With the VIX touching 38 today, we feel comfortable that we are, at the very least, close.

With the spike higher in intermediate and longer-term rates at the beginning of the month, the higher valuation sectors of the market are particularly vulnerable and are leading the declines. Fundamentally, we are seeing signs that inflation and the rapidly spreading Omicron variant of COVID-19 combined to suppress demand at the end of Q4 and the beginning of the current quarter.

COVID-19 beneficiaries such as Netflix and Peloton were prominent in the headlines last week and may be providing early confirmation of our premise that inflation has peaked. This may be especially true with the strong possibility of deflation developing in the coming months in certain goods sectors as replenished (and in some cases overbuilt) inventories meet with less demand.

Fed tightening into a naturally slowing economy is heightening the risk of a policy error, especially as the central bankers feel pressure to react to what could be more lagging, as opposed to leading, inflationary indicators. The decline in equity markets and the recent flattening of the yield curve may be providing a strong signal to the Fed to judiciously execute the tightening cycle and try to reduce talk of a 50-bps rate hike or a more immediate end to Quantitative Easing at the Federal Open Market Meeting (FOMC) meeting this week.

The month-to-date market decline is likely also factoring in the uncertainty around the Russia/Ukraine conflict and a potential invasion. No doubt this is influencing market psychology, but also the real economy should energy prices spike even higher. This will have a particular effect on a fledgling European recovery although it is noteworthy that European equity markets, while down with most of the rest of the world, are outperforming the U.S. This may be due to the market structure issues we have been discussing, which are driving the relative performance of value/cyclicals over growth.

The Atlanta Fed GDP Now model lowered its 4Q estimate to 5% from 7% growth because of inflation and the apparent holiday sales pull forward indicated in the December retail sales report. The higher frequency statistics and early January surveys are also showing some weakness with Omicron driving the notable rise in weekly jobless claims.

We had differing signals coming from the first two January regional manufacturing surveys – New York plunged to -0.7 from +31.9 in December and was way below the expectation for a more moderate decline to +25.0.

However, the Philadelphia survey, one from a more manufacturing-based economy, reported a better month-over-month result and a beat of estimates. Consistent in both surveys was a decline in both supplier delivery times and unfilled orders. a leveling in prices paid, and a rebuild in inventories which further reinforces our belief that we have approached peak supply chain disruption and peak inflation.

Housing could be viewed as a microcosm of the factors influencing the broader economy – December existing home sales were down 4.6% on still tight inventories and higher prices squeezing some potential buyers. However, homebuilders appear to be shrugging off rising costs and materials shortages: December housing starts were up 1.4% and the more leading indicator of building permits was up 9.1%, a big beat of estimates. The prospect of a greater supply with a flattening of demand should, at a minimum, slow the inflation rate in this sector.

We believe the largest risk to the equity markets is aggressive monetary tightening into an already slowing economic environment. While we will get more color from the Fed this week on their approach, it is somewhat encouraging that the Bank of Japan held steady on its rate and bond buying policies while the People's Bank of China used its greater flexibility to cut rates slightly last week. The Omicron wave is following the pattern seen in South African and the UK and is beginning to dissipate in U.S. states that were hit the earliest.

While the stock market is reacting to these macroeconomic and geopolitical forces, it is important to note that there are plenty of positives to support the long-run picture of 2022 and beyond:

- Profits are high and growing.
- Valuations have declined to a reasonable level where the S&P 500 is now 19 times this year's estimates.
- Capital expenditure is strong. Intel announced a $20B investment in Ohio last week, represents yet another semiconductor plant announcement.
- Jobs are plentiful which will sustain consumer spending.
- Infrastructure spending has been approved and rally-killing tax hikes have been avoided.

There are plenty of positives to sustain the stock market.

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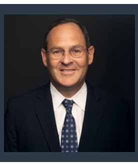

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