Stewart Capital

Market Commentary – Second Quarter 2022

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According to the Federal Reserve Bank of Atlanta's most recent GDP *nowcast*, they are expecting Q2 Gross Domestic Product (GDP) to come in at -1.6%; this is after posting an actual decline of 1.6% for the first quarter. While we have been hearing from some that we have entered at least a mild recession, we would also be quick to point out that in the National Bureau of Economic Research's (NBER) view a recession does not happen simply because we have posted two consecutive quarters of negative GDP.

While we are not yet in the recession camp, we have had some concerns. It is clear to us that while jobs are still plentiful, sky-high fuel prices, higher food prices, and higher mortgage rates and rents are causing stress. With the consumer still representing two-thirds of economic activity, when they are stressed, the economic environment becomes tenuous.

Area of Concern

An area of particular concern to us has been the continued upward move in housing prices, and not just because owner equivalent rents are a component of consumer price index (CPI).

As the median price of a home rises, the affordability declines, even before factoring in higher mortgage rates.

Indeed, with the median price of a home in the United States now more than $428,000 (source: Federal Reserve Bank of St Louis, FRED Database), the down payment ($85,740, assuming 20%) exceeds the median home price in the mid-1980s and represents more than 125% of median income (compared to roughly two-thirds of median income in the 1980s). The payment on that median priced home has jumped from roughly $1,549 at the beginning of this year when average mortgage rates were at 3.55%, to $1,862 with mortgage rates now above 5.1%, an increase of more than 20%.

Do you think it is better to rent? The average rent for a two-bedroom apartment in the United States had climbed to more than $1,000 per month as of the beginning of the year (Source: US Census Bureau), and the average rent for a four-bedroom apartment sat at $1,600 per month, with many major metropolitan areas significantly higher. If we use 30% of gross monthly income for housing as a metric for affordability, that translates to a minimum gross income of $40,000 per year to afford an average two-bedroom apartment and minimum gross income of $64,000 per year to be able to afford a four-bedroom apartment.

Yet we also know that the average monthly rent on a national basis won't get much of anything in some of the major metropolitan areas. For instance, in San Francisco, the average monthly rent for a two-bedroom apartment is $3,198.00; in Boston, it is $2,399.00; in New York City, it is $2,340.00; in Washington, DC, it is $1,785.00; and in Seattle, it is $2,044.00. In those metropolitan areas, one would need annual income of between $71,400 (Washington, DC) and $127,920! For comparison purposes, the median household income in the United States was $67,521 as of 2020 (Source: US Census Bureau, Current Population Survey).

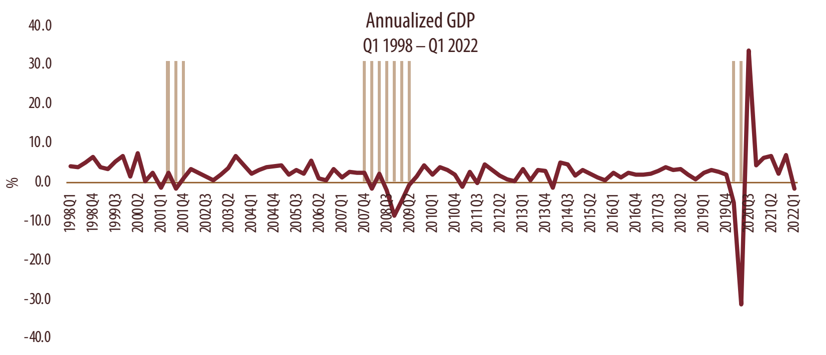
With housing affordability dropping, things like higher oil prices effectively become a tax, particularly for the lower half of the income spectrum.

This ripples through the economy as consumers cut back spending on all but necessities.

In fact, from an anecdotal standpoint, we have seen this play out with a local retailer we know, whose inventory caters largely to discretionary purchases, and has seen business trail off dramatically from one year ago. We would expect other retailers to face similar issues, particularly those who cater to the economically disadvantaged.

If higher energy prices weren't enough of a concern, we also have higher food prices. After a brief respite from sharply higher prices in the three quarters immediately subsequent to the sharp, short COVID recession, food price increases have been high and accelerating. Higher food prices, in our estimation, are being pushed by follow-on effects from shuttering the economy in 2020 and follow-on effects from transportation bottlenecks, and will only be moderated through the passing of time. That said, higher food prices also translate to an effective tax on consumers that disproportionately impacts the more lowly compensated. As a result, we have added wage pressures and/or higher than expected voluntary quits as consumers look for higher compensation in order to offset higher consumer costs. Unfortunately, this tends to create a negative feedback loop. Higher wage demands create higher prices (absent higher productivity), which creates higher inflation and pushes wage demands still higher, ultimately forcing the Federal Reserve Open Market Committee's (FOMC) hand into hiking short-term interest rates to calm inflation. Which gets us to the topic of this quarter's missive.

Will we have a recession?



Source: US Bureau of Labor Statistics

The Economy

The short answer to the question above is yes, we will have a recession.

Economists have not yet figured out how to end the economic cycle, so a recession is as inevitable as night following day.

The real question and its corollary are this: When will the recession occur and how bad will it get?

In order to understand how to determine whether the domestic economy has entered a recession, it is necessary to understand how a recession is defined by the only real group that matters, the NBER. This organization is responsible for determining the beginning and endpoints of economic contractions and expansions (recession and recovery). Contrary to popularly held and widely discussed beliefs that a recession is two successive quarters of negative GDP, the NBER defines a recession as a "significant decline in economic activity that is spread across the economy and lasts more than a few months (depth, diffusion and duration)." While the NBER treats all three criteria as somewhat interchangeable and each needs to be met individually to some degree, extreme conditions within one criterion may partially offset weaker conditions in another. Put simply, just because we have weakness in the economy does not necessarily mean we will have a full-blown recession.

GDP encompasses three broad market segments: Personal Spending (Personal Consumption Expenditures), Business Spending (Gross Private Investment) and Government Spending (Government Consumption Expenditures and Gross Investment). Net Exports are also part of the GDP calculation, but have been a net drag on economic activity for decades.

To put this into context, we need to look at some history. We have provided, in the chart above, a look at GDP data from Q1 1998 to Q1 2022. You will note that there have been three recessionary periods within the timeframe indicated, March 2001–November 2001, December 2007–June 2009 and February 2020–April 2020. If we simply use two successive quarters of negative GDP growth as our criteria for a recession, then the March 2001–November 2001 recession doesn't meet the criteria, as only one of the three quarters touched saw negative GDP growth.

Alternatively, it is possible to have pockets of economic weakness that don't necessarily become a recession as they are not as widely felt, even though there is plenty of pain in the sector and it might feel like a recession. A case in point is the second half of 2015 and the first half of 2016, when business spending contracted sharply, led by structures and equipment. While the economy did not officially fall into recession, the manufacturing sector contracted.

Might employment hold the key? If we look at each of the last three recessions, we see that job openings peaked anywhere from 2–15 months prior to the beginning of a recession, and it would appear on the surface that job openings peaked in the current cycle in March of this year. Assuming a similar timeframe between a peak in job openings and the beginning of a recession, we might assume that a recession would start anywhere from last May (May 2022) to this coming June (June 2023).

Yet the employment data is still a bit murky.

Much like the case of the job openings downturn in November 2018, there are currently more job openings than unemployed people.

Unlike the November 2018 downturn, that gap has opened so that there are currently approximately two job openings for each unemployed person. (The U.S. economy peaked at 1.24 jobs for every unemployed person prior to the COVID recession.) In our view, the shortage of workers likely puts a floor under the employment situation, which could soften the economic fallout when we do enter a recession.

Which gets us back to inflation and the Fed. . .

It is clear to us that the Fed was late to the party when it came to tightening the reins and lost quite a bit of credibility. They started quantitative tightening late (not starting until November 2021) and then were somewhat muted in their response. They started raising interest rates well after it had become clear that inflation was running hotter than desired, and they started hiking rates in a typically understated fashion by only increasing short-term rates by 25 basis points (one basis point is equal to one one-hundredth of a percent). As a result, the Fed will likely need to be more aggressive in order to recover some level of credibility, which simply increases the likelihood of pushing the domestic economy into recession.

Will it be a soft landing, a steep recession or something in between? We are currently of the belief that the next recession will be a shallow recession due to the employment picture, and because both consumers and businesses are in pretty good financial health. The problem child, in this case, is the federal government, for whom rising interest rates mean a significant increase in debt service costs and significantly reducing any spending flexibility as a larger and larger portion of the federal budget goes towards non-discretionary payments (interest on the national debt, Medicare, Medicaid, Social Security, etc.).

Interest Rates

Interest rate expectations keep climbing higher. We have now had three successively higher rate hikes by the FOMC: 0.25% in March, 0.50% in May and 0.75% in June. This does not necessarily mean that a full 1% increase is in the cards, but expectations for year-end have climbed across the board and the Fed's dot plot (a graphical plot of FOMC participants' expectations for interest rates, provided below) now expects Fed Funds to end the year just shy of 3.5%. This would seem to indicate half-percent increases in short-term interest rates for the balance of the year and a larger single-year increase in rates than the 1994 hikes under former Fed Chair Allan Greenspan. For the record, we currently believe that Fed Funds will end the year in a range of 3.5%-3.75%.

Even though we have seen rates at the short end of the yield curve move steadily higher, the longer end of the yield curve seems to have more or less plateaued. Last quarter we took our expectations for the 10-year and 30-year bonds up to 3.10%

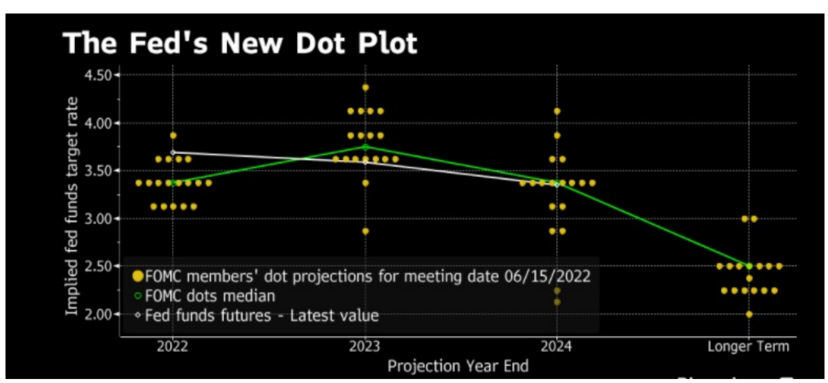


Figure 1: Source: Bloomberg Professional

and 3.40%, respectively. Although the short end of the yield curve has marched steadily higher, we are going to leave our current estimate of the closing yields for the 10-year and 30-year bonds in place. Yes, we realize that this implies an inverted yield curve if Fed Funds get to where we and the dot-plot expect, and yes, an inverted yield curve tends to happen prior to a recession.

While we do not expect a recession until early 2023, if we are currently in a recession (as some pundits believe) the Fed will then face a very real quandary.

Will they risk losing what little credibility this Fed has and end their tightening (something the Futures Markets do not expect) or will they stay the course and continue tightening in the face of declining economic activity in order to tame the inflationary dragon?

Will this be (for those of us old enough to remember) an Arthur Burns Fed or a Paul Volker Fed? That remains to be seen.

Market Overview

It is official. We are in a bear market (defined as a decline of at least 20%). While this marks the fourth bear market since the turn of the century, it is differentiated in that it has been the shallowest (so far) of the lot. (Some would not classify the decline in the first half of 2020 as a bear market because it did not last that long. We would point out that in terms of duration, the 2020 bear market was similar to the 1987 bear market that had corrected itself by year-end but was not fun to live through, as we can attest.)

We have been suggesting that lower duration (shorter term, higher yielding) assets would perform relatively better than longer duration assets in the current environment. That has certainly played out well so far this year regardless of whether we refer to stock or bond investments.

Short(er) term bonds have led the performance derby with 90-day T-Bills as the only asset class with positive returns for the year. While we understand that one cannot eat relative performance, particularly when it is negative, 1–3 year municipals (Bloomberg Municipal 1–3 Yr. Total Return Index) and 1–5 year government bonds (Bloomberg Government 1–5 Yr. Total Return Index) lead the non-cash investment return derby with losses of 2.03% and 4.19%, respectively.

Within the equity markets, shorter duration is generally defined by those companies who pay dividends, which from a quantitative measure includes value indices. Like the fixed-income markets, shorter duration equities are also leading the performance derby with none of those asset classes entering bear market territory and one of the dividend benchmarks (Dow Jones US Select Dividend Total Return Index) showing only modest negative returns through the first six months of the year, down 2.56%. Absent that one benchmark, there have been no other equity asset classes that have escaped unscathed.

The only places equity investors may have found some respite from the carnage through the first six months of the year has been utilities (down between -0.55% and -4.8%) and energy, although the returns in energy are a bit misleading.

The energy sector easily won the performance derby with returns through the first six months of between 17.22% and 31.84%, with more than all of its performance occurring in the first three months of the year. During the second three months of the first half, energy lost between -5.17% and -13.49%, depending on size (larger capitalization stocks did better than smaller capitalization stocks). If energy prices continue to trend down during the second half of the year, then energy stocks may continue to struggle. That said, many of the companies now pay dividends, which should improve overall performance.

What had been a bit of a mystery to us is that we had not seen many analysts reduce earnings estimates.

If the economy enters a recession and sales growth has stalled or will stall, and margins continue to be stressed due to labor and other cost pressures, then one would have expected the concerns to be reflected in analyst estimates.

We should not have been concerned, as it would appear that the downgrades are beginning. According to Lu Wang with Bloomberg News (Source: *Stock Drubbings Convince Holdout Analysts to Get Real*, Bloomberg News, July 11, 2022), Wall Street analysts have issued more than 500 downgrades on share-price targets and earnings estimates for S&P 500 companies over the five trading sessions ending July 11, 2022. It looks like PE ratios are heading higher due to lowered earnings forecasts despite poor stock market performance, which implies additional difficulties over the remainder of the year.

One positive is that the market tends to be forward looking. As a result, the market should start anticipating a turn in the economy and earnings before year-end, which may help equities in the latter part of the year.

Outlook

Returns across asset classes should continue to struggle through the balance of the year. Bonds will probably see some moderation in negative returns as the market begins to anticipate a recession. This should, in an odd way, help longer-dated bonds as the higher likelihood of a yield curve inversion probably puts a modest floor under longer-term returns. With rates having climbed around 1% across the yield curve from May to the end of the quarter, additional losses in bonds should moderate. Indeed, we are at a point now where even if rates rise by 1% at the shortest end of the yield curve (T-Bills to 1–3-year investment grade bonds), the shorter bonds should be able to eke out a positive return. (This is based on yields that are above their respective durations, where duration explains what happens to the price of a bond based on a one percent change in interest rates.)

While equities will likely be under pressure through the summer as analysts take down earnings estimates, returns within this asset class should also moderate as we get into the fourth quarter as the market begins to discount the end of a recession. This should allow equity returns to stabilize as more cyclical names begin to outperform as the market begins to anticipate the next expansion. We are still sticking with our expectations from beginning of the year for full-year equity returns of between -7% and 7%.

In our mind, there are two overriding risks to our outlook. One, as we enter mid-year elections, Washington (whether it is Congress or the current administration) does something stupid and makes things worse by ramping up spending or through negative regulatory changes. Two, some geopolitical event, whether it be China, the Russian/Ukrainian conflict or increased terrorist activity at home or abroad, significantly ramps up risks that are not yet priced into asset class returns.

Strategy Overview

We believe that downside risks relative to upside potential are moderating. As such, we believe it makes sense to increase exposure to risk.

While we are always vigilant of the relationship between risk and return, we are actively looking for opportunities that are more numerous now than they were earlier in the year.

That said, we continue to try to ensure that investors are more than adequately compensated for any risks taken.

We believe that by taking a little extra time to fully understand what is happening in the economy and the market, we can help avoid bad surprises and identify situations where risks have either been overpriced or find situations where the potential downside may be relatively limited.

Gauging appropriate valuation and purchase prices relative to risks has always been, and will always be, our primary focus. Linking investment decisions to something tangible like the cash-generating capabilities of a business or investment and assuming a minimum acceptable rate of return for each decision should add value. Elevated risks should translate into higher return requirements and lower valuations, all else equal.

Looking at investments, as would any rational person, helps us focus on the things that are the most important: return of and return on capital invested.

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