



Q2 Recap: Is recession a fait accompli?

The first half of 2022 will go down in the record books as the worst S&P 500 performance since 1970 and the worst 6-month start to the year for Treasuries since 1788 according to Deutsche Bank analysts. The culprit behind all of this? None other than the US Federal Reserve, which, despite all its academic horsepower, seriously miscalculated today's inflationary pressures, naively believing for too long that they would simply and conveniently abate. With inflationary pressures having only amplified over the past six months, the Fed finds itself in the unfortunate position of having to play catch-up - not a game financial markets like.

And so, with historical records firmly and somewhat discomfitingly in hand, investors find themselves looking ahead to a challenging second half of the year, reading headline after headline about a pending recession that may have already started in Q1. Stagflation is the buzzword for the balance of the year and financial markets will remain acutely sensitive to data supporting that notion. The bond market itself, fresh off that lousy start, is rapidly performing an about-face, with rising bond prices and falling yields suggesting that slowing growth is upon us. Whether it is or not, only time (and the National Bureau of Economic Research) will tell.

What we do know, however, is that asset prices everywhere have fallen, and some dramatically so. They may fall more if indeed we do experience a severe economic contraction. That said, there is already a lot of bad news priced into equities. And bond prices have adjusted meaningfully off the zero-bound (although not quite in step with today's elevated inflation). To borrow some wisdom from country singer Rodney Atkins, if you're going through hell, keep on going!

Although I'm not going to suggest we see light at the end of the tunnel, I'll reiterate my point that a lot of bad news has been priced into equities. Possibly even a mild recession. The challenge we face is that recessions can sometimes morph into self-fulfilling prophecies. If we all decide we're worried about a global growth slowdown and employers stop hiring (or begin layoffs) and consumers defer or stop spending altogether, then a recession is almost guaranteed.

To date, consumer spending has been robust, despite the worst University of Michigan Consumer Sentiment reading on record in June. We've commented on strong household and corporate balance sheets in the recent past, so we enter this uncertain period from a decidedly good spot. Demand for travel and services, in general, remains elevated, while that for goods is falling. Oversupply, following product shortages related to the pandemic, means many retailers will struggle to clear shelves by year-end, and the bargain outlets should see plenty of inventory come their way. But again, the market has priced a lot of this into equity prices.

XLY, the SPDR Consumer Discretionary ETF, has fallen -33% thus far in 2022. XLP, the Consumer Staples sector counterpart, is down only -5%. XLK, the SPDR Technology Sector ETF is down -27% YTD, while XLV, the Health Care Sector ETF has dropped only -8%. Facebook (now Meta) has been cut in half in 2022, down -52%, and now trades at 13x estimated earnings! Netflix is down a stunning -71%, while Tesla has fallen -36% and even Apple, arguably the greatest company in the world, has fallen -23%.

My point here is that a lot of damage has been done. Don't get me wrong, clearly, stock prices can and indeed may fall further. But right now we can invest in the S&P 600 small-cap index at 11x forward earnings and the S&P 400 mid-cap index at 12.4x estimated earnings. And we are! We know these earnings estimates may get ratcheted down as companies begin to report Q2 numbers next week. That could cause prices to fall even further. In which case, we're likely to buy some more. Over the next 5 to 7 years, we're willing to bet that today's prices will represent an attractive entry point for investors.

Looking internationally, the MSCI Emerging Market index is trading at under 10x forward earnings. Talk about discounting a LOT of bad news! International developed stocks are going for 10.8x estimated earnings. Now, we're not suggesting low P/E multiples are guarantees of strong future returns, but history suggests that we'll have a good chance of making money over the next decade.

In the fixed income arena, we're seeing yields that we could have only dreamt about over the past 5 years. Tax-free municipal bond yields of 3% to 4% in the 6 to 15-year range. High-quality corporate bonds yielding 5% out 8 to 10 years! Sorry, but these are things that get us excited. We know inflation is running hot, but we doubt it will remain elevated for too long, in light of the Fed's pledge to squash it. Locking in good yields on quality bonds right now makes a lot of sense to us. As with equities, bond prices may indeed fall some more, with yields drifting higher. In which case we'll buy some more of those too!

The crypto fantasy is rapidly withering on the vine and younger people are learning the hard way (courtesy of web "broker" -a kind name for it - Robinhood) that there is a big difference between gambling and investing. I think we'll look back on this episode with equal parts amazement and disbelief. A lot of money was undeservingly made in this realm and now it is getting deservedly lost. Saner times lie ahead, we hope.

Reluctantly, part of our job here at Nottingham is forecasting, and sadly, that onus usually falls on me. As the great Yogi Berra once opined, it's tough to make predictions, especially about the future. However, there you have it. 2022 has been a rough one for investors, and it may get worse before it gets better. Nevertheless, it will get better, as much of the excess is wrung out of the stock market, and the Fed moves away from its overt manipulation of interest rates (aka quantitative easing).

Earnings announcements begin next week and we should hear executives walk back expectations for Q3 and Q4 estimates, likely leading to some downgrades and more rational year-end price talk. Commodity prices are already falling and this should eventually translate into lower producer prices. The Fed meets again in late July and another 75 basis point hike is likely. Congress is still working on "build back smaller" and a spending package could come together ahead of the midterm elections in November. With all the doom and gloom hanging over markets today, any positive surprises could be met with outsized moves up in stock prices.

In summary, we're hoping for the best while planning for the worst. Time and patience are two critical components of successful investing. Both are required these days. Good things lie ahead. After having had to realize an unusual amount of capital gains last year, we've been able to harvest valuable tax losses this year thanks to falling prices. Lemonade from lemons. Nottingham's research team continues to sift through the data every day to unearth opportunities for risk and return enhancements in the portfolios. Volatility breeds opportunity. We hope your summer is a

little more relaxing than ours! We look forward to mid-year reviews and welcome any questions or concerns you may have.

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