

LAURELHURST ASSET MANAGEMENT

John's Market Outlook – September 12, 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 . . . In my opinion, the probability of a market correction in 2022 is significant.”*

The March 2022 Outlook said *“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.”*

The June 2022 Outlook added *“We should be prepared for a recession . . . 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”* and *“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.”*

The US economy has had two quarters of negative GDP growth, a “technical” recession, but a broad recession has not yet emerged. Leading indicators point down, much of the economy is slowing (housing, corporate profits, consumer spending), but employment remains robust. The S&P 500 is about flat with its June 10 level. The dollar continues to strengthen. Compared to other major economies (China, Europe), the US has been more resilient.

We may be seeing inflation beginning to ease. July’s *monthly* CPI inflation was 0.0%, a big decline from previous months’ 1.0%. Annual inflation (8.5% in July) reflects past prices; the Fed focuses on the trend of monthly inflation which determines future prices. 2.0% annual inflation requires monthly inflation to sustain a trend of 0.1-0.2%. One month is not a trend. I expect the Fed to raise rates this month even if this week’s inflation reports are positive (i.e. low). Continued positive inflation reports will allow the Fed to end its tightening, which has been the largest negative pressure on markets.

I began moving portfolios to more conservative starting summer 2021, and continued doing so through June 2022. In the last couple of months, overall portfolio exposures have been fairly stable.

Are we nearing an inflection point? Is market risk-reward turning attractive enough to justify moving less conservative and starting to deploy the “dry powder” (cash etc) in portfolios?

*My opinions and best judgment as of the date written, not investment recommendations or guarantees.
For clients of Laurelhurst Asset Management, 1001 SE Water Ave Ste 217 Portland OR 97214.*

In my view, we are getting closer. This is my best sense for what to expect in coming months:

- US monthly inflation trends lower. Supply chains untangle, commodities stabilize, inventories are worked down, the strong dollar lowers import prices, and discretionary consumer spending weakens. I expect progress in “fits and starts”, but if monthly inflation starts trending down toward 0.2%, the Fed can shift from raising rates to holding rates steady.
- The US job market weakens. From today’s overly “hot” market, job openings decline and unemployment rises to more “normal” levels. Less wage growth helps lower inflation.
- Housing markets slump. Higher mortgage rates and overheated prices drive falling sales and price declines, which eventually feed into lower inflation with a year’s lag.
- Overall, the recession is mild or moderate, as far as the “real economy” (Main Street, not Wall Street) goes. Think 1990 or 2001, not 2008.
- Earnings weaken. Sales and exports slow, consumers pare back, companies slow hiring and investment, credit losses rise, margins revert to pre-pandemic levels, and 2023 estimates decline. Earnings cuts often emerge in September-October; watch 3Q’s reports.

If this proves correct, we will be closing on the positive scenario described in June’s Outlook (“*slowdown brings inflation down to the Fed’s target, investors will anticipate the end of Fed tightening, which could . . . allow equity markets to bottom*”) and I am prepared to start investing cash.

Will markets decline again before bottoming? I think most likely, because 2023 estimates have further to decline in my view. Rapidly easing inflation, an early end to the Fed’s tightening cycle, and a recession that turns out very mild, could mean a smaller, shorter decline.

What could make the buying point arrive sooner? In March I noted “*the development of a market bottom is more likely to be pulled forward than pushed back by the sound of cannons in Ukraine*”. The war accelerated the inflation-tightening cycle. A surprisingly fast end to the war, which recent Ukrainian success suggest is possible, may pull the end of this bear market further forward.

As for sectors and asset classes:

- Many oil stocks now look fully-valued with global economies slowing. Global LNG demand should support natural gas names. Renewables are a focus as energy storage improves reliability.
- Many consumer, healthcare, and real estate names are attractive, for the reasons outlined in June.
- Most US technology names still have too-optimistic estimates or too-high valuations. Still, these include the best companies in the world, so I have started small positions.
- Europe and the UK have a significant recession ahead, as soaring energy prices close businesses and impoverish households. China is in recession, with a deflating property bubble (3X 2006 US), weak consumers, and the highest total debt/GDP of major countries. For now, favor US markets.
- While the Fed will push short term interest rates higher from here, long rates are sensitive to future inflation and economic growth. Declining inflation and slowing growth are a favorable environment for high-quality bonds, whose yields are finally meaningful.

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!

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