Market Strategy
by STRATEGAS A BAIRD COMPANY

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Market Strategy Update

June 27, 2022

With market volatility elevated, Strategas answers a few of their most commonly-asked questions on inflation, earnings, policy, and their outlook for both equity and fixed income markets.

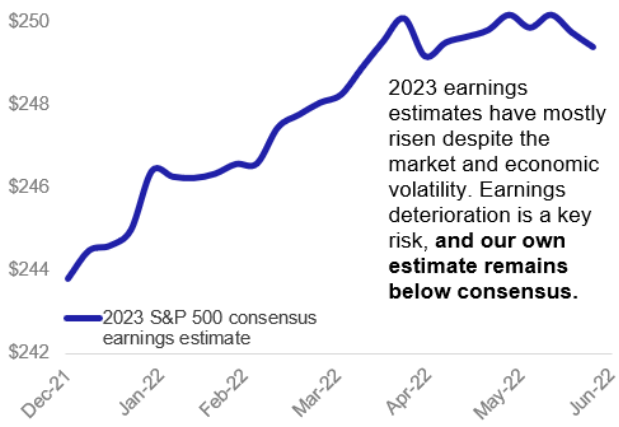
Strategas Research Team

ANSWERS TO OUR MOST FREQUENTLY ASKED CLIENT QUESTIONS

Have we seen the bottom in stock prices? Although we'd like to say yes, Q2 earnings and guidance (which will be reported over the next month) might finally reflect recession concerns and signal another leg lower for the market. There has been little movement in the consensus 2023 S&P 500 earnings estimate of roughly $250 (up 10% from the 2022 estimate of $228). Further, an examination of past bear market bottoms suggests that a significant increase in high yield credit spreads and the VIX (the market's "fear gauge") would be necessary to mark a capitulative bottom. Generally speaking, bear market bottoms are also associated with lower earnings multiples.

What worries you most about the stock market now? In short, 1) the potential for a policy error (e.g., higher taxes); 2) the general tendency to expect a quick, V-shaped recovery in the stock market and the economy (unlikely without stimulus, and even less likely given how much more the Fed has to do); and 3) weaker Q2 earnings guidance as noted above.

Where do you differ most from the consensus? Probably on how much time it will take for the Fed to extinguish inflation, as well as the central bank's willingness to rescue markets (i.e., the "Fed put"). We are taking the Fed at its word that the only part of their policy mandate that counts today is price stability. Also, few of our clients are bullish on the Energy sector, while we remain overweight Energy.



Are you still comfortable with your 2023 EPS estimate? Yes. We established our S&P 500 2023 estimate of $233.75 in February when the odds of a recession (over the next 12 months) were still below 50/50, and the same story remains intact. Profit margins are showing signs of rolling over, costs are growing at about 15% year over year, and the unemployment picture is beginning to weaken. If the U.S. does enter recession, even our estimate for flat earnings growth next year will be too high (consensus is at $250).

Have we seen enough downside pressure to signal a market bottom? We remain reluctant to make a "capitulation call" with trading volumes among the market's most important stocks still relatively benign, put/call ratios below past extremes (i.e., investors are not getting overly defensive), and the VIX (the market's "fear gauge") still acting fairly calm. As we wrote last week, "oversold" is a different call from "major bottom." Many price indicators are oversold, but bounces must be viewed within the context of the market's primary downtrend.

What are you hearing in your meetings lately? Oddly, we get the impression that investors now view a recession as likely to revive the relative outperformance of Growth stocks and Tech. We're more skeptical – it's true that Growth has a reputation for outperforming when economic growth is scarce, but our suspicion remains that higher rates (generally bad for Growth shares) are more important to what works this cycle.

What are the odds of a recession in the next year? We've had a very weak first half of 2022. The Atlanta Fed's tracking estimate for U.S. Q2 real GDP is 0% q/q A.R. We're using the following odds: 50% recession, 40% soft-ish landing, and 10% upside surprise over the next year. The reasons the recession odds are not even higher are: 1) the 11.4 million job openings in the U.S. economy vs. 6 million unemployed; and 2) the cash cushion that's still likely available for upper-income consumers.

What are the odds of a U.S. recession over the next 2 years? 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, the key is for inflation to peak and 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 and needing heads twice to avoid recession at the 2-year horizon doesn't make for great odds.

What are the downside vs. upside risks for the U.S. economy? The downside risks are that we've already had a surprise negative GDP quarter in the U.S. in Q1 of 2022 (which is rare), global supply shocks are still in play, we've lost help from U.S. productivity, demand must fall to meet restrained supply, and corporate profits should come under further pressure. We can compare this to the (narrowing) path to a "soft-ish" landing: job openings provide cushion to take air out of the labor market, goods could cheapen with global bottlenecks clearing, the Fed has wiggle room around its 2% target (e.g., declare victory at 2.5%), and wealthy economies could sacrifice consumer surplus to get productivity back up.

Is there any good news coming on inflation? Food and energy are roughly 20% of the U.S. CPI, core goods are 20%, and services 60%. There are reasons to expect some relief on goods inflation going forward, which should come down as bottlenecks clear and retailers unload inventory. This should support the "peak inflation" camp. But commodities could still hold higher until we get past recent geopolitical disruptions, while core services inflation should also be higher given wage increases.

Have 10-year Treasury yields peaked? If the Fed funds rate is set to peak at or below 3.75% by mid-2023, then we've likely seen 10-year yields hit their cycle peak at around 3.50%. But if inflation drifts higher again next month, then the market is likely to push its terminal Fed funds rate expectation higher, perhaps above 4.0%, which should lead to another push higher in 10-year yields, likely pushing 10s above the 3.50% hit a week and a half ago.

Will President Biden do anything on inflation before the election? Biden had a chance to do an "all of the above" energy approach when Russia invaded Ukraine but has tried to increase global oil production while resisting fossil fuel expansion in the US. This has now limited his options. He could force refiners to ramp up through the Defense Production Act and/or limit crude and refined exports. He could also reduce tariffs on China (but the effect on inflation would be relatively small). Democrats are likely settling around the idea that if they increase taxes, reduce the deficit, and make progress on drug price negotiation, inflation will come down (though tax increases have failed to reduce inflation in the past). This is the center of the negotiations between Senators Schumer and Manchin on a new bill ahead of the midterms. Democrats see that they are likely to lose the House this fall, and this is their last chance to get something done on climate and health care before the clock runs out.

What is your outlook for the midterm elections? On average a president loses 29 House seats in their first midterm election, and Republicans need just four to win the House. It's very likely that the Republicans will control the House. The bigger question is the size of the Republican gains. A low 40% presidential approval rating is consistent with a 40-seat loss. The consensus is around 25-30 seats for Republicans, but special elections are showing that the environment has moved even further towards Republicans and gains could be larger than consensus anticipates. If the Republicans flip a higher range of seats in November, that will likely cement their hold in 2025-26. The real issue will be the Senate. We expect the Republicans to win a net 1-2 seats and gain control, but candidate quality is worth monitoring for any market change.

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