A Painful Spring Season

An understatement to say that stocks and bonds have been whipsawed the past few weeks. Unfortunately, it's hard to expect any upside traction until we get more clarity on the Fed's game plan on fighting inflation, China's recent Covid shutdown and the Russia-Ukraine conflict. However, depending on how the data plays out over the next few months, there's reason to hope for a soft landing in the 2nd half of 2022.

In our eyes, what's happening today is stocks are pricing a recession even though earnings have actually been decent. The sharp rise in interest rates in 2022 has triggered a sharp P/E multiple compression with technology and growth stocks suffering the biggest casualties. The Nasdaq is down over -22% since the start of the year while the S&P 500 has fallen over -13%. Concerns of aggressive monetary tightening by the Fed and supply chain disruptions tied to Covid lockdowns in China and the Russia-Ukraine war has overwhelmed otherwise positive economic data and corporate earnings.

While investors await new data on the health of the consumer and economy, technical data will likely lead the way for the time being. Unfortunately, the near term direction is lower as the S&P 500 breached an important support level of 4114 last week indicating a further potential decline of -8-10% to a new threshold at 3800.

Earnings should slow given the overall slowdown in the economy, however the current state of the U.S. economy remains reasonably strong. Last week's advanced reading of Q1 U.S. GDP declining -1.4% was misleading as it reflected a widening trade deficit versus weak consumer demand. Exports slowed (due largely to weakness overseas,) however imports were very strong. Separately, the US economy added over 1.68 million jobs in 1Q 2022.

On the inflation front, we see signs that wages are beginning to cool as the labor market normalizes and aggregate incomes moderate. The strong U.S. dollar should also help put downward pressure on core goods inflation and tighten financial conditions. On a trade-weighted basis, the US dollar is up over +15% since it bottomed back last May.

While the Fed's ultimate goal is to get inflation back to 2%, the pathway getting there likely will see inflation running above its target but moving in the right direction. This should allow labor markets to adjust without leading to a surge in unemployment. Today's high inflation expectations provide cover for the Fed to prioritize employment over inflation to keep the expansion on track. We expect the Fed to announce another 50bp hike in June, followed by a more measured approach of 25bp hikes at subsequent meetings depending on new data releases.

The risk of a recession has certainly increased over the past few weeks, however we believe that three things must occur over the remainder of 2022 to dial up the risk of a recession:

- The trajectory of future interest rate increases must remain uncertain. Once we have better clarity on the Fed's pathway for interest rates and inflation, rate volatility should subside, encouraging a greater risk appetite for stocks.
- Covid lockdowns in China must continue to linger. Once this wave fades however, it's very reasonable to expect China's population to experience a wave of consumption as they return to normal. With this backdrop, supply chain issues should improve.
- Russia/Ukraine conflict persists for longer. This event has much less certainty and we could be under-appreciating the lasting effects from a prolonged conflict.

If all of these issues linger over the next nine months, then the odds of a recession definitely increase. On the flip side, if these issues don't persist, they could be net accretive to growth in the 2nd half of the year.

Time will tell, but we're still in the growth scare camp.

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