CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

July 5, 2022

A Wicked First Half of the Year

The first half of this year is one for the record books, the record book of difficulties. The stock market fell by 21 percent as measured by the S&P 500 and by 30 percent in Nasdaq terms. For the S&P, this was the worst half year since 1970; for the Nasdaq, it was the worst ever. Moreover, the bond market had its own difficulties. The index of all tradable US bonds fell by 10 percent, leaving investors with few places to hide.

The accounts that Core manages fell by about 10 percent in the first half, an unhappy event for all of us. As I wrote in 2021, the stock market was very overvalued and, as we began 2022, our stock holdings were few. During January, I reduced those stock positions by one half. But, given that the first half produced nothing but red ink for stocks, essentially all equity holdings were losers. Our large holdings in bonds gave us no comfort. As inflation rose, the Fed's rhetoric became more harsh, promising to tighten monetary policy significantly by raising interest rates and by reducing the assets it holds. The Fed's rhetoric and its actions caused bond prices to fall to the detriment of our holdings.

The prospects changed. Beginning in May, as somewhat weak economic reports flowed in, investors' views of recession risk began to rise. With that grew the view that the Fed would not be able to raise rates as much as threatened. The bond market found its footing and has rallied, particularly in the last three weeks. It has not been widely remarked that the US economy shrank in the first quarter; Gross Domestic Product (GDP) fell by 1.6 percent. The Atlanta Federal Reserve Bank publishes its daily estimates of economic activity, called the Atlanta Fed Nowcast. On Friday of last week, after a particularly dismal economic report (the purchasing managers report), the Atlanta Fed revised downward its Nowcast model for second quarter GDP to a decline of 2.1 percent. This is not, of course, the official final number for the GDP, but it strongly suggests that the US economy declined in both the first and second quarters of this year.

A long-standing Wall Street rule of thumb is that two quarters of shrinking economy means that a recession has begun. (The basis for this rule of thumb is that <u>every</u> time that US GDP has declined in successive quarters, the economy is in a recession.) For the Fed to be tightening monetary policy so significantly in a weakening economy—into a recession--is bad news for the stock market and good news for the bond market. The Fed's sharp monetary tightening arose because of the very high inflation readings. The Fed was quite slow to recognize the high and rising inflation. Given that the Fed's first job is to create conditions for stable and low inflation, it has determined that it must crush inflation. The problem is that the tools it employs to lower inflation will very likely crush the well

By

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being of many people. It will suppress demand, raise unemployment and cut personal income.

The stock market's decline so far has largely been the result of cutting the prices paid for the earnings stream of the stock market. As we wrote extensively last year, stock prices rose to extraordinarily high multiples of underlying earnings. Now these earnings have come down to more normal levels. Well and good. But consider the other element in this mix, that is, the level of underlying profits of stocks. So far this year, the estimates of corporate profits have actually risen slightly. When companies announce earnings later this month and comment on prospects for future earnings, it is highly likely that estimates of corporate earnings will fall. How can they not? If not yet in recession, we are close to it. Corporate earnings do not rise in recessions. They fall. If more realistic estimates of corporate profits were at hand now, we would see that the price-to-earnings multiple attached to those earnings is in fact still quite high. Hence, it seems very likely to me that stock prices will fall further to reflect the lower corporate earnings.

An astute commentator of asset markets, John Authers of Bloomberg, writes today as follows on this matter:

> The mathematics of the situation are merciless. Either profits are about to fall or, if they don't, central banks will have to keep raising rates until they do. That would continue to put pressure on multiples. To quote Lapthorne [Andrew Lapthorne of Societe Generale]:
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> *The problem facing equity investors is if a slowdown/recession is indeed on the way, then today's earnings forecasts are way too optimistic, and there have only been a limited number of downgrades so far (currently, globally there are as many upgrades as there are downgrades). This surely must change during the upcoming reporting season; otherwise, we assume, that both demand and price increases are holding up and the central banks would need to continue hiking.*

Recall, as written in recent letters, that Core's sole equity position for clients is a fund that rises in prices as the Nasdaq falls. It has appreciated well since we began to build the position in May. More of the same is likely.

My expectation is that the Fed will raise interest rates at its next two meetings, as it promises. The result will be further declines in stock markets and increases in bond prices. The Fed and the economy will not make for a pleasant summer, but it should be a tonic for the portfolios Core manages. After the rather grim first half of the year, this will be a welcome turn of events.

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