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MAY 02, 2022 — MARKET UPDATE

The Standard & Poor's 500 equity index was down 3.63% on Friday while the tech heavy NASDAQ index performed even worse down 4.17% to close out a difficult April where the S&P 500 index was down 8.8%. After rebounding nicely from the early March lows, equities retested and broke below those lows. They are now 14% below the early January highs as the 2022 stock market correction continues.

While a confluence of factors is driving prices lower this year, there is growing doubt that the U.S. Federal Reserve can effectively engineer a "soft landing" of the economy as it withdraws the monetary ease it established at the start of the pandemic.

AMAZON AND APPLE

Friday's selloff was precipitated by the earnings reports from Amazon and Apple, two exceptionally large components of the broader market indices whose managements offered differing levels of results and commentary that disappointed markets.

Amazon is beginning to see the impact of the long-awaited transition of consumer spending from goods to services. They may have expanded inventories too aggressively to meet Covid induced stay-at-home demand as consumers continue to spend more on experiences as opposed to goods. Apple beat estimates on both revenues and earnings but offered disappointing guidance for the second quarter citing ongoing supply chain issues.

THE TRADE DEFICIT

Markets may have also had a delayed reaction to the negative first quarter GDP print (-1.4%) which may have further stoked recessionary concerns. However, when looking through the components of the GDP report, the negative growth was primarily attributable to an outsized increase in the trade deficit. The surge in reported imports resulted from strong consumer spending on imported products that were finally able to make it through the clogged transportation chains. Exports were constrained by the strong dollar and lower demand within the relatively weaker foreign economies.

TECH SPENDING UP

In addition to healthy consumer spending driven largely by strong jobs and wage growth, business spending increased nicely in the quarter with strength seen in technology spending on intellectual property and software. These investments should help boost employee productivity over the coming quarters and years and help offset the pressure on wages. Look for a nice rebound in second quarter growth and a possible upward revision to first quarter when the March trade deficit is reported.

Beyond the high-profile technology and communication services stocks whose revenues accelerated during the Covid pandemic, first quarter earnings season has been rather good as many companies benefit from a recovery in services spending and greater pricing flexibility.

INFLATION PEAKING?

As the Fed has been forced to pivot in its policy stance and focus solely on battling inflation rates not seen since the 1980's, the core PCE inflation indicator has become its preferred inflation gage. There are preliminary signs that inflation may be peaking, according to the March report released last Friday.

Fed Chair Jerome Powell would probably prefer to let inflation decline naturally, but the current generationally high rates are forcing his hand in bowing to the hawks on the Committee. As we are at the very beginning of the tightening cycle, the economy can likely manage a couple of 50 basis point rate hikes, but an aggressive move to an above neutral 3.00% rate currently anticipated by markets may depress demand too much just when ample supply finally returns.

INVENTORY ACCUMULATION

Inventory accumulation is another indicator worth monitoring to assess if supply is catching up to demand. It also will show if there has been a pronounced trend this year of higher-than-expected inventory growth which should soon reduce pricing pressure in most goods sectors.

A potentially negative implication of this inventory dynamic would be an excessive amount of involuntary accumulation which would have to be worked off should demand slow faster than businesses expect. This kind of inventory boom and bust cycle has been very much a characteristic of the modern U.S. economy. However, the duration of previous cycles has lengthened over the last 30 years as the U.S. economy has become driven by services.

The bond market was also weak on Friday with the 10-year yield up 5 bps and the yield curve also in danger of again inverting in the closely watched 2/10-year portion over the coming weeks. High yield bond spreads are widening compared to treasuries, but not to excessive levels that would be predictive of an oncoming recession. These bond market indicators will provide early warnings of potentially excessive Fed tightening.

OUR OUTLOOK

The economic indicators recently reported for the end of first quarter and early second quarter are indicative of a growth slowdown as opposed to recession. Financially healthy consumers and corporations should drive continued spending growth in both components of the economy. With no recession leading to negative corporate earnings growth, equities should stabilize and not decline dramatically from current levels.

We rarely discuss technical indicators, but it is hard not to notice the horrible sentiment in the individual investor surveys which is usually a good contrarian indicator, and another sign the equity markets may be trying to find a bottom.

It is natural to sometimes let emotions overtake analysis as the driver of investment decisions. The fear and anxiety of potentially losing money may become the dominant emotion in this volatile market. Logic derived from analysis will balance the risk by focusing on opportunities derived from sharply lower multiples on earnings that are still growing nicely. Based on our analysis we think the stock market is in a correction, not poised on the edge of a bear market.

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