Mid-Year Outlook: Market Resilience

Douglas Coté, CFA
Head of
Global Perspectives

Executive Summary

- The party had to stop sometime; central banks are now "taking the punch bowl away" with higher interest rates.
- With inflation still high and rising and the economic growth slowing, stagflation has emerged as the base case.
- A severe energy crisis and concomitant high energy prices, primarily in Europe, have been exacerbated by Russian hegemony over natural gas supplies.
- Despite the burgeoning risks businesses do not get a pass on meeting their profit goals, and this necessity tends to make them resilient in any environment. This time will be no different.

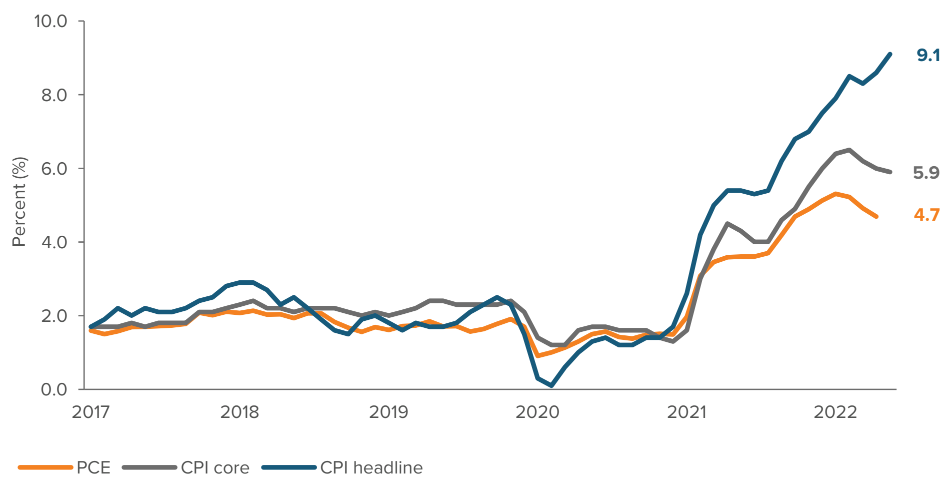
Stagflation becomes more likely

In the 4Q21 issue of Global Perspectives, I noted that stagflation risks were rising due to cost-push inflation sparked by global supply chain shortages and surging energy prices: "At this point in time, stagflation is a long, left-tailed risk, i.e., a low probability, but it is nonetheless a genuine concern given that the magnitude of its impact is like a meteor hitting earth. There is little policymakers can do with the cost-push inflation in the system, but the demand-push inflation induced by the U.S. Federal Reserve's artificial manipulation of the money supply is leading to a boom-bust business cycle."

Low probability notwithstanding, stagflation — slow economic growth paired with high inflation — has now emerged as a salient risk (Figure 1). Nearly 70% of GDP comes from consumer spending; the Fed's policy to rein in consumer demand is working, maybe too fast, and raising recession fears.

Figure 1. Declining spending and rising inflation increase stagflation risk

U.S. personal consumption expenditures and inflation, year over year percent change



Source: CPI Home: U.S. Bureau of Labor Statistics.

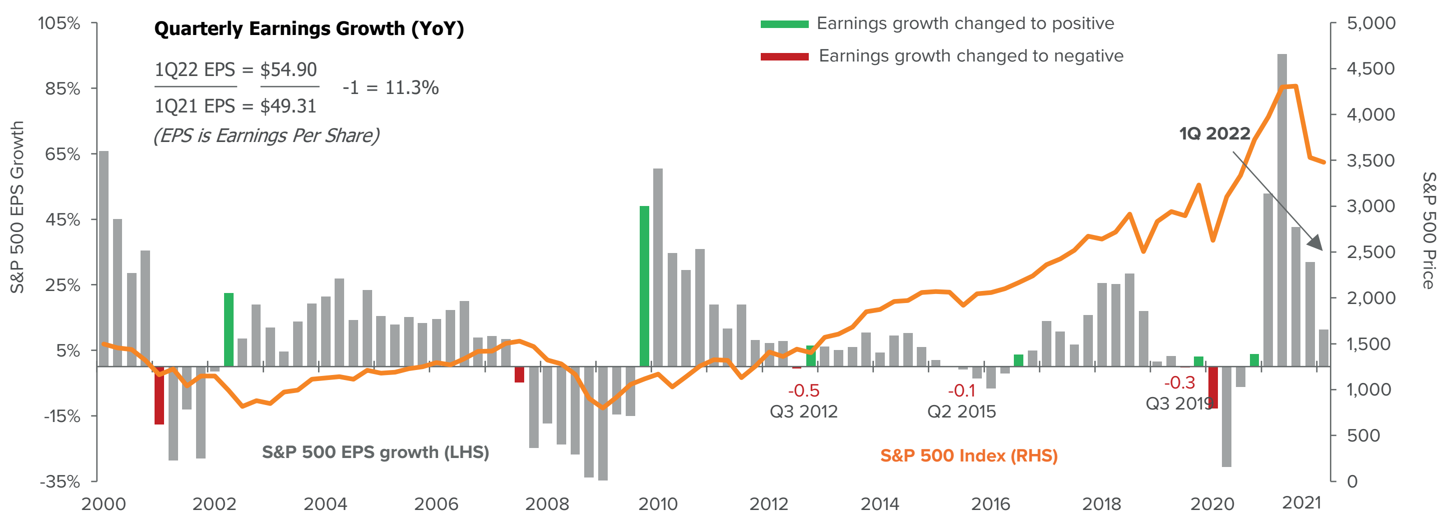
Certainly, slowing consumer demand will help to lower inflation, but not when both oil prices and home prices (rents) are at risk of going even higher. The last time U.S. energy supplies surged, oil prices subsequently collapsed; so even with today's high prices, drilling and supply have languished — "once bitten, twice shy", that is energy companies don't want to be "left holding the bag" – again. Higher mortgage rates have put a house out of reach for many potential buyers, creating more demand and higher prices for rentals. The Fed does not have all the answers, but its efforts to lower inflation may be sowing the seeds of a recession.

This raises the risks of stagflation, though there are optimistic counterpoints. In my view, market fundamentals are the major counterpoint offsetting the negative news. And despite great adversity, businesses big and small always seem to find a way to grow and prosper.

Advancing corporate earnings

The most recently reported, actual quarterly results for the S&P 500 index were for the first quarter of 2022 (Figure 2). Index earnings per share (EPS) grew 11.4%, with topline revenue growth of 14.0%, led by the energy sector with growth of 269.5%. Wall Street analysts underestimated these results by nearly half, forecasting as of April 1, 2022 – one day after the end of the first quarter – that S&P 500 earnings would grow only 6.4%. While those early estimates were subject to revision, profits continued to grow despite a market that wandered in and out of bear territory.

Figure 2. Fundamentals drive markets with good 1Q22 EPS growth



Source: Refinitiv – Thomson Reuters and FactSet, Voya Investment Management. Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. The S&P 500 index is a gauge of the U.S. stock market that includes 500 leading companies in major industries of the U.S. economy. **Past performance is no guarantee of future results. Indexes are unmanaged and not available for direct investment.**

First-quarter GDP growth declined by 1.6% in its final reading, certainly an ominous sign. Consumption, the largest component of GDP, grew by a paltry 1.8% versus 3.2% forecast in the preliminary estimate. Nondurable purchases fell 3.7% and services rose only by 3.0% — both lower than expected. Second-quarter GDP growth is expected to increase by 1.4% and show consumption still growing, though again at a paltry 1.9% rate. We do not expect a recession in 2022 but slowing consumer spending makes our 4.6% forecast seem too optimistic, due largely to the Fed's aggressive interest rate hikes and quantitative tightening (QT) policies, which are withdrawing liquidity from the economy and markets.

Broadening manufacturing

United States

The good news is that U.S. industrial production growth looks poised to exceed GDP growth in 2022. Industrial production grew 5.1% in 1Q22 and is expected to grow 9.2% in 2Q22. The bad news is that the ISM manufacturing index fell 3.1 points to 53.0 in June, a two-year low. The subcomponents painted an even worse picture, with new orders and employment in contraction and supplier deliveries plummeting from 65.7 to 57.3. On the other hand, the 53.0 reading still points to expansion of the manufacturing sector, which is expected to continue through year-end.

Europe

Eurozone S&P Global Composite PMI was revised up to 52.0 in the final reading for June, from 51.9 in the preliminary report. Even with the upward revision, the headline was at a 26-month low, as manufacturing sentiment continued to deteriorate. Recession risks are mounting as European economies struggle with the sharp rise in energy prices and the wider fallout from Russia's war in Ukraine. The energy crisis might be the worst ever, according to recent headlines from Bloomberg:

- "Worst of Global Energy Crisis May Still Be Ahead, IEA says" – July 11, 2022
- "European Heatwave Risks Curbing French Nuclear Power Production" – July 12, 2022
- "German Power Prices Jump on Little Wind and Less Russian Gas" – July 11, 2022
- "London Hit with Dangerous Heat Wave That Could Get Worse" – July 11, 2022
- "Texas Power Grid Withstands Strain of Blistering Heat Wave" – July 11, 2022
- "California Warns of Possible Summer Blackouts as Power Runs Low" – May 6, 2022

This global energy crisis has left no nation unscathed, but is especially bad in Europe due to the Russia–Ukraine fighting. This may mark a turning point in the renewables versus fossil fuels debate, where pragmatic plans for the two co-existing might make more sense. One unarguable point is that the "ESG – the Next Generation" will be living it; companies are already developing ways to integrate less stable renewable energy with highly stable fossil fuels via high tech data centers, to create uninterruptable power supplies.

China lockdowns and slowing growth

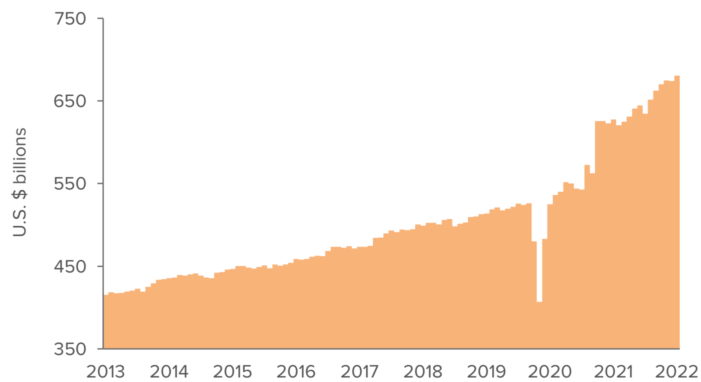
Lockdowns in Shanghai, a city of about 26 million people that contributes nearly 4% of China's total GDP, are worrisome. Shanghai, the biggest container port in the world, is operating at a fraction of its capacity. Like it or not, China is critical for the growth of the global economy and is still the epicenter for shipping and global trade. An upturn in the outlook for China, if it can move beyond its draconian Covid policy, could turn a dire forecast into a better if not rosy one.

Consumer as gamechanger

As always in my view, the consumer is the gamechanger. The question now is, Will consumers' impact be negative or positive? U.S. retail and food service sales for June 2022 totaled $680.6 billion (Figure 3), an increase of 1.0% from May and a y/y increase of 8.4%. (Sales are stated in nominal dollars and are not inflation adjusted.) Consumer confidence in March 2022 fell to 106.4 compared to 128.9 in June 2021 and a six-year low of 85.7 in April 2020.

Figure 3. U.S. retail sales beat expectations

Monthly sales, U.S. $ billions



Source: FactSet, data as of 6/30/22.

Consumer spending is predicated on job growth; the June nonfarm payrolls report showed the U.S. economy added 372,000 jobs, pushing the unemployment rate down to 3.6%. On the other hand, U.S. household wealth fell for the first time in two years as stocks lost $3 trillion. Real estate values climbed $1.7 trillion in the quarter and now stand at $149.8 trillion.

Rising inflation is cutting into consumers' discretionary spending, which likely will fall further in subsequent quarters. For example, in the first half of the year the consumer discretionary sector was the worst performer in the S&P 500, with a stunning 26.2% loss. Consumers are likely to feel more as inflation proves more intractable than anticipated and Fed policy becomes increasingly draconian.

Housing market

This isn't 2008, when speculation was rampant and the biggest speculators were people who had no net wealth. For many years, banks have enforced strict lending standards: buyers must be adequately capitalized and able to put at least 20% down for home purchases. There almost certainly is speculation in the housing market, and the speculators likely will face detrimental financial consequences, but the damage is not likely to spread to the banks. Higher housing costs may prompt consumers to curtail other spending. Those companies that depend on consumer spending will feel pain as their profits diminish — but again, this isn't 2008.

Market review first half 2022

The second quarter prolonged the woes of the first quarter, with worse results for both stocks and bonds. On Thursday, June 30, 2022, stocks closed out their worst first half-year since 1970, as inflation concerns, Fed rate hikes and slowing economic growth weighed on markets. The S&P 500 posted a loss of nearly 20%, while the S&P MidCap 400 and S&P SmallCap 600 performed slightly better (Figure 4).

Figure 4. Second-quarter market performance prolonged the year to date downturn

Index	2Q22	YTD 2022
Equity		
S&P 500	-16.10	-19.96
S&P mid cap	-15.42	-19.54
S&P small cap	-14.11	-18.94
Global REITs	-17.23	-20.35
MSCI EAFE	-14.29	-19.25
MSCI emerging markets	-11.34	-17.47
Equity average*	-14.75	-19.25
Fixed income		
U.S investment grade corporates	-7.26	-14.39
U.S. Treasury 20+ year	-12.67	-22.29
Global aggregate	-8.26	-13.91
High yield	-9.83	-14.19
FI average*	-9.50	-16.19
Overall average*	**-12.65**	**-18.03**

Source: FactSet, data as of June 30, 2022.

* Simple averages of all the indexes included in each group: all equity indexes, all fixed income indexes and a combination of all equity and all fixed income indexes. Please see disclosures at the end of this commentary for index definitions. **Past performance is no guarantee of future results. Investors cannot invest directly in an index.**

The S&P 500 Value index (-11.27%) outperformed the S&P 500 Growth index (-20.81%). Consumer staples, a defensive sector (-4.62%), outperformed its growth counterpart, consumer discretionary (-26.16%). Market volatility, as measured by the CBOE Volatility index, ended at 28.71%. Commodities, as measured by the S&P GCSI index, returned 2.01% for the quarter.

Conclusion

The fire hose of bad news has been spraying from geopolitics, inflation and the markets all year long, wreaking havoc on investors' ability to make coherent decisions. This is because it is so much more than an inflation problem and can't be resolved by raising the fed funds rate. Europe is in a full-blown energy crisis brought on by its own botched planning and an unforeseen but not unforeseeable dependence on Russian gas. As if that isn't enough stress, the changing climate brings on a global heatwave. The markets seem to believe that the Fed is omnipotent and able to solve all these problems – it is not.

The good news is that while the macro environment may drive markets in the short term, as it is doing now, fundamentals ultimately drive markets over the long term. The fundamentals are the ABCs of investing, and as we have discussed in this commentary, they are positive, working together to overcome obstacles. Advancing corporate earnings, the A, are especially important; companies continue to be resilient because they have to find a way to achieve their goals despite the macro environment.

Disclosures

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