Where We Stand

June 28, 2022

As of market close on Monday, the S&P 500 and Nasdaq are down -18.2% and -26.3%, respectively, year-to-date, while the DJIA has fallen -13.5%. A lot of damage has been done as markets price in inflation expectations, rising interest rates, and the possibility of recession. We've witnessed an overwhelming display of panic selling, with virtually no stocks being spared from losses. In fact, the average stock is down more than the index itself. The average stock on the S&P 500 has declined -30% from its recent high, while the average stock on the Nasdaq composite has declined -48%. Here's what you should know as we head into the second half of 2022:

How did we get here? The combination of high inflation and rising interest rates is triggering worries about the U.S. economy and financial markets. The war in Ukraine, geopolitical tensions, and renewed Covid-19 lockdowns in China have further added to the problem and complicated the solution. The Fed has transitioned from an accommodative fiscal policy to a policy much less ideal for risk assets. Financial markets, forward-looking in nature, are pricing in the reality of a new regime – the end to the era of ample liquidity, low inflation, and low interest rates that followed the 2008-2009 global financial crisis.

What is the Fed doing and why? Rampant inflation has forced the Fed to further accelerate its rate-hiking campaign in an effort to tame price pressures. In mid-June, the central bank raised the fed funds target range by 75 basis points (0.75%), the biggest hike in 28 years. More aggressive moves may follow depending on how economic data evolves between now and the next FOMC meeting at the end of July. Meanwhile, the Fed also began shrinking its bloated $9 trillion balance sheet on June 15th at a pace of $47.5 billion per month through August. In September, the Fed will accelerate the pace of quantitative tightening (QT) to $95 billion per month. The plan is to cut the balance sheet by a third over the next three years, which equates to an additional effective tightening of about 25 basis points (0.25%) annually.

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Interest rates are the Fed's main tool to combat inflation, because inflation is driven by strong consumer demand. When the Fed raises rates, everything becomes more expensive, which helps to dampen consumers' willingness to spend. If inflation doesn't abate, rates will continue to increase. But if rates rise too far too quickly, it can stall the economy rather than slowing it. Last week, Fed Chair Jerome Powell stated that a recession is a possibility, but emphasized it is not the central bank's intended outcome. The key question now is whether the Fed will be able to balance inflation and growth risks.

What is a recession? A recession is a temporary but significant decline in economic activity, generally identified by at least two consecutive quarters of decline in GDP after a period of growth. Many factors can contribute to a recession, and the main cause often changes. Some of the main drivers of recession are excessive inflation, exorbitant debt, asset bubbles, technological change, and unexpected, widespread shocks such as the Covid-19 pandemic. Past recessions have occurred for various reasons but are typically the result of imbalances in the economy.

How can it be avoided? On Wall Street, skepticism is growing that a recession can be avoided. Goldman Sachs has raised its probability to 30% over the next year, up from 15% previously, while Citigroup now sees a 50% chance of a global recession. Though it's entirely possible that the Fed pushes the economy into recession, not all the economic data yet supports these fears.

Private sector cash holdings remain at robust levels, providing an unprecedented cushion against soaring food and energy prices, the stock market decline, and any potential correction in home prices. Capital expenditures have a runway for continued growth as businesses sit on $300 billion in excess cash and debt service costs remain at record lows. Meanwhile, jobless claims are still hovering around pre-pandemic levels and the unemployment rate is holding at its lowest level since February 2020, both signs that the labor market remains strong. Wage growth has moderated in recent months, already exerting downward pressure on core price numbers. Finally, supply chain pressures continue to moderate and retail and wholesale inventories have jumped to pre-Covid levels, or higher, as a result. This is opposite of inventories rising from sunken demand as is commonly seen ahead of recession and supports the case that margin re-compression (from extraordinarily high levels) due mostly to rising supply, not falling demand, will be a big part of the disinflation story.

Underlying demand remains strong, giving way to the possibility that a slowdown in growth, rather than a full-blown recession, is a possible outcome.

Looking Ahead

Q2 reporting season is just a few weeks away and will provide important insight on the impact of tightening financial conditions. S&P 500 earnings growth expectations currently stand at 4.3% y/y for Q2, down from 5.9% expected at the start of the quarter. While this would be the lowest growth rate since Q4 of 2020, it is still a long way from negative. We'll be paying close attention to the results.

This has been a very challenging market environment, besieged by negative headlines and high uncertainty. On the bright side, the pullback that has transpired in markets has made the risk versus reward in both equities (valuations) and fixed income (bond yields) incrementally more compelling. We remain steadfast in our belief that, over the long-term, the stock market will deliver positive returns, and that investing in high-quality companies at attractive valuations will help us to deliver strong results to our clients over market cycles. As always, please feel free to reach out to us with any questions or concerns.

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