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TUG OF WAR: FED VS. EARNINGS

APRIL 25, 2022 MARKET UPDATE

With Friday's sharp decline and Monday's weak open, the S&P 500 is back in correction territory from the early January all-time highs. The NASDAQ is performing even worse, closing in on a bear market as the previously high-priced technology and communication services sectors have lost even more value in this rising rate environment.

Commodities, which have generally been the star performers of 2022, are also struggling at the start of this week as concerns mount that the Fed may be tightening too aggressively into an already slowing economy.

The dollar, and perhaps U.S. treasuries, appear to be the only safe havens on Monday.

HAWKISH STANCE FROM FED

Last week, both the Federal Reserve Chair Jerome Powell and European Central Bank Chair Christine Lagarde spoke at an International Monetary Fund event. The markets perceived their comments as incrementally hawkish considering the two leaders had been consistently more moderate in their approaches to the inevitable removal of excessive monetary ease.

Lagarde cited inflation as a growing concern which may take precedence over economic growth while Powell basically admitted what the markets have been discounting by saying a 50-bps rate hike was "on the table" for next week's Federal Open Market Committee meeting and that the markets are acting "appropriately."

The Chairman may be trying to break the impression the Fed, and Powell particularly, have become slaves to the market. Today, the markets may be in the process of testing their resolve.

HOUSING STABLE DESPITE CRACKS

U.S. economic statistics continue to be generally positive. However, slight cracks in the housing market are emerging.

» The April sentiment survey from the National Association of Home Builders fell 2 points to 77 as ongoing home price increases and construction costs are taking somewhat of a toll on confidence.

» March existing home sales were down 2.7% on the month as higher mortgage rates and inflation are weakening purchasing power although low inventories continue to be the larger problem in this space.

» Housing starts improved only slightly in March (+0.3%) while building permits were up 0.4%.

» Housing completions were down 4.5% month over month as builders continue to struggle with labor shortages and high materials prices.

Housing is not likely to fall into recession over the coming months since demand still appears to be ample. However, this sector is not likely to be additive to GDP for the rest of the year.

MANUFACTURING ROBUST

With the release of the Fed Beige Book last week came the assessment that the economy is continuing to grow at a moderate rate since mid-February. Employment is increasing although job vacancies are still high and growing wages still aren't quickly solving the supply problem. The impending end of the Covid-19 pandemic and subsequent economic reopenings are driving consumer spending.

Manufacturing activity remains robust despite ongoing supply chain disruptions, labor market shortages, and higher input costs. We saw the continued effort of manufacturers to keep up with demand in some of the PMI surveys for April:

» The Philly Fed survey was weaker than the 27.4 reported in March but still came in at a rather strong 17.6.

» The national IHS Markit flash manufacturing survey improved from March at 59.7 vs. 58.8 and it beat the 58.1 estimate as new orders, production, and employment were all better.

However, worsening prices paid and supplier delivery trends show that logistics issues persist. The services survey declined to 54.7 from 58.0 in March which was likely reflective of higher prices. Inflation in services in a post-Covid rebound environment, however, has yet to notably slow demand, but markets are on the lookout for any impact.

LEI HIGHER THAN ESTIMATE

The Conference Board Leading Economic Indicators (LEI) index was +0.3%, higher than the +0.2% estimate with February revised nicely upward to +0.6% from +0.3%.

The yield curve, a cause of concern for those who watch the 2/10 year spread, was a big positive contributor as the Conference Board incorporates the three-months to 10-year spread, which is still quite positive.

DECLINES IN CHINA

In China, equities saw large declines overnight as Shanghai's Covid-19 lockdown entered a fourth week with the virus apparently (inevitably?) making its way to Beijing. More aggressive lockdowns in the capital city may lead to more supply chain pressures.

IS INFLATION PEAKING?

Central bankers would love to see inflation slow of its own accord due to naturally reduced demand and a price driven recovery in clogged supply chains.

On the demand front, federal outlays are now down approximately 20% year-over-year on the anniversary of the 2021 fiscal stimulus check distributions – slower income growth, especially among the lower income groups, should eventually slow the Consumer Price Index (CPI). The core Personal Consumption Expenditures (PCE) inflation report for March and the 1Q Employment Cost Index, both reported on Friday, could provide some additional clues about whether inflation is indeed beginning to peak.

2022 LOOKING POSITIVE, BUT 2023?

Bullish sentiment is at its lowest level since 1992 which, in a contrarian way, historically bodes for stronger returns over the next year.

While exceptions occurred during the deep recessionary environments of 2001 and 2008, we do not believe we are on the precipice of that type of economic fallout. In fact, we continue to believe in positive growth for 2022.

The 2023 outlook is very much dependent on the aggressiveness of the global monetary tightening cycle led by the Fed. For now, the yield curve and credit spreads appear to be predicting a growth slowdown as opposed to an imminent recession.

WHAT MONDAY TELLS US

The stock market is caught in a tug of war between the Fed and earnings. China's Covid shutdown and the ongoing war in Ukraine are also affecting the downside, but the relentless aggressiveness of recent Fedspeak is the dominant force.

Yet those three negative effects can only go on so long. The last three rate hike cycles saw multi-year 10%+ per annum gains in the S&P 500 from the first rate hike. So far, we've only had one 25 basis point hike. And on the positive side of the ledger, earnings are coming in once again better than expectations, along with guidance. That will lead to more upward estimate revisions.

Consider that the S&P 500 is currently at 17x 2023 earnings. That's not expensive, particularly if earnings continue to grow and may be revised higher. But the market has been stuck in a range all year. Often, a "capitulation" day of unmitigated selling is needed to clear the decks for the resumed march higher.

Between Thursday, Friday of last week, and the way Monday started this week, we may be seeing that now.