MV CAPITAL MANAGEMENT

Weekly Market Flash

Earnings and Inflation Are Top H2 Concerns

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And just like that…it's already the second half of 2022. Not too many folks other than habitual short sellers and permabears will be sad to see the year's first half slide into the history books. The big headline making its way through financial news platforms today is that the stock market's performance in the year to date is the worst since 1970, fully 52 years ago.

That headline should come with an asterisk (though of course it won't), in that the period from January 3 to June 30 2022 is not anywhere close to being the worst six month stretch ever during this half century of activity. The 21.1 percent decline the S&P 500 registered upon its June 30 close falls far short of the bear market drawdowns of 2000-02 (48 percent) and 2008-09 (57 percent), to say nothing of 1987 (34 percent) or 1973-74 (48 percent).

But the 2022 decline had the dumb luck of starting on January 3, the first trading day of the year. That was the last time the S&P 500 hit a record high, meaning that this bear market neatly coincides with the calendar markers everyone obsesses over. Is there any practical difference between a six month stretch that runs from January 1 to June 30 and one that spans, say, March 15 to September 14? Of course not. But we are a calendar-centric species, and so "worst first half since 1970" is here to stay.

Bracing for Earnings

As we look ahead to the second half, there are a couple early hurdles to clear if we are going to avoid having "worst first half" extend to the year's final two quarters. Already we are getting a preview of how the second quarter earnings season, which officially gets under way late next week, is going to shape up in terms of expectations meeting reality. A handful of companies that report outside the "official" earnings season (usually because their fiscal years do not follow the calendar year) have already warned that forthcoming revenues and earnings are likely to be meaningfully lower than what they previously thought. Micron Technologies and General Motors both cut forward guidance in their reports this morning.

Meanwhile, analysts are still forecasting 2022 earnings to grow by more than 10 percent, higher today than their consensus estimates back in March. That outlook seems destined for a sharp downward revision. Just to cite the Micron Technologies example, in the aftermath of today's report brokers cut their earnings estimates for the next quarter by more than 20 percent. We can expect to see plenty more where that came from.

How Much More Inflation?

Earnings forecasts are trending lower because consumers are starting to adjust their spending plans in light of the persistence of high inflation. In the coming months we will see how effective the Fed, ECB and other central banks are in taming inflation with their increasingly stringent interest rate targets. The good news, such as it is, is that core inflation does not seem to be accelerating from month to month. The Core Personal Consumption Expenditure measure, which is the Fed's preferred inflation gauge, showed an increase of 0.35 percent from April to May, which is roughly the same month-on-month increase seen in the four previous periods. That's good. But the core measure excludes the two things most households care about the most – food and gas prices – and those are largely beyond the control of central bankers. That's not so good.

Things are worse over in Europe, as we discussed in our commentary last week. The Eurozone CPI report for June came out this morning, and it shows an 8.6% year-on-year increase in headline inflation, higher than economists forecasted. There is not likely to be much relief for beleaguered European households as long as the war in Ukraine drags on – and with the days of cold weather inching ever closer, the energy problem in particular is going to be vexing.

What's Next?

So what does this mean for portfolios? How much of the reality about earnings and inflation has already been baked into the cake, so to speak? There are no clear answers to that, but we think it is reasonable to expect more intermittent rallies and pullbacks of short duration, similar to what we have seen in the past month or so. Just since late May we have seen the S&P 500 rally by more than 6 percent on two separate occasions, only to fall back after stalling out. These "dead cat bounces" don't do much to improve longer-term sentiment, but they do act as a brake against things going from negative to all-out panic.

In fact, despite being stuck with the "worst first half since 1970" label, what we really did not see in the first six months of 2022 was panic selling. We think this is in large part due to important differences in today's environment versus, say, the pandemic pullback in March 2020 or the financial crisis of 2008. Those were genuine panic-inducing events: in one, that the whole world was getting sick from this rampaging virus, and in the other that the entire global financial system seemed to be on the edge of collapse. Investors couldn't get to the exits fast enough.

What we have today is different. We have a clear problem, which is inflation, and we have clearly identified agents – central banks – trying to fix that problem with as little collateral economic fallout as possible. We have external variables that have made the problem worse, notably the war in Ukraine and China's zero-Covid lockdown, but we also have a strong labor market and (at least up to now) resilient consumer spending. This kind of environment lends itself to speculation about different outcomes, which are getting fleshed out in market chatter using the analogy of landing a plane – hard, soft, bumpy, short runway, aircraft carrier, air traffic control, and on and on. The point is, there are coherent cases to make for a variety of scenarios. As long as that is the case, we expect this push and pull dynamic to continue – high intraday volatility with periodic pullbacks and relief rallies. We don't think this is the right time to be calling a screaming buy on the market; nor do we think it is a slam-dunk sell. Stay the course is our advice as we head into H2 2022.

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