HFG Wealth Management

INSIGHT

PERSPECTIVES FOR THE GOAL-FOCUSED INVESTOR

Summer 2022

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Summer Insight – Questions and Answers

1. Do you think we have seen the bottom in the market?

On a number of fronts (price, valuation, inflation) we would be inclined to say yes (or at least most of the way through), but timing is an inexact science. Many of the indicators for a market bottom are present, but we have not seen the capitulation phase yet – and we may not see it. The one issue that may prove troubling to put in a true "bottom" is the fact that earnings estimates have not really been reduced. Right now, the market has revalued to a lower and more reasonable multiple by historical standards, but if corporate earnings don't come in as expected during the second half, there could be lower levels ahead. Conversely, if earnings go according to plan, we are probably set up for a positive second half. History supports that view. Generally speaking, bear market bottoms are also associated with lower trailing and forward earnings multiples. Some positive historical precedent is that since 1932, there have been six instances where the equity market has been down more than 15% in the first half and in every instance, the second half had a positive return.

2. What is the biggest concern about the market right now?

The most direct factors are the twin fears of inflation and interest rates, with a dash of recession fear thrown in.

Actually, the recession drumbeats have sounded louder lately, with commodity prices tumbling to reflect those concerns. As we have discussed, these factors are well documented, and we believe that the market has overly discounted the negatives with respect to future prices.

However, one of the factors that we don't believe has been priced in is difficult to control or predict – and it has to do with what comes out of Washington, D.C. The potential for political decisions to overstep and create unintended economic issues is something that was a concern early on in the Biden administration, but has dissipated until recently. Discussions to revive the Build Back Better initiative would include an increase in some taxes on corporate profits, which may have the effect of upsetting an already fragile market environment. This has not helped with the inflation issue, and other policy ideas — curbs on exports, a windfall profits tax, etc. — would add significant cost to American businesses at a time when companies can least afford. The good news is that this is unlikely to occur, given that we are so close to the mid-year election season, and this may be one reason why the market has discounted much of the potential effect. Still, it is wise to never underestimate the incompetence that may come out of Washington politics.

In recent weeks, the question I've most frequently received is "when do I back up the truck and buy stocks?"

3. What is your view about the Energy sector?

Up until recently, energy has been a standout performer, especially relative to the equity market. However, as the recession drumbeats sound louder given the macro Fed driven nature of the market, the sector has suffered even greater losses than the general equity market. One factor that seems to be playing a role is money flows. Investors appear better to sell energy related funds and ETF's, even during a massive rally so far this year. Interestingly, Ark Innovation ETF (ARKK), which is down more than 50% on the year and almost 70% over the past 12 months has seen big inflows while energy funds have seen outflows during 2022. This seems to speak to the deep PTSD that still exists among energy investors, who fear the worst even as oil outperforms equities and is reflective of the overall animosity towards energy. The energy space is massively under owned – it is currently just 4% of the S&P as opposed to 22% at its peak. Politics has also played a role in the energy arena. Earlier this year, President Biden recently had a real chance to create an effective energy approach when Russia invaded Ukraine. Instead, he tried to "politically" increase global oil production while resisting any fossil fuel expansion in the U.S. This has not fared well, and the recent declines in energy prices is somewhat of a reflection of that.

4. What are the odds of a U.S. recession over the next year?

From a numbers standpoint, we have had a weak first half of 2022. However, that does depend somewhat on which numbers you focus on. While the technical definition of recession is two consecutive quarters of negative GDP growth, there are other measures of the economy that do not paint such a dark picture. GDI (Gross Domestic Income) is one of them. In national economic accounting, GDP and GDI are conceptually equal. GDP measures overall economic activity by final expenditures, and GDI measures the incomes generated from producing GDP. While GDP declined 1.4% in the first quarter, GDI increased by 2.1%. Over time, these numbers tend to reinforce each other, but it does suggest that the economy may not be in as bad a shape as some people believe.

Additionally, we see other factors that lead us to believe we are not about to enter recession.

- the 11.4 million job openings in the U.S. economy vs. "just" 6 million unemployed people
- the cash cushion that's still likely available for upper-income consumers
- China "reopening" from COVID lock-down

While we may enter a "technical recession" from GDP standards, we believe that it will be shallow and short, and the more important focus should be on inflation and interest rates.

Central banks need to focus on anchoring long-run inflation expectations. Until that happens, inflation data (hot) remains more important than growth data (cold). If recession is a coin-flip in the next year (cash savings + U.S. job openings create a cushion vs. 1H weakness), the key is for inflation to peak & come down quickly. Otherwise, the year after that could see an equal 50/50 chance of a downturn (the central bank will have to keep tightening, and policy acts with a lag). Flipping two coins & needing heads on both to avoid recession at the two-year horizon doesn't make for great odds (0.5^2 = 0.25). What are the downside vs. upside risks for the U.S. economy?

The downside risks are: we've already had a surprise negative GDP quarter in the U.S. in 1Q of 2022 (which is rare); global supply shocks are still in play (Russia/Ukraine); we've lost help from U.S. productivity (more pressure on supply); demand must fall to meet (restrained) supply; and corporate profits should come under further pressure. We can compare this again to the (narrowing) path to a "soft-ish" landing: job openings > unemployed cushion; goods could cheapen with global bottlenecks clearing (bullwhip over-ordering); QT could balance fed rate hikes; the FOMC has wiggle room around the 2% target (e.g., declare victory at 2.5%), and wealthy economies could sacrifice consumer surplus to get productivity back up.

5. Is there any good news on inflation coming?

There are reasons to expect some relief on goods inflation going forward, which should come down as bottlenecks clear and retailers unload inventory. We are already seeing signs that prices are retreating – lumber costs are back to pre-COVID levels after a meteoric rise, and energy and other commodity prices have recently retreated 15–20%. Food and energy are roughly 20% of the U.S. CPI, core goods are 20%, and services 60%. This should support the "peak inflation" camp. But commodities could still hold up the headline CPI, until we get past recent geopolitical disruptions. One-year inflation expectations are also trending down, although we have not seen the monthly inflation numbers reflect that yet.

The other good news is that Central banks (especially U.S.) are focused on anchoring long-run inflation expectations. Until that expectation meets reality, the markets will focus on current inflation data (hot) which is more important than growth data (cold). The key is for inflation to peak and then start to move lower. If that does not happen, then the odds of a deeper recession increase – most likely around the Presidential election timeline (more bad news for Democrats).

Negatives

• Negative GDP quarter in the U.S. in 1Q of 2022
• Global supply shocks are still in play (Russia/Ukraine)
• U.S. productivity weak because of supply
• Demand still strong (must fall to meet supply)
• Corporate profits could weaken

Positives

• Strong employment picture
• Global bottlenecks clearing, leading to lower prices
• Quantitative tightening
• Fed has inflation as top priority

6. What is the outlook for the midterm elections?

Whether Republican or Democrat, the mid-term elections usually go against a sitting President. On average, the party in charge loses 29 House seats. The Republicans only need four seats to regain control, so it is very likely that the House will be Republican for the next two years – it is really a question of how much. Biden has an extremely low popularity rating, which makes the Senate a battleground that the Democrats are likely to lose. Estimates are that they could lose 4-5 seats, which would also impact future elections. In all likelihood, this will create a "lame duck" political atmosphere, which should be a net benefit for equity markets. History is also on the side of markets – the average gain in the year after mid-term election losses is 19%.