

Market Commentary

Domino Effect

July 2022

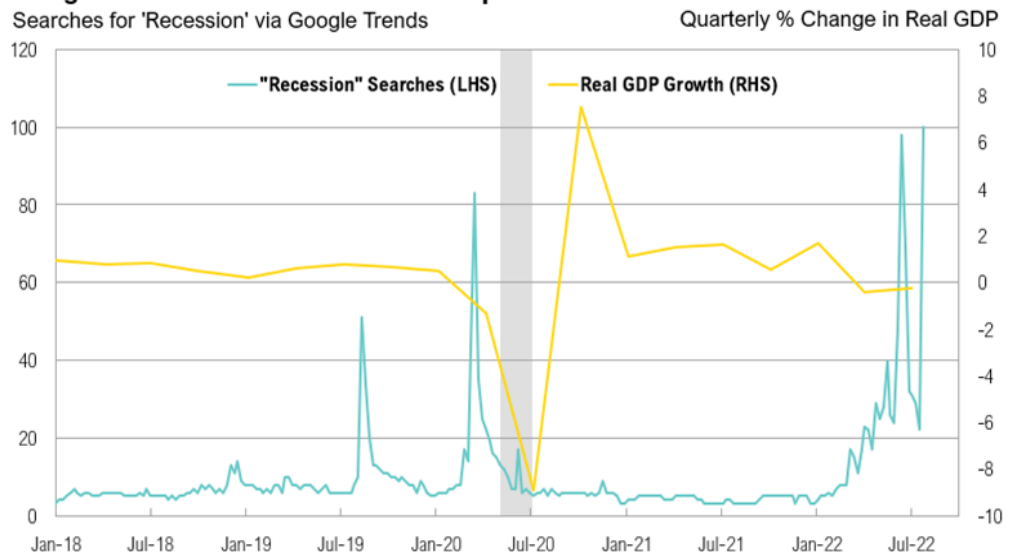
Summary

- Though second-quarter S&P 500 earnings were up overall, excluding the energy sector, earnings are expected to decline 3.7% relative to the same quarter last year.
- Despite these relatively lackluster results, investors have reacted positively to earnings news, indicating that expectations were very negative heading into reporting season.
- Today, markets are at a fork in the road, and whether or not it's prudent to "buy the dip" may depend on where the economy goes next.
- A reactive Federal Reserve within an economy that lacks spare capacity—in labor, energy, and housing—can cause more disruptions, as well as bouts of irrational exuberance, within economic activity, earnings, and asset prices.

Overview

Merriam-Webster defines "domino effect" as "a cumulative effect produced when one event initiates a succession of similar events."¹ The term usually refers to something that is inevitable or at least very likely to happen, due to causal events that have already occurred. Given the series of historically significant—if not unprecedented—events that have transpired over the past few years, the "domino effect" seems particularly applicable to today's most pressing economic question, a question that may stay front of mind through the remainder of the year. Is the U.S. economy headed for a recession?

Google Searches for "Recession" Jump as Growth Stalls



Source: FRED, Google

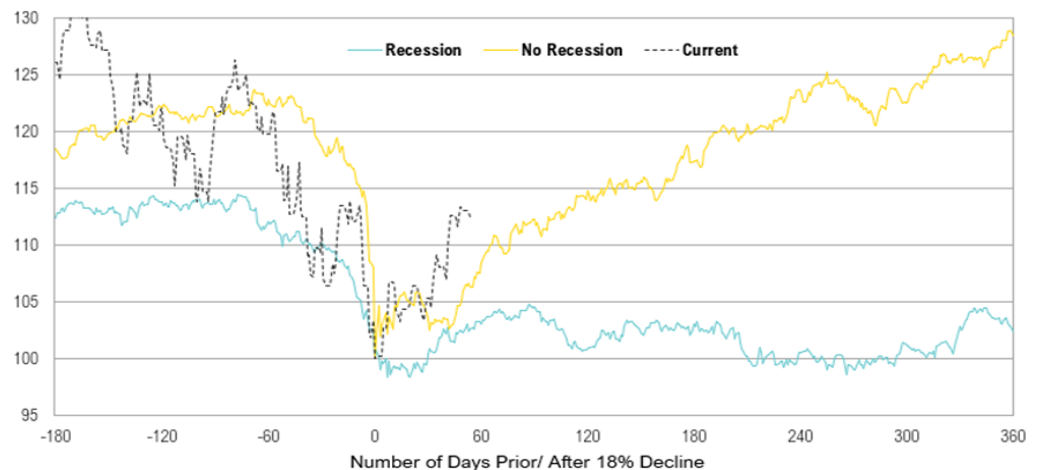
Recent concerns about a possible recession were triggered by news that U.S. real gross domestic product (GDP) declined by 0.9% in the second quarter, following a decline of 1.6% in the first quarter.² Whether the National Bureau of Economic Research will officially label this a recession remains to be seen, but the data are clear: Real economic activity is slowing and very close to stalling out. With the benefit of hindsight, the individual dominos

pointing to our economic malaise seem straightforward to line up: pandemic lockdowns caused portions of the economy to stall and severely curtailed production; this triggered a policy overaction, including massive fiscal and monetary stimulus. This in turn drove up demand, which—combined with the already constrained supply—brought about rapidly rising inflation, which was further exacerbated by a war and rising geopolitical tensions. Now, policymakers are scrambling to slow demand and raise interest rates, which in turn has slowed growth. When the Federal Reserve hiked interest rates in July by an additional 0.75% (bringing the Fed Funds rate to 2.25%-2.5%), it indicated that its future decisions would be based on incoming data. So, today we are left wondering if the combined impact of slowing growth, still-high inflation, and a wait-and-see Federal Reserve will drive the U.S. economy into an unmistakable, full-blown recession.



Recessions matter for a number of reasons, not least of which is their impact on corporate earnings and stock prices. Currently, markets are sitting at a fork in the road, which might be best assessed by examining previous bear markets—comparing those that were not associated with recessions to ones that were. The results are presented in the chart below. Recessions have historically caused two very different outcomes for the stock market. If, according to the ticker tape of history, the U.S. economy can skirt a recession, dips like the one this year should be bought. If, however, we enter recession, earnings will likely suffer, and more volatility may be ahead.

S&P 500 After Bear Markets: Associated with Recession & No Recession
S&P 500 Growth of 100



Source: Bloomberg, SpringTide
Bear markets defined as -18% from peak in order to include near-bear markets of 1990, 1998, and 2018.

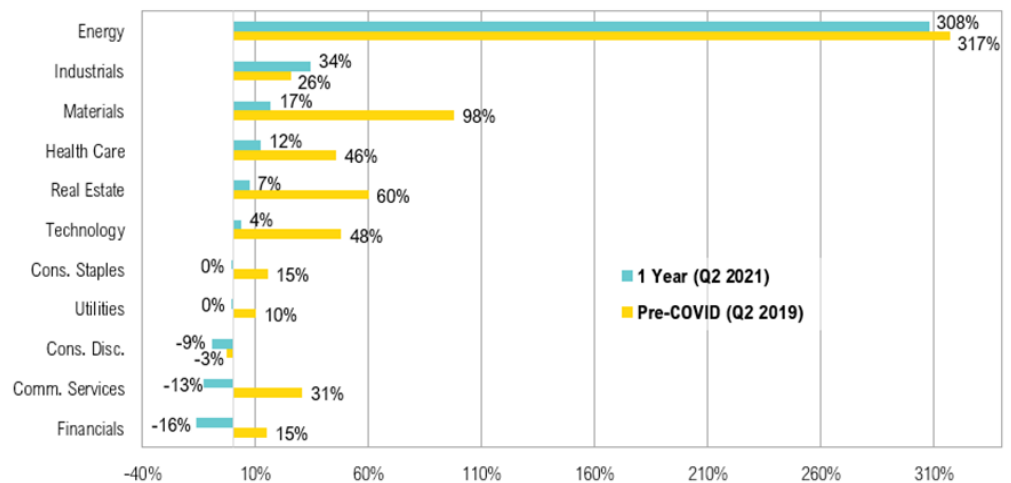
The Earnings Domino

We've all experienced information overload this year as a steady stream of sensational news has disrupted our attention. During times like these, it may be helpful to focus on the core principles of investing. A stock, for instance, represents a claim on a potential stream of future earnings that may be paid out through dividends or reinvested in a business for future growth. Highly profitable businesses with high reinvestment rates can grow exponentially. Every multi-national behemoth, after all, began as a small company, sometimes in a garage.³ It was the dream—and later the realization—of profits that drove them to their current glory. Conversely, companies that fail to generate profits over the long term generally get penalized, sometimes through bankruptcy (although less so in recent years, as corporate bankruptcies hit a record low last year).⁴ While the wild gyrations over the past several years highlight that anything can happen in the short term, earnings still drive stock returns. According to data compiled by University of Yale Professor Robert Shiller, the stock market, as proxied by the S&P 500, has returned 7% annualized on an inflation-adjusted basis since 1871. Adjusted for dividends, that number falls to 4.7%, which is roughly in line with real earnings growth of 4.2% per year over the same period.⁵

How are earnings holding up? Through August 5, 87% of companies in the S&P 500 had reported second-quarter earnings with a projected year-over-year growth rate of 6.7%, a modest increase from the 4% expected at the beginning of July.⁶ The largest contributor to this positive surprise was the energy sector, collectively reporting 308% earnings growth over that period. The two largest energy companies in the U.S., Exxon Mobil and Chevron, posted record profits of nearly \$18 billion and \$12 billion, respectively.⁷ Chevron more than doubled its capital expenditures from a year earlier while Exxon increased its production 4% compared to the first quarter. Despite this investment, Exxon and Chevron maintained dividend yields above 3%.^{8,9} Chevron's stock price increased 9% overnight after the earnings announcement, while Exxon's increased 4%. The average oil price over the quarter was \$109 per barrel. Changes in oil prices are highly correlated with energy company earnings, so any decrease from these levels will translate to lower earnings and vice versa. Excluding the energy sector, the earnings of companies in the S&P 500 are expected to decline 3.7% relative to the same quarter last year.⁶

Mixed Bag For Earnings

S&P 500 Earnings Per Share Growth by Sector: Q2 2022



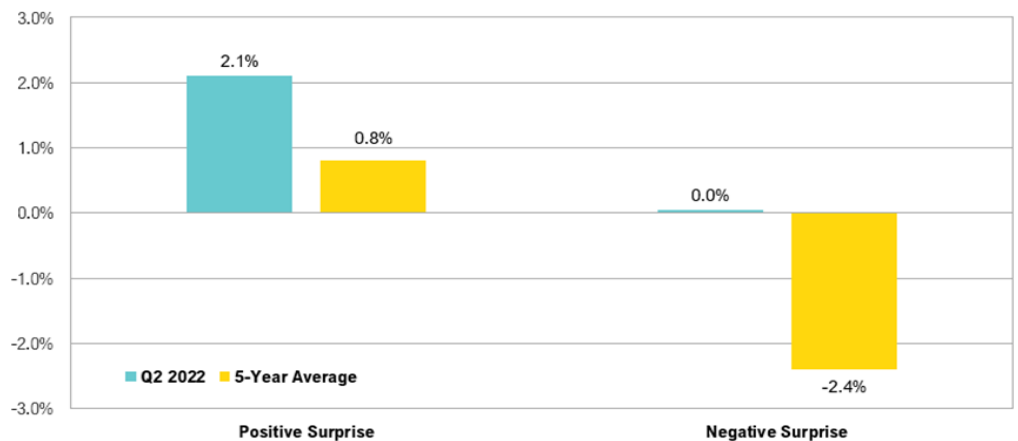
Source: Bloomberg

Despite relatively lackluster results overall, investors have reacted positively to earnings news, which clearly indicates that expectations were overly negative heading into reporting season. The average two-day price change in response to an earnings surprise for S&P 500 constituents was +2.1%, much higher than the 5-year average of +0.8%.¹⁰ Netflix, for example, beat earnings estimates by 8.8% despite reporting a loss of nearly one million subscribers, the largest decline in its history.¹¹ The stock rose 7.3% in response suggesting *even worse* news had been expected and priced in. Co-CEO Reed Hastings summed it up best by describing their results as “less bad.”¹¹

Additionally, the market has reacted relatively indifferently to earnings misses, returning 0% on average in the event of a miss.¹⁰ This is the first time the S&P 500 has not reacted negatively to negative earnings surprises since the first quarter of 2009. Microsoft, for example, missed analyst estimates by 3% due to a sharp slowdown in its cloud business, declining videogame sales, and the effects of a strong dollar.¹² Despite this, the stock rallied 7% the following day after management said sales and operating income on a currency-adjusted basis should increase by a double-digit percentage in 2022.¹³ Microsoft’s earnings also highlight a surprising slowdown in big tech’s cloud operations. While the coveted segment is normally thought of as being both high growth and “recession-proof,” Amazon, Microsoft, and Google’s combined cloud revenue grew at 28% from a year earlier, down from 33% growth in the first quarter and the lowest growth rate in seven quarters.¹⁴ While 28% growth is still outstanding in absolute terms, any further slowing in this area will be a key trend to watch in the coming quarters.

Positive Reaction to Earnings Beats and Misses

Average S&P 500 Company Price Reaction to Earnings Surprise



Source: Bloomberg

The last theme we are watching regarding corporate earnings is how higher interest rates, combined with the risk of inflation, could hurt companies’ bottom lines, as evidenced by relatively strong revenue growth (coming in at +8.8% excluding-energy), coupled with waning profits (-3.7% excluding-energy).⁶ Although promising signs point to lower inflation, especially lower oil and gasoline prices, growth is also slowing.

Markets

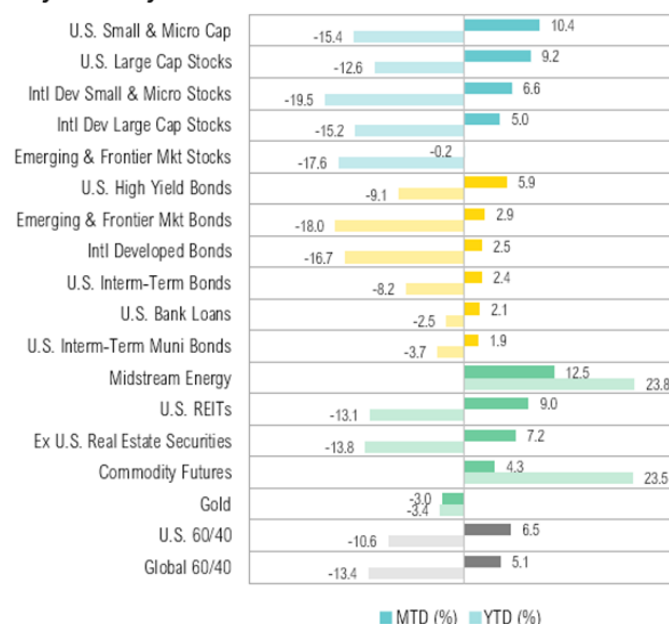
The S&P 500 jumped 9.2% higher in July, representing the best monthly return for the index since November 2020. From a style perspective, growth stocks outperformed value stocks, as the Russell 1000 Growth Index gained 12.0% while the Russell 1000 Value Index rose 6.6%. Small cap stocks slightly beat large cap stocks, returning 10.4% as proxied by the Russell 2000 Index. Midstream energy was one of the top performers over

the month, returning 12.5%. Year-to-date, the industry has returned 23.8%, outperforming the S&P 500 by 36.4%. Despite relatively good performance by other real assets, gold disappointed over the month, falling 3.0%.

International equities underperformed their U.S. counterparts in July, with the MSCI EAFE Index up 5.0% while the MSCI Emerging Markets Index fell -0.2%. While some of this can be attributed to the U.S. dollar strengthening 1.2% over the month as proxied by the U.S. Dollar Index, international companies still underperformed on a local currency basis. Within emerging markets, China was the largest detractor, falling 9.5% over the month. Chinese equities have gone through an extremely volatile period ever since the Chinese Communist Party (CCP) started its most recent crackdown on the corporate sector early in 2021.¹⁵ This was exacerbated by their decision to implement a “zero-COVID” policy, requiring cities to initiate strict lockdowns if just a handful of cases are reported.¹⁶ Despite these worrisome headwinds, Chinese equities had outperformed in the first half of the year through June, falling just 11.3% compared to the MSCI ACWI Index’s drop of 20.2%. However, signs of a renewed crackdown on the tech sector, an escalation of the property developer crisis that has been ongoing for over a year now, and a rebound in COVID cases all weighed heavily on equity valuations and led to this most recent slide in prices.¹⁷

Fixed income investors finally received some relief in July with the Bloomberg U.S. Aggregate Index gaining 2.4% over the month, its highest monthly return since August 2019. Notably, the U.S. treasury curve inverted as longer term yields fell significantly while shorter term yields rose. The 10-year yield minus the 2-year yield, a common representation of the Treasury yield curve and harbinger of economic growth, flattened from 6 basis points to -22 basis points over the month. The last time the U.S. treasury curve was this inverted was November 2000, as the dot-com bubble was just beginning to unwind. U.S. high yield bonds had their best month since October 2011, returning 5.9% as credit spreads tightened materially from 587 basis points to 483 basis points. Finally, emerging markets debt also had a good month, returning 2.9% despite U.S. dollar strength.

July 2022 Key Market Total Returns



Source: Bloomberg

Looking Forward

The economy is, of course, far more complex and dynamic than a row of dominos, and we do not have the benefit of hindsight. The intersection of slowing growth and high, albeit easing, inflation has driven real economic activity to stall. How the Fed responds to this dynamic remains the wild card, but there are no easy decisions ahead. If the Fed stops tightening policy too soon, it may reignite risk-taking and stoke inflationary pressures. If it continues to tighten, the U.S. economy will likely continue to slow, taking corporate profits with it.

One of the most concerning dynamics we continue to watch closely is the explosion in consumer credit card debt, especially considering interest rates are now over 15%.¹⁸ Revolving credit has surged by 13.8% over the past year, the highest annual increase since 1996.¹⁹ Similarly, the most recent savings rate for June came in at 5.1%, the lowest since 2009.²⁰ This pace of debt-financed spending by the consumer is not sustainable, a point that was reiterated on Starwood Property Trust's quarterly earnings call by CEO Barry Sternlicht:

"The consumer, which is the backbone of the U.S. economy, well, he may still be spending but confidence is [at] the lowest point it's been in decades and it's even worse in Europe. So there's no question that the consumer will stop spending the way he has spent in my mind. And you can't look backward, you have to look forward and he's facing dwindling savings rates because he's spending his money on gas, food, rents and housing prices, and interest expense. I don't see the offset."²¹

Nominal growth is relatively strong, but trending in the wrong direction. Conversely, inflation is much too high, but trending in the right direction. The policy feedback loop in the context of an economy without the luxury of much spare capacity—in labor, energy, housing, and a host of other markets—has the potential to drive more fits, starts, and whipsaws for economic activity, earnings, and asset prices in the years ahead. This environment could prove perilous for investors who chase returns, but could also indicate massive opportunity for those with patience and discipline.

Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

Citations

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Asset Class Definitions

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Interm-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Interm-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

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