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GMAG Monthly Market Update: July 2022

Dear Friends,

The US-focused 60–40 stock–bond portfolio declined ***-11.5%*** in Q2, posting its worst quarter in its history, dating back to 1976 (***Figure 1***). Investors are weighing whether this is a time to be aggressive or defensive. We believe the data suggests that the latter is prudent for now. As always, we are available to discuss how this affects your personal portfolio more specifically.

We are currently working on our quarterly market review, which will be distributed around the middle of July. This monthly update outlines many of the topics that we will cover and is longer than normal given the current state of market conditions.

June Performance Recap:

- The MSCI All World Equity Index declined ***-8.4%*** in June and is down ***-20.2%*** year-to-date.
- The US Aggregate Bond Index declined ***-1.6%*** in June and is down ***-10.4%*** year-to-date.
- The Goldman Sachs Commodity Index declined ***-7.6%*** in June but is up ***+35.8%*** year-to-date. Gold declined ***-1.2%*** in June and is up ***+0.6%*** year-to-date.

Outlook and Positioning Summary: Inflation has been elusive during the past year due to the volatility of supply-side conditions that was primarily driven by the pandemic and then exacerbated by geopolitical events like the war in Ukraine. That said, the combination of improving supply chain data, rising inventories, slowing demand, falling commodity prices, and steepening base effects suggest that inflation will likely peak from a rate-of-change perspective in June (to be reported next week). We expect inflation fears will transition to growth fears as elevated prices combined with hawkish central bank policies constrain economic activity.

Data suggest the risk of entering a recession in the next six months is material (if we are not already in one), and as a result, a more defensive investment approach is prudent. Currently, this means maintaining a high cash balance, but if we are correct with respect to inflation, then bonds should begin to perform well, and we would generally favor adding to this asset class. Furthermore, peak inflation could provide the Fed with the “out” it needs to pivot monetary policy, which could catalyze a near-term boost to equity prices. However, given the tightness of present labor market conditions, we are cautious that stocks will ultimately fall further prior to forming a major bottom (three-to-five year buying opportunity).

Causes for Pessimism:

- **Some of the world's most prominent venture capitalists (often considered to be smart-*money investors) are preparing for a prolonged economic downturn.***
    - Last month, Sequoia Capital delivered a 52-page presentation, warning its founders to prepare for very difficult times ahead. They believe that "we are just beginning to see how the increasing cost of money flows through to impact the real economy" and that "the recovery will be long." See the full presentation here.
    - David Sacks, CEO of Craft Ventures, is telling his founders to prepare for valuation compression to the tune of 90% in some cases and that they should be prepared to cut spending by up to 75% (listen at the 47-minute mark).
    - Jim Swartz, cofounder of Accel says, "I'm behaving like there's a major crash coming, and whatever opportunity I have to get out of very high-priced assets, I do."
- ***Sentiment is at an all-time low.*** Consumer sentiment (***Figure 4***) and the outlook for small business owners (***Figure 5***) have declined to all-time lows. Historically, sentiment has not deteriorated to such levels outside of recessions.
- ***There are early signs of stress in a tight labor market.*** Initial jobless claims (i.e., people filing for unemployment for the first time) have been rising since March, and at the same time, many firms, including Tesla, Netflix, Meta, Microsoft, PayPal, Coinbase, and JP Morgan, have either rolled out layoffs or are anticipating hiring freezes. Generally, when unemployment rises, it is difficult to rein in, and given that the unemployment rate is already at an extremely depressed level (94th percentile going back to 1948), the labor market slack needed to power future economic gains is limited.
- ***The inventory glut is expected to curb the purchase of future goods.*** The Philadelphia Fed is forecasting a substantial decline in new goods orders over the next six months (***Figure 6***) as retailers find themselves flushed with inventory after a period of excessive demand and constrained supply caused businesses to overorder. Going forward, this should result in lower prices but reduced economic activity—on Friday, Micron issued a profit warning, flagging reduced demand for the chips used in computers and smartphones.
- ***Expect downward earnings revisions.*** Data from Variant Perception indicate that business cycle indicators are now at worse levels than during the mid-cycle slowdowns of 2012, 2015, and 2018, creating material downside risk to earnings estimates (***Figure 7***), which remain elevated currently.
- ***Housing risk is consequential.*** Housing demand is slowing fast after mortgage rates have nearly doubled so far in 2022 (***Figure 8***). This could result in lower home prices following a two-year period when prices soared by nearly 40% (4 to 5x the historical annual rate). Hedgeye Risk Management believes that the wealth effect—a behavioral economic theory suggesting that consumers spend more when their stock portfolio and houses are worth more, and vice versa—peaked in Q2 and will cause a material drag on personal consumption and GDP growth over the next one to two years (***Figure 9***).

Causes for Optimism:

- ***Slowing inflation could catalyze a Fed pivot, which could extend the economic expansion.***
  Commodity prices are running out of steam, inflation expectations have rolled over, inventories are plentiful, and supply chain pressures are easing. The combination of these factors suggest that inflation is likely peaking.
  If true, this could provide the "out" the Fed needs to reverse its hawkish guidance. Historically, such pivots, on average, have lengthened the economic expansion by 6–12 months, in some cases propelling stocks to new all-time highs (***Figure 10***). That said, a pivot in Fed policy is not guaranteed to boost share prices—for example, it did not have this affect in 1973 or 2001—especially if a pivot toward easier financial conditions causes inflation expectations to reaccelerate.

- ***Sentiment is so bad today . . . how much worse can it get?*** It is true that the path of least resistance with respect to sentiment is up. When economic conditions reaccelerate, there should be a great buying opportunity coming out of this. However, we believe it is still early if we are headed into a recession.

Our market bottoming indicators suggest it is not yet the time to buy stocks.

- We are keying on our market bottoming signals to identify a major buying opportunity in stocks. So far, only 1 of our 10 signals have triggered (***Figure 11***), and history suggests it is not prudent to aggressively buy stocks until at least 50% of the signals have triggered. The takeaway is that if we are headed into a recession, we will likely need to suffer through a prolonged period of economic pain before stocks form a bottom.

In contrast, bonds may have already bottomed.

- Historically, bond yields have peaked around the same time as the Fed Funds Rate, and therefore, the end of the Fed's hiking cycle has historically signaled an attractive entry point to buy bonds (***Figure 12***). Most of the remaining interest rate hikes are expected to occur by November. But if inflation slows, market participants could anticipate this several months in advance. We believe it makes sense to start legging into bonds today and to plan to be more aggressive as our conviction that inflation has peaked increases.

Positioning Highlights
We have favored adjusting portfolios to a more defensive posture by bringing asset allocations underweight equities and fixed income, moving closer to neutral sector weightings within each asset class, and maintaining a high cash balance.

- ***Equities:*** We favor being underweight equities because the risk of recession has increased. Within equities, we favor being overweight US equities relative to international equities while the conflict in Ukraine and lockdowns in China persist.
- ***Fixed Income:*** We favor remaining underweight fixed income but favor adding to this asset class as evidence that inflation has peaked increases.
- ***Commodities:*** We favor being overweight commodities, particularly gold, while stagflation risks are increasing. Historically, gold has acted as a safe-haven commodity during periods of stagflation. Gold prices should also benefit if the Fed begins to ease its guidance for monetary policy tightening because this should push real yields lower (all else being equal).
- ***Cash:*** We have favored being overweight cash given the rising risk of recession. Cash should help client portfolios realize lower levels of performance volatility and provide them with dry powder to reinvest opportunistically.

As always, we thank you for your ongoing trust and confidence. Please do not hesitate to reach out with any questions relating to our outlook or the management of your individual portfolio.

Best regards,

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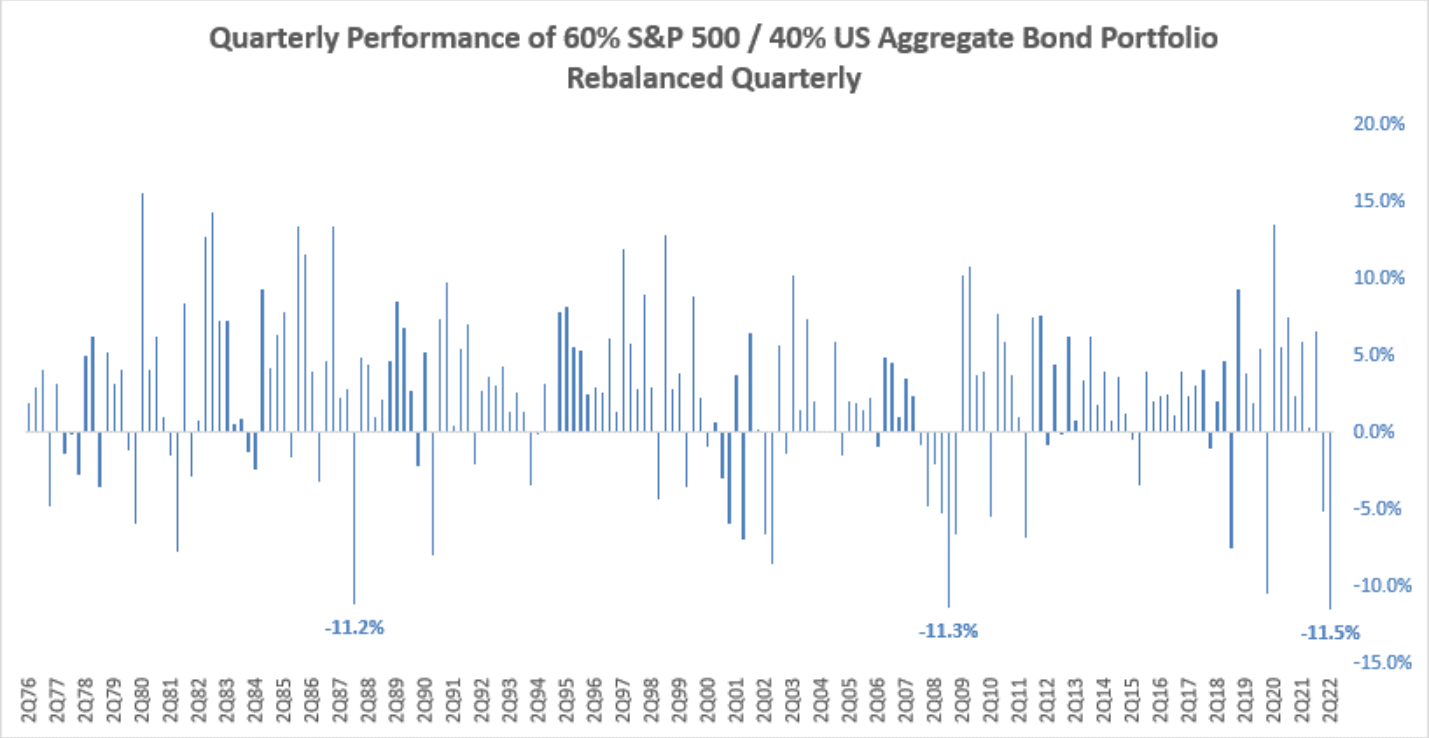
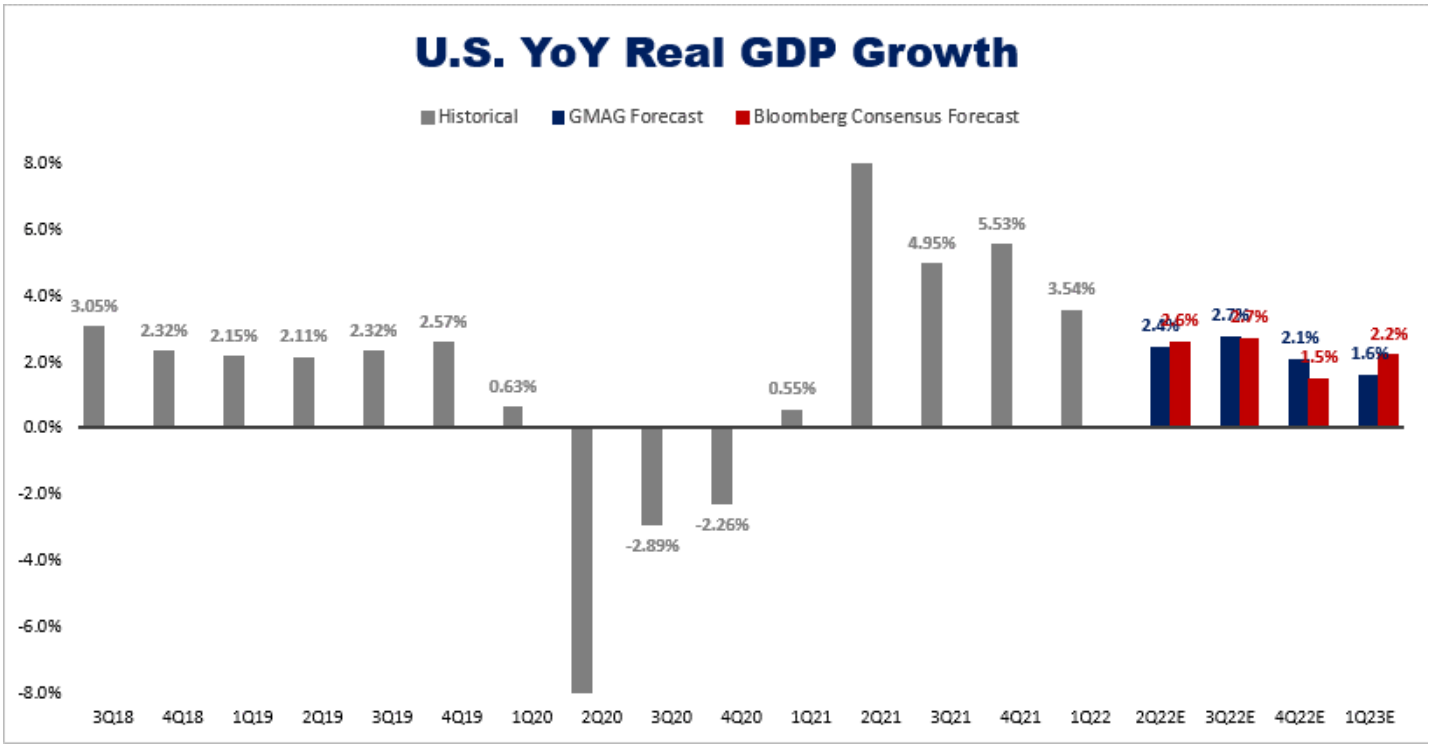
Figure 1: The US-focused 60-40 portfolio posted its worst return ever in Q2.



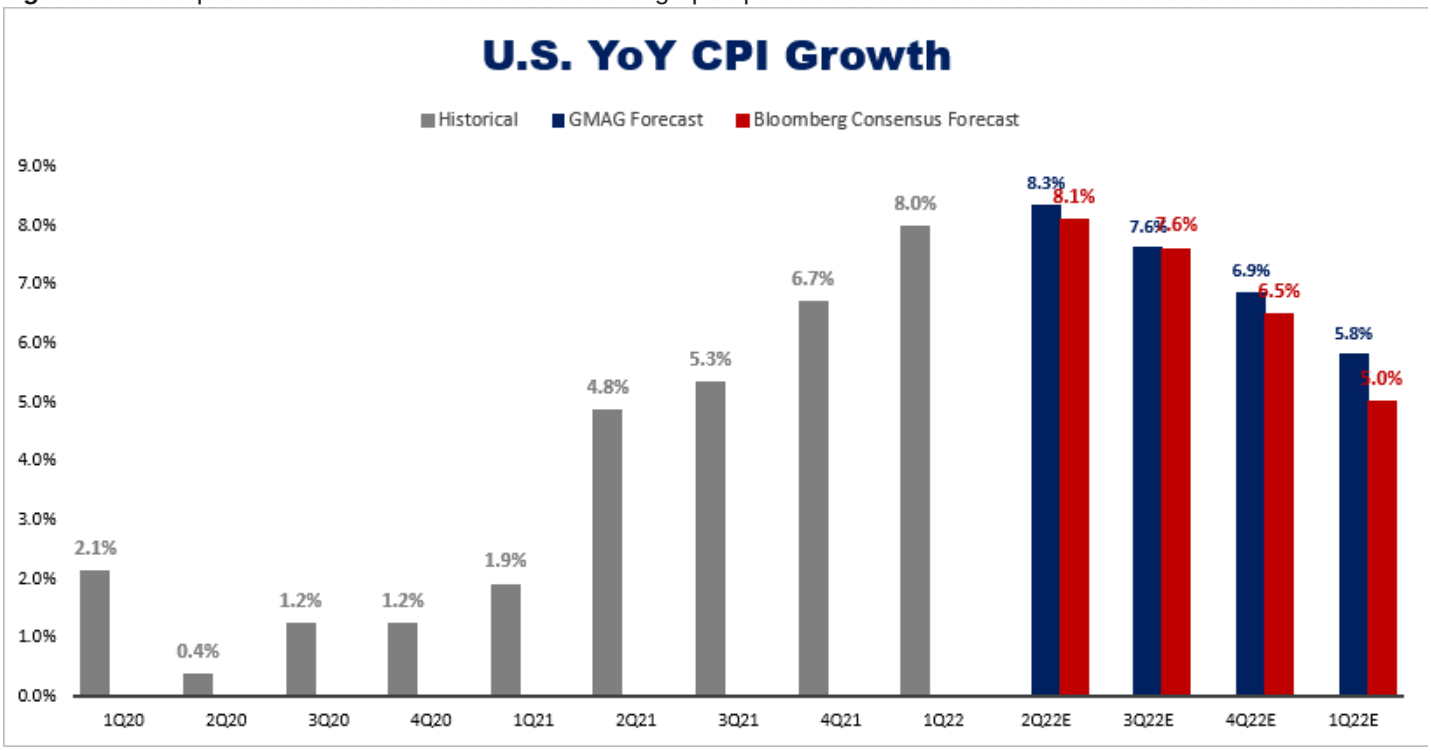
Source: Bloomberg, GMAG Research

Figure 2: We expect US growth to slow through year-end.



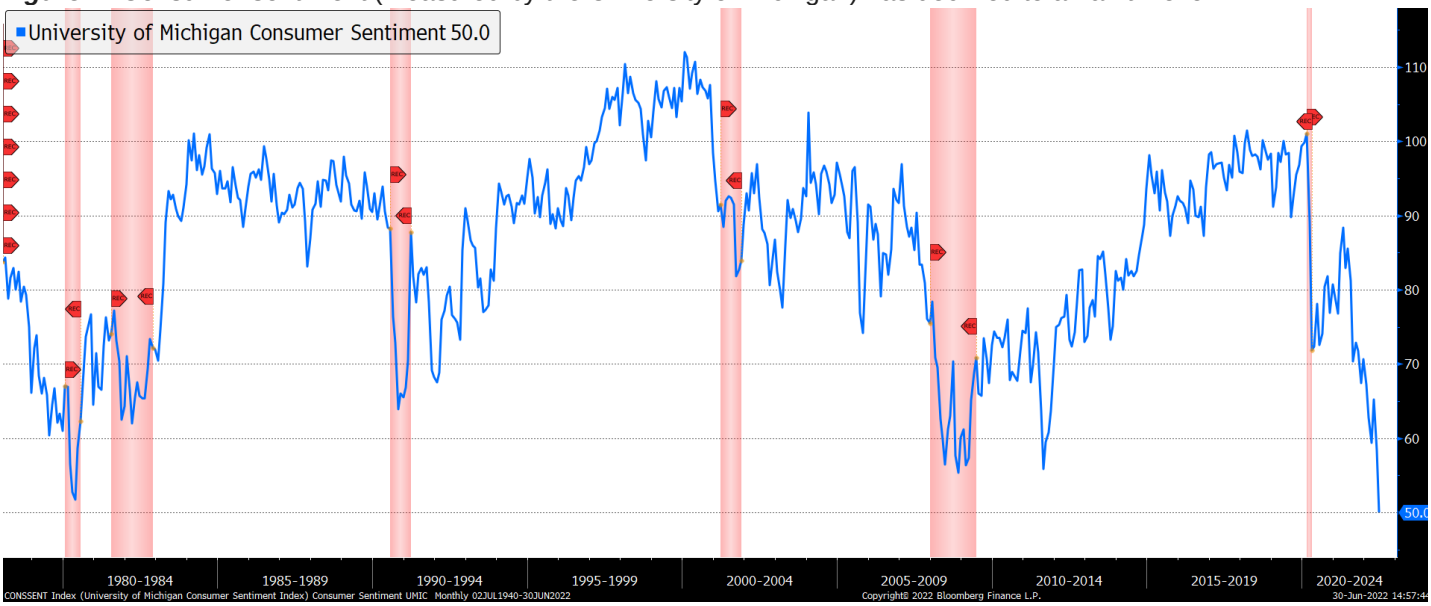
Source: Bloomberg, GMAG Research

Figure 3: We expect CPI to decline from a rate-of-change perspective but remain elevated in absolute terms.



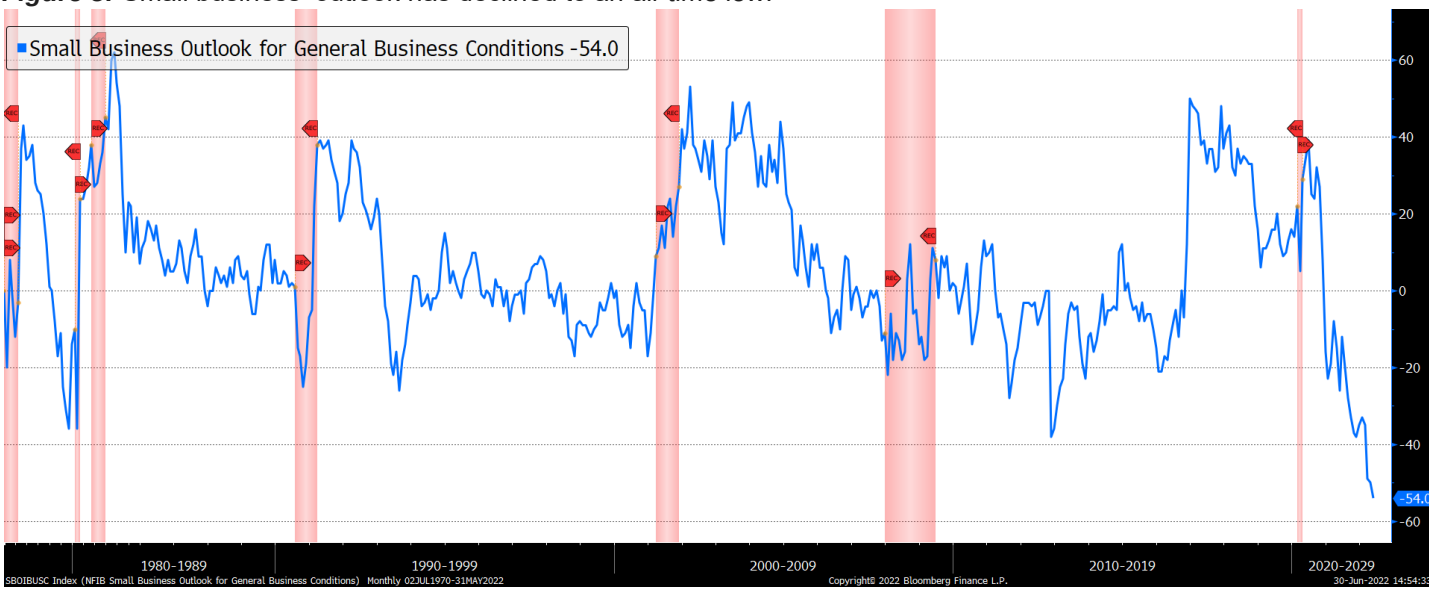
Source: Bloomberg, GMAG Research

Figure 4: Consumer sentiment (measured by the University of Michigan) has declined to an all-time low.



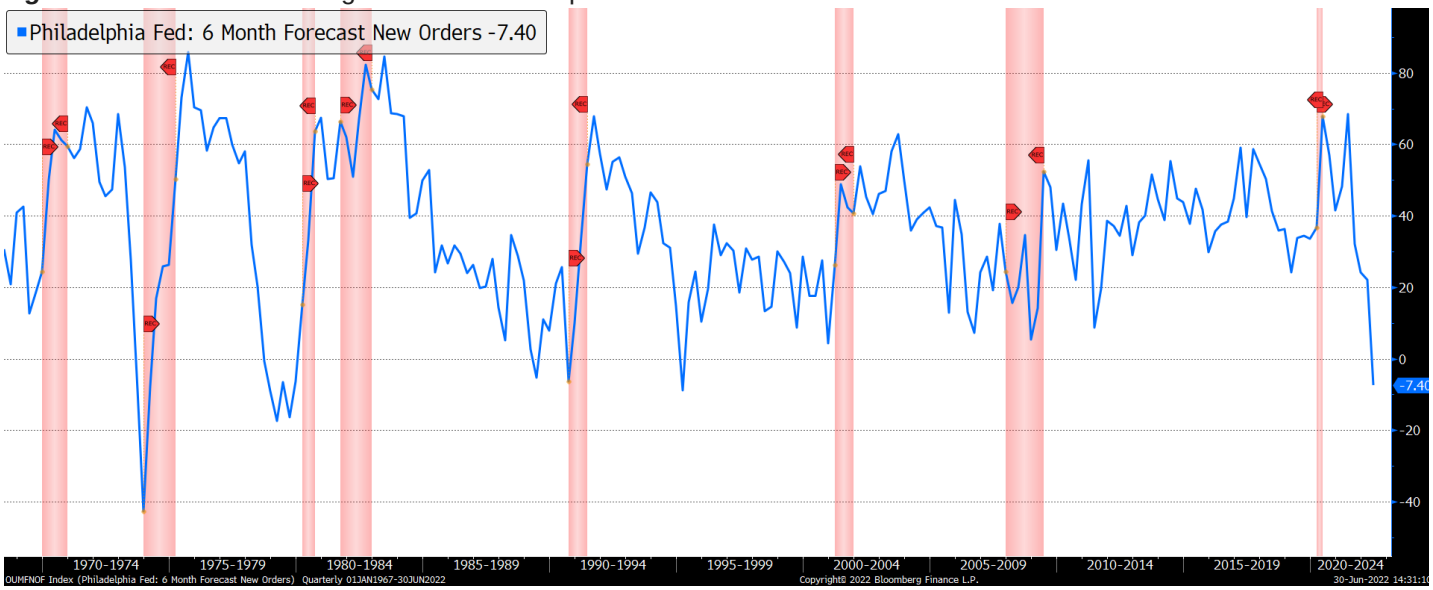
Source: Bloomberg

Figure 5: Small business' outlook has declined to an all-time low.



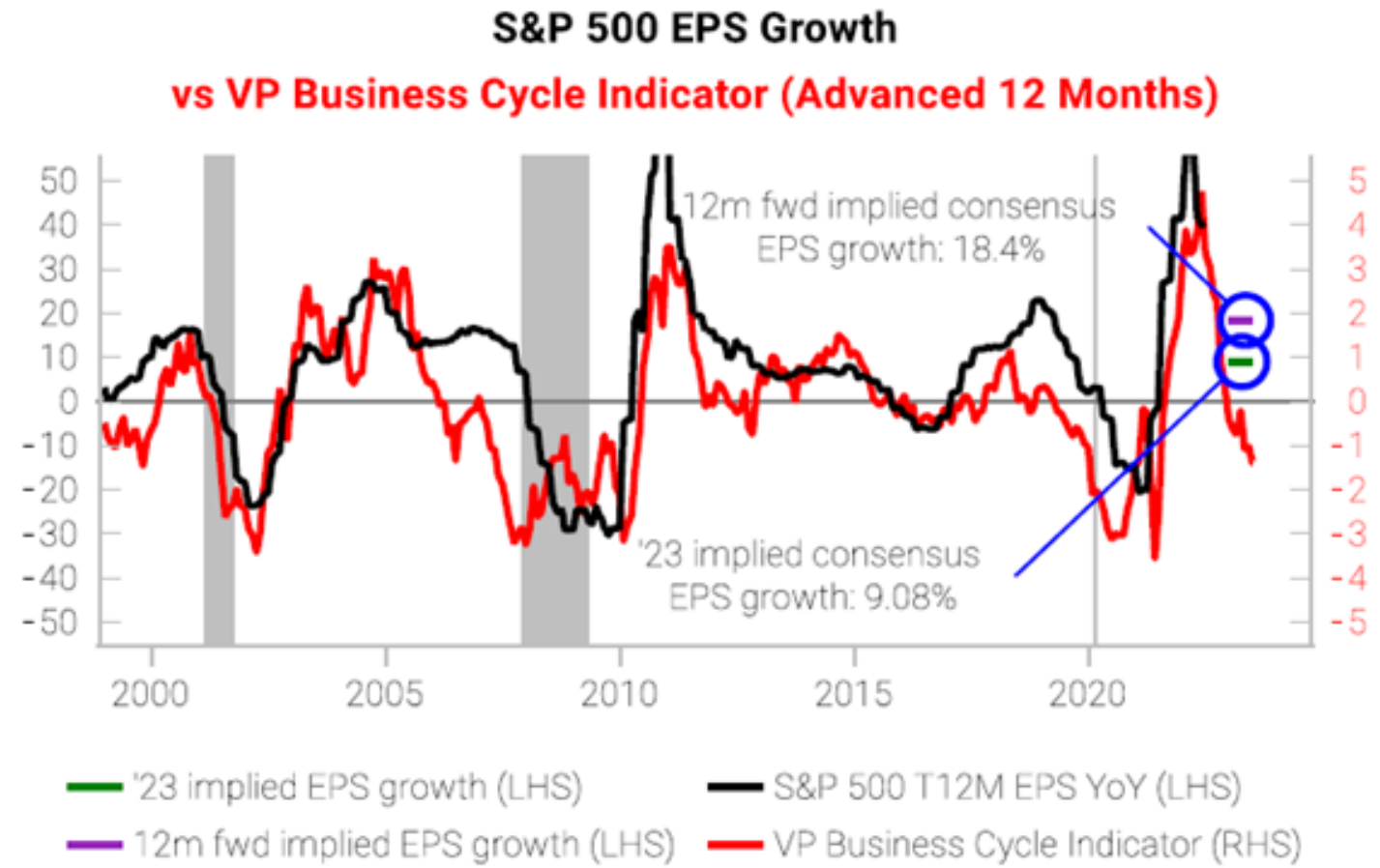
Source: Bloomberg

Figure 6: Forecasts for new goods orders have plummeted.



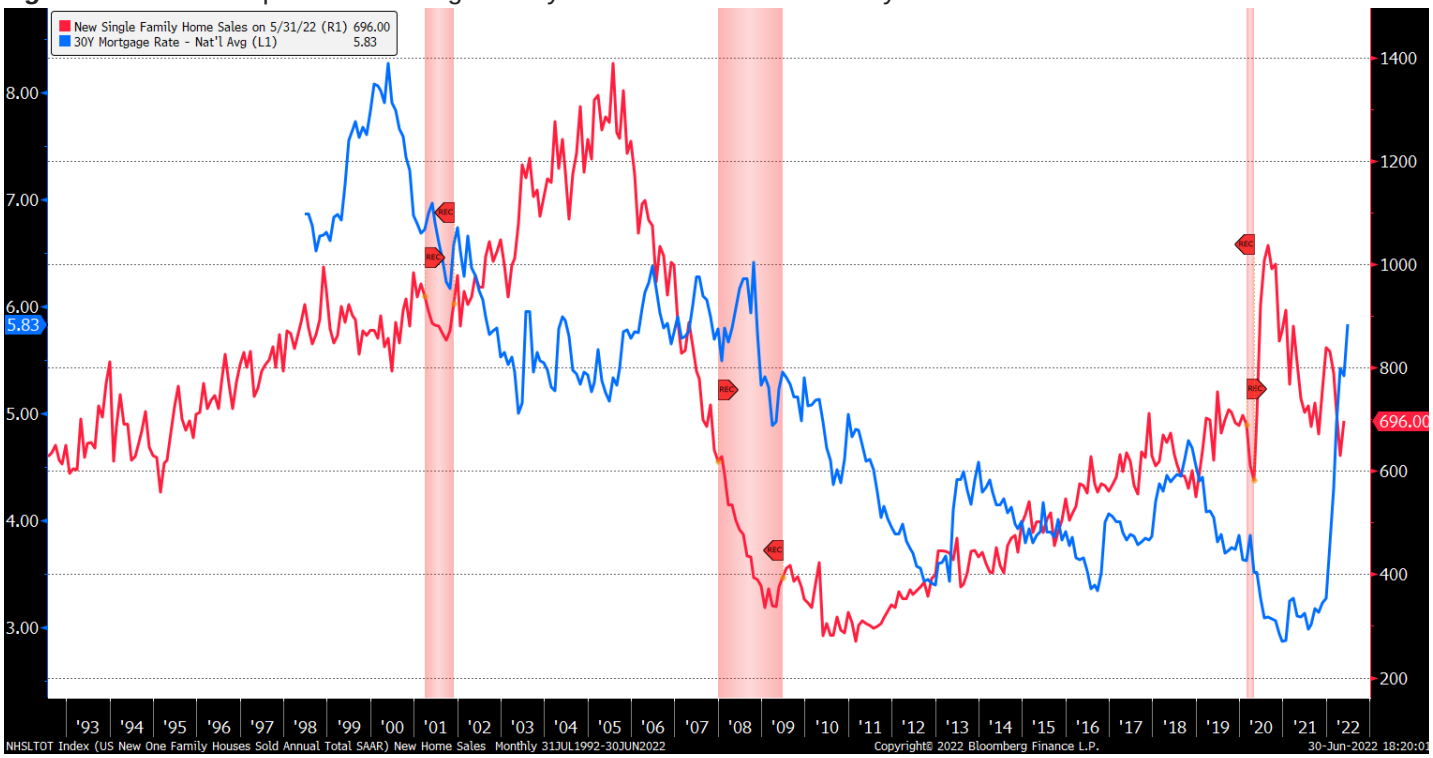
Source: Bloomberg, GMAG Research

Figure 7: Variant Perception's business cycle indicator suggests that consensus earnings estimates will have to be revised downward.



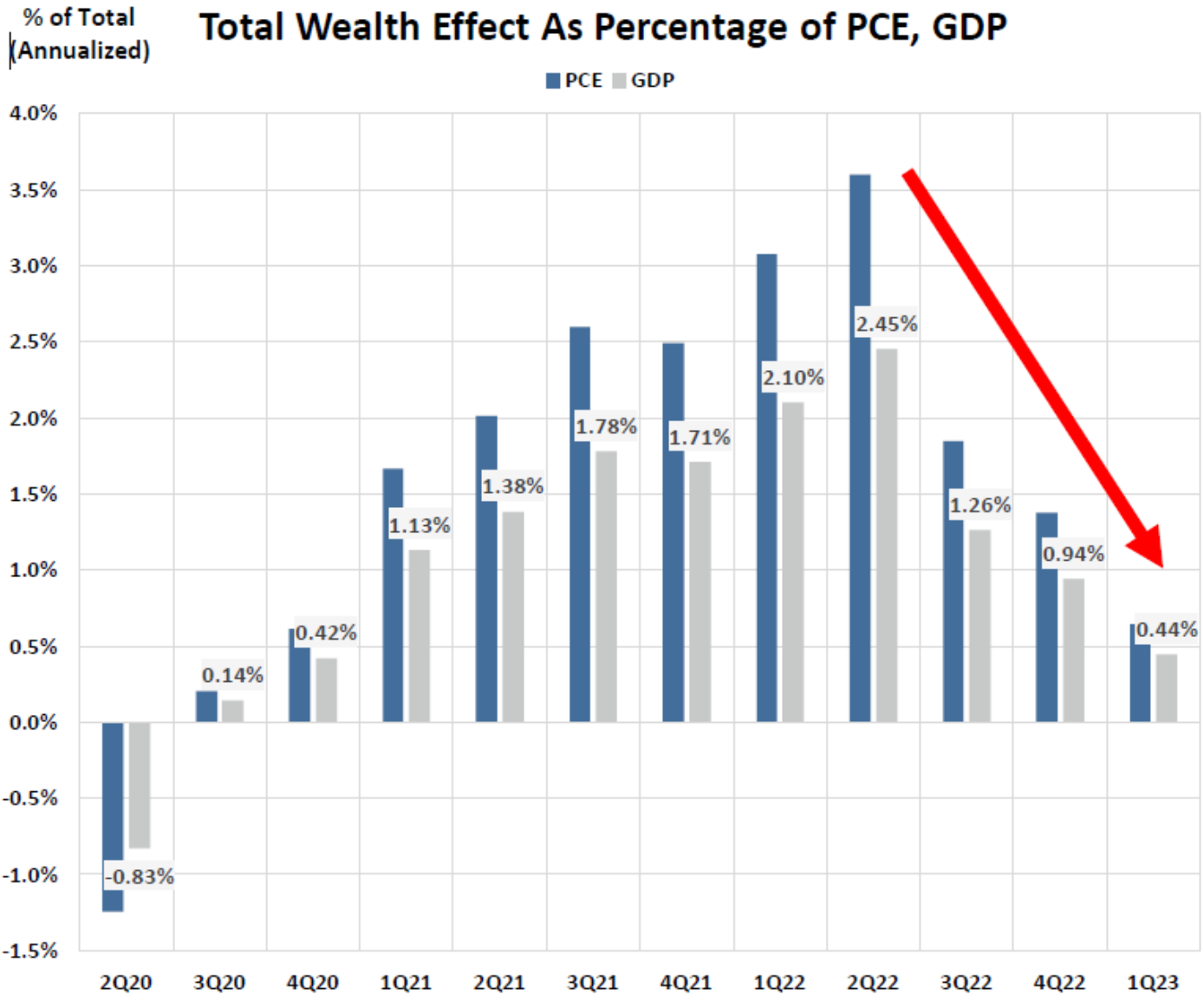
Source: Variant Perception

Figure 8: The annual pace of new single family home sales has declined by 30% so far in 2022.



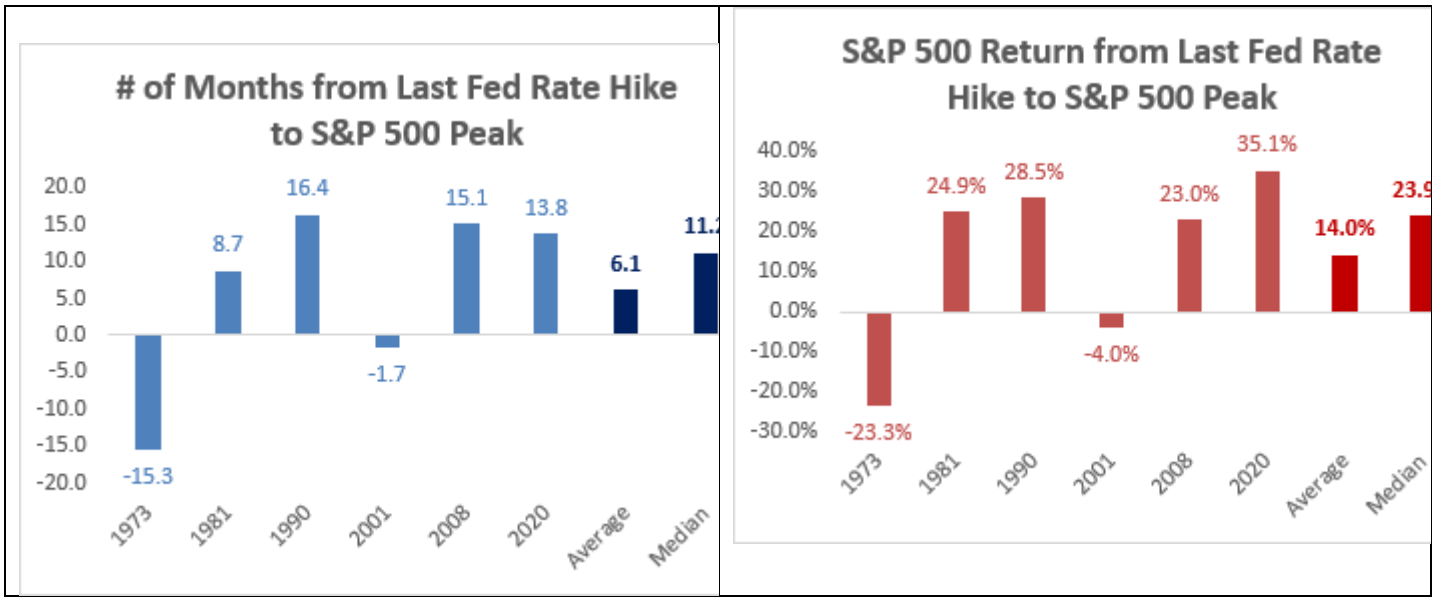
Source: Bloomberg

Figure 9: Hedgeye Risk Management estimates that the wealth effect peaked in Q2 and will be a drag on economic growth going forward.



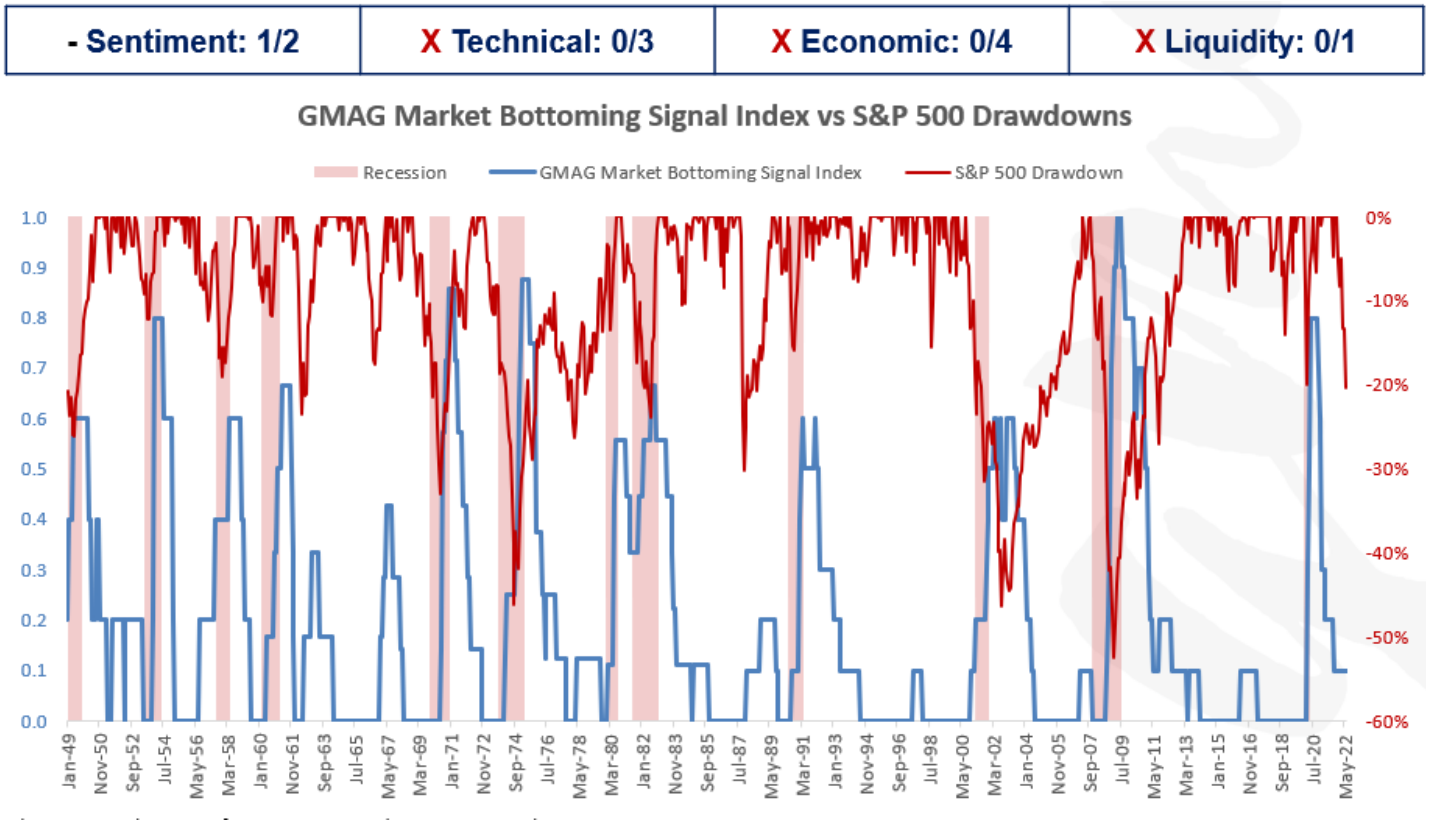
Source: Hedgeye Risk Management

Figure 10: Historically, major pivots in Fed policy have often extended the economic expansion by 6–12 months, in many cases providing a material boost to equity prices.



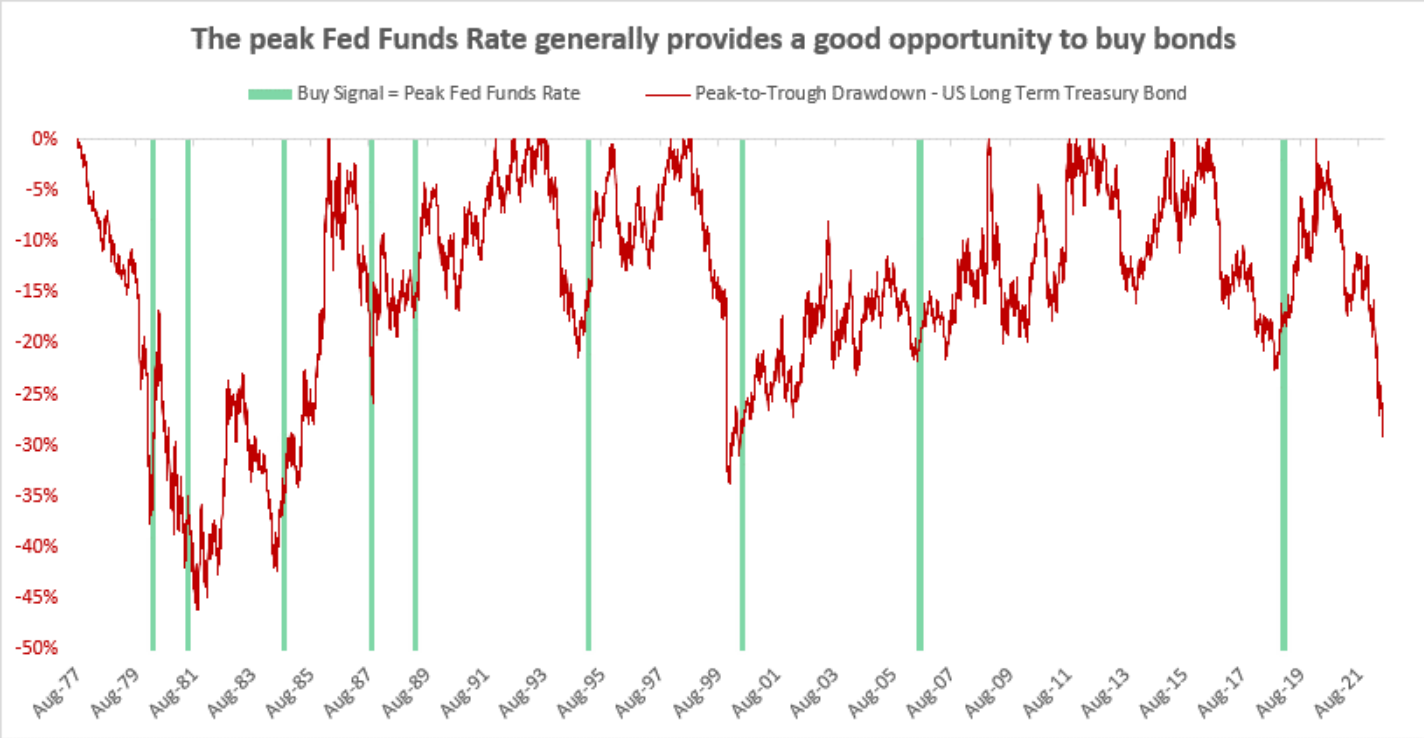
Source: Bloomberg, GMAG Research

Figure 11: Only 1 of our 10 signals for identifying major market bottoms have triggered. History suggests it is prudent to buy aggressively when at least 50% of the signals have triggered.



Source: Bloomberg, National Bureau of Economic Research, GMAG Research

Figure 12: The peak in the Fed Funds Rate has historically signaled a good opportunity to buy bonds.



Source: Bloomberg, GMAG Research

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