Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Quarterly Market Update

Second Quarter, 2022

INFLATION, GROWTH, AND THE FEDERAL RESERVE

Persistent and broadening inflation has jolted financial markets. Given the pandemic that shuttered the world's economy and the overwhelming fiscal and monetary responses employed to combat the recession that followed, perhaps it's not all-that-surprising that the bill for the global economy would come due sooner or later. The real question now is whether that debt has been paid, at least metaphorically, or whether a balance remains.

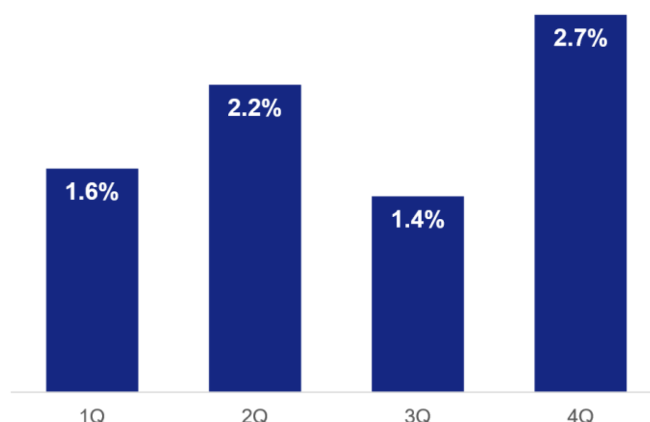
As of today, we're more inclined to believe that the effects of inflation are not yet finished with our economy and markets. Although a strong case can be made that current market multiples (e.g., P/E ratios) already reflect a higher-inflation environment, it would be difficult to suggest, based on analyst estimates, that lower earnings expectations have been fully factored into current stock prices. As of today, expectations for 2023 S&P 500 earnings remain at $250, roughly a 10% increase from 2022 estimates.

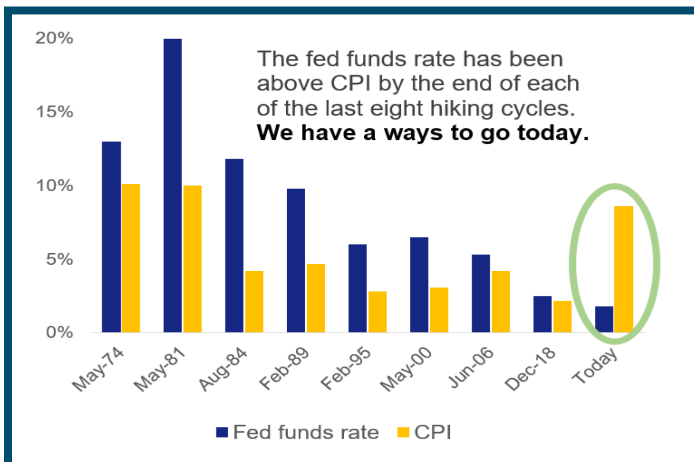
This earnings forecast remains wholly inconsistent with the growing odds of economic slowdown. The Atlanta Fed GDPNow model estimate is currently indicating that real GDP growth in the second quarter fell -2.1%. If this turns out to be correct, it will mark the second quarter in a row of negative GDP prints, the rule of thumb generally used to determine whether an economy is in recession. It should be noted that earnings have fallen by 30% on average in past recessions.

Taken together, these circumstances place the Fed on the horns of a dilemma. For while one could make the case that inflation may be peaking, headline price increases of over 8% are still well-above the central bank's target of 2.0%–2.5%. For both reputational and political reasons, we believe the Fed must continue to tighten until it becomes obvious that they've made significant progress in fighting inflation. Stock prices are unlikely to be thrown a lifeline anytime soon.

As a way to invest in this environment, we think individuals should stick with shorter duration equities that throw off lots of cash. These are stocks that generate a majority of their cash flow in the near-term vs. farther in the future, which helps avoid the need to tap increasingly difficult-to-access capital markets for funding/liquidity. Although such firms are more easily found in Value sectors like Energy, there are candidates in every sector. We remain overweight Energy, Materials, Industrials, and Healthcare, with a tilt towards Value over Growth and Small over Large.

Asset Class	Representative Benchmark	Q2 Return
US Large Cap	S&P 500	-16.1%
US Small Cap	Russell 2000	-17.2%
International	MSCI EAFE (USD)	-14.3%
Commodities	Bloomberg Commodity	-5.7%
Municipal Bonds	BBgBarc. Municipal Index	-2.9%
Taxable Bonds	BBgBarc. Aggregate	-4.7%
Cash	FTSE 3-Month T-Bills	0.1%

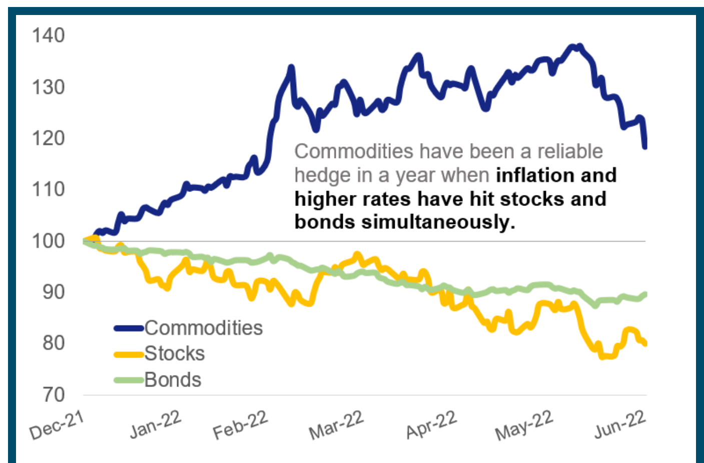




Tightening cycle			Max	annualized
			draw-	S&P 500
Start	End	Months	down	return
Mar-72	May-74	26	-26%	-4%
Dec-76	May-81	53	-19%	11%
May-83	Aug-84	16	-14%	7%
Dec-86	Feb-89	26	-34%	10%
Feb-94	Feb-95	12	-7%	3%
Jun-99	May-00	11	-12%	9%
Jun-04	Jun-06	24	-8%	8%
Dec-15	Dec-18	36	-14%	9%
	Average:	**26**	**-17%**	**7%**

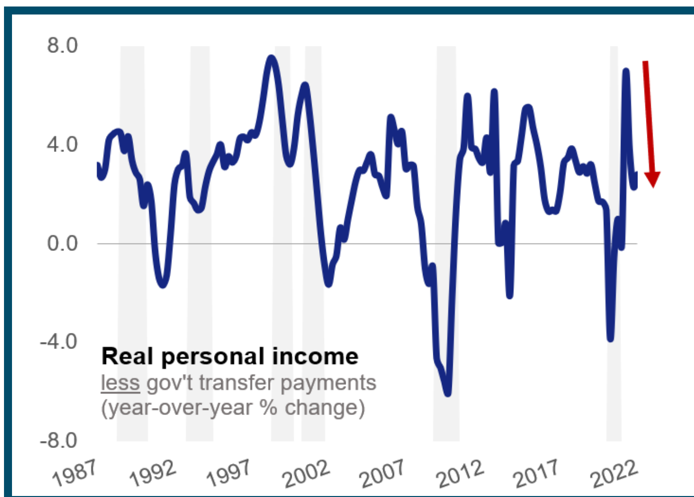
Historically, tightening cycles don't end until the Fed funds rate is above the inflation rate. In fact, if our perception of the market varies from the consensus view, it has a lot to do with the time we believe it will take for the Fed to bring inflation near its target of 2 to 2.5%. Without a little luck (i.e., peace in Ukraine), we may have a long way to go. And while it seems reasonable to expect the rate of inflation to peak soon (if it hasn't already), it seems unlikely that the Fed will stop tightening any time soon.

In most cycles, the market bottoms before the Fed finishes raising interest rates. In fact, on average, a market low is about halfway through a tightening cycle. This helps explain why stocks have averaged 7% annually across tightening cycles since 1970 despite the negative connotations associated with higher interest rates. However, during when the market is dealing with significant overvaluation (1973-74, 1999-2000) the market low often occurs only after the Fed stops tightening. In our current situation, that could be some time away.

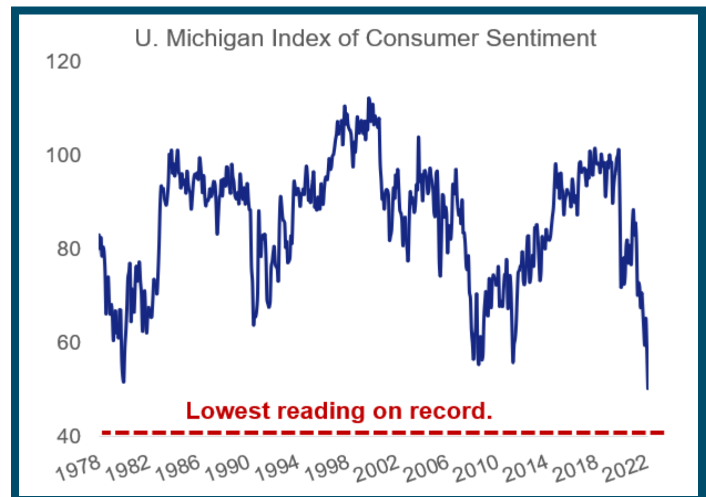


As we noted in these pages last quarter, higher inflation and higher interest rates have historically led to a lower price multiple on stocks. This has proven true again this year, as the S&P 500's forward price-to-earnings ratio has fallen 26%, accounting for nearly all of the stock market decline. Going forward, however, earnings are the bigger item to watch. Earnings estimates for 2023 have yet to come down despite the growing odds of near-term recession. We think corporate guidance over the next few earnings seasons will be a critical factor in where the market heads from here.

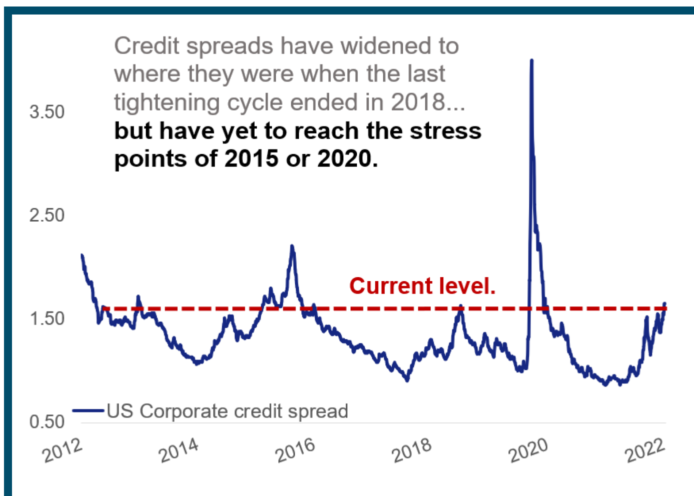
Of the 186 quarters since 1976, a negative quarterly return for both stocks and bonds has occurred just 20 times (including Q1 and Q2 of 2022). Furthermore, over the same period, there are just five instances where both stocks and bonds were negative for two consecutive quarters. Recessions have been associated with three of those previous four periods. To the extent to which this twin underperformance causes investors to reevaluate what "diversification" means, commodities may prove a valuable alternative as a direct hedge to inflation-induced volatility.



The National Bureau of Economic Research relies on a variety of data to determine when a recession starts and ends but, according to its website, relies most heavily on real personal income less transfers and nonfarm payrolls. While the employment picture is strong, real income growth has started to slow. Wage gains have been above their longer-term average but not strong enough to keep up with headline inflation over 8%. A weakening consumer would be a recession harbinger to watch.



Inflation – particularly in gasoline, food, and housing – has begun to meaningfully pressure consumers, especially on the lower end of the income spectrum. The high-end consumer is still spending but may not be able to fully support the economy, especially with consumer sentiment weakening to 50-year lows. This will not only have a spillover effect on spending, but will show up in the polls, as well: gasoline prices are one of the most important leading indicators of presidential approval rating -- and consequently of midterm election performance.



Despite the selloff in stocks and bonds, credit spreads have remained fairly tame in 2022, perhaps in part due to larger-than-average corporate cash cushions and pent-up aggregate savings. However, past bear market bottoms suggest that a significant increase in high yield credit spreads is needed to mark a capitulative bottom. History suggests that we're approaching the point where recession risk could be a catalyst for a rapid move higher in spreads, and credit exposure would need to be culled.

The US consumer is under pressure thanks to broadening inflation. Past the obvious strain on household financials, higher prices at the grocery store and gas pump are becoming entrenched in consumer expectations (i.e., what people think inflation will be in the coming years). This is a problem for the Fed and has helped feed the more-aggressive-than-expected monetary policy shift (including the surprise 0.75 percentage point rate hike in June). Prior spikes in consumer strain have often led recessions.

S&P 500 Index (Large Cap / U.S. Stocks): A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally $7 billion plus market cap) companies having growth and value characteristics. ● **Russell 2000® Index (Small Cap / Small Core):** Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equity of small capitalization.● **MSCI EAFE Index Net (International / Developed Markets):** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of May 27, 2010 the MSCI EAFE Index consisted of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. ● **BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds):** Comprised of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years. ● **BBgBarc Muni Bond Index (Municipal Bonds):** Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, part of a transaction of at least $50 million, issued after December 31, 1990 and have a year or longer remaining maturity ● **FTSE 3-month T-bill Index (Cash):** This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively. ●**Bloomberg Commodity Index (Commodities):** Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Subindices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

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