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# John's Market Outlook – June 10, 2022

In the December 2021 Market Outlook, I wrote *"In 2022, most pandemic-related US government aid will expire, effectively ending a several-trillion dollar flow of liquidity . . . The Federal Reserve will wind down aka "taper" quantitative easing and begin raising interest rates, withdrawing a similar-sized liquidity flow . . . The liquidity response in 2020 was far larger than 2009's; its withdrawal will leave that much larger a hole that to fill. In my opinion, the probability of a market correction in 2022 is significant."*

The March 2022 Outlook added *"the primary factor for the market remains . . . transition from the stimulus response to the pandemic, to the tightening response to inflation. For the US economy, the invasion of Ukraine means higher inflation pressure, and may accelerate the tightening."*

Indeed, inflation has accelerated globally, including in the US, with May CPI over 8%. The Fed has been raising short term rates at an accelerating pace. Two year Treasury yields rose from near-zero to 3.0% and ten year yields from 0.7% to 3.2%. Fixed income (bond) prices declined but the larger declines were in equity (stock) prices, starting with the most speculative stocks in late 2021, spreading to mega-technology names like Apple and Microsoft in early 2022, and now to "broad economy" names like Walmart. Year to date, the S&P 500 is down -18%.

I began moving portfolios to be more conservative starting last summer and have continued doing so this year. Five months into the market correction and half-way through 2022, we should ask: *Is a recession coming? Where will markets go? How to position portfolios?*

<u>Recession or not?</u> I think a recession, probably on the moderate side, is *likely*. The US economy started this year strong but imbalanced, with supply of goods and workers too low for surging demand. This imbalanced strength led to inflation, but gives the Fed room to withdraw liquidity, slow the economy and cool demand. The Fed hopes to avoid a recession ("soft landing"). We should be prepared for a recession because *external* causes of inflation are beyond the Fed's control. Russia's war in Ukraine has driven global prices higher for energy and food; China's Covid lockdowns disrupted global supply chains. External inflation forces the Fed to slow the US economy even more – likely into recession.

<u>Second: markets up or down?</u> For equities (stocks) I remain cautious in the short term. As rates rise, demand weakens, and earnings estimates are revised down, I expect stocks to be volatile and pressured.

By this fall, I think the Fed will have raised short term rates over 2.0% from 2021's near-zero, and parts of the US economy will have slowed significantly – for example, consumer spending, durable goods orders, house sales and prices. I expect weaker earnings, fewer job openings and rising unemployment.

***If*** the slowdown brings inflation down to the Fed's target, investors will anticipate the end of Fed tightening, which could reduce pressure on stocks and allow equity markets to bottom and begin recovering. This scenario *could* include a fourth quarter rally.

***However***, if inflation is still too high, the Fed will have difficult choices: a) continue tightening despite growing job losses and recession risk, or b) stop tightening in hopes of sparing jobs and avoiding recession, while accepting sustained high inflation. Both may send stocks significantly lower.

For fixed income (bonds), the picture is becoming more positive. The decline in bond prices this year was mostly due to the rapid rise in interest rates. If inflation stabilizes, even at elevated levels, prices of high quality bonds can also stabilize or rise even with a recession.

<u>Third: how to position portfolios?</u> With high levels of cash and equivalents, both to reduce volatility and exposure to market declines and as "dry powder" for the market bottom.

As for sectors and asset classes:

- Some consumer brand/retailer stocks are now at attractive prices, some below pre-pandemic levels. Those that did *not* enjoy a demand surge should have less risk to estimates.
- Traditional energy (oil & gas) stocks have been strong. The stocks are vulnerable to slowing demand from stretched consumers or hints of an end to the war in Ukraine. Renewable energy is in high demand and supply disruptions (solar panels, wind turbines) should ease.
- Healthcare typically outperforms in slowdowns. Large pharmas have reasonable valuations, stable demand, and political risk is easing; biotechs are at the lowest valuations in a decade.
- Real estate often benefits from inflation. Apartment REITs are raising rents over +10%/yr. Higher mortgage rates keep households renting. Other REITs have inflation escalators in leases.
- As explained, I think buying opportunities are approaching in fixed income.
- My other comments from March still apply.

I would be happy to go deeper into this outlook and other investment topics than was possible in this brief summary. Please email johnliu@laurelhurstasset.com or call 510 847 0070.

Thank you!