BULLS&BEARS

By: Sean McCreery, AFIM
AVP, Wealth Investment Officer

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Historic Start

If the year ended on 7/1, investment grade bonds would have posted the worst year in the history of the Bloomberg Aggregate Index. The S&P 500, meanwhile, is having the worst first half of a year in over half a century. If it ended on 7/1, there would only be two years in the last 30 that would have been worse for stocks: 2002 (-23.8%) and 2008 (-37.6%).

The good news is that the year isn't over yet. In fact, the three other years that finished the first half with a 20%+ decline (1932, 1962, and 1970) all posted gains for the second half. Historically, 20% downturns have been good for future returns. Reviewing all declines of 20% or more over the last 60 years, the stock market advanced over the next 12 months in 87% of those instances and in 100% of the times in which the economy avoided recession.

As the second half progresses into late summer, we see three potential scenarios for the U.S. economy. Between a bullish case in which the economy posts average growth and the bearish case of a hard recession, our base case is for a slow-growth economy that sidesteps recession (or only a modest recession). In our base-case scenario, the stock market as of mid-2022 would have made its bottom for the year.

Also in our base case, the consumer price index, which hit a multidecade high of 9.1% for June, falls toward 5.0% by year-end. The Fed finishes its rate-hiking campaign early in 2023; and, to stimulate the now faltering economy, the Fed pivots to accommodative policy (rate cuts) by mid-2023. GDP growth, which runs in the mid-1% range in 2022, recovers to upper 1% growth across 2023. Only time will tell which scenario plays out.

Valuations or Earnings

The market's wild ride has brought us to an important crossroad. Thus far, the correction has been a valuation reset driven by tightening liquidity. If that's all it is, then after a 24% decline from the all-time high in early January through mid-June on the S&P 500 (using intraday values), the stock market may have possibly already hit its low. If the market also has an earnings problem, then this reset might not yet be over.

Serious bear markets tend to be hit by a double whammy: a valuation derating and an earnings recession. So far, this bear reflects only a correction in price-to-earnings (P/E) ratios, caused by the rising cost of capital and an outgoing liquidity tide. Its magnitude is on par with past non-recessionary drawdowns, such as 1994 (–10%), 1998 (–21%), 2011 (–21%), 2015–16 (–15%), and 2018 (–20%).

Earnings estimates for 2022 and beyond continue to rise, with 2022 projections now at 10.9%. That said, we are clearly past peak earnings growth. Earnings downgrades are now nearly as common as upgrades, with only the energy sector sustaining any momentum for positive estimate revisions. None of this is particularly surprising at this point in the business cycle. Declining inflation expectations may help contain the amount the Fed has to increase rates from here. Those dynamics could give investors a better handle on what to expect—and could help lower the risk of the market suffering an earnings decline on top of the valuation haircut.

"Softish"

A review of the Fed's history shows that soft landings are possible but require favorable economic context. Across two meetings, the Fed hiked its policy rate by 1.25% to 1.75%, began to roll off its balance sheet and talked up a "strong commitment" to restoring price stability. With a resolute focus on bringing down inflation, central bank policy has set out to lower demand in line with supply. This, combined with stickier-than-expected inflation, has reset U.S. interest rates higher. Toward quarter end, yields came off peaks over recession concerns. With financial conditions already deteriorating, the Fed appears somewhat complacent that the economy can weather significant monetary tightening.

Please contact us at 1-855-829-7192 if we may be of assistance.

Market Indicators

6/30/22 Year-to-Date Change	
S&P 500	-19.96%
NASDAQ	-29.23%
Russell 2000	-23.43%

Interest Rates	6/30/22	12/31/21
10-Year Treasury Note	3.01%	1.51%
3-Month Treasury Bill	1.67%	0.05%

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