MEDALLION WEALTH MANAGEMENT

July 2022 Market Commentary

Who'll Stop The Rain

Long as I remember
The rain been comin' down
Clouds of mystery pourin'
Confusion on the ground
Good men through the ages
Tryin' to find the sun
And I wonder,
Still I wonder,
Who'll stop the rain?

https://www.youtube.com/watch?v=ekw13v8Et7U

Well, as far as the markets are concerned, it certainly feels like it's been raining for a long time now. In fact, you have to go all the way back to 1970 to find a year that matches 2022's first half S&P 500 decline of 20%. Can you guess the number one song back in 1970? Yep, the number one song in 1970 was Creedence Clearwater Revival's ***"Who'll Stop the Rain***".

If you're thinking that was a long time ago you're right, 52 years is a while. I was ten years old in 1970, and more interested in building forts and fishing than watching the markets. But here we are, starting 2022 with one of the worst starts to any year.

S&P 500: Worst Performance through 124 Trading Days (1928 - 2022)				
Rank	Year	Price Return: First 124 Trading Days	Price Return: Day 125 to Year-End	Price Return: Full Year
1	1932	-44.5%	53.4%	-14.8%
2	1962	-26.5%	20.0%	-11.8%
3	1940	-20.9%	7.4%	-15.1%
4	2022	-20.6%	?	?
5	1970	-20.2%	25.3%	0.0%
6	1939	-17.9%	15.5%	-5.2%
7	2002	-13.8%	-11.1%	-23.4%
8	2008	-12.9%	-30.3%	-39.3%
9	1974	-11.5%	-20.6%	-29.7%
10	1973	-11.3%	-6.8%	-17.4%
11	1937	-10.4%	-31.5%	-38.6%
12	1982	-10.1%	27.3%	14.5%
13	1953	-9.1%	2.8%	-6.6%
14	1984	-8.1%	9.6%	0.8%
15	1949	-7.9%	19.9%	10.5%

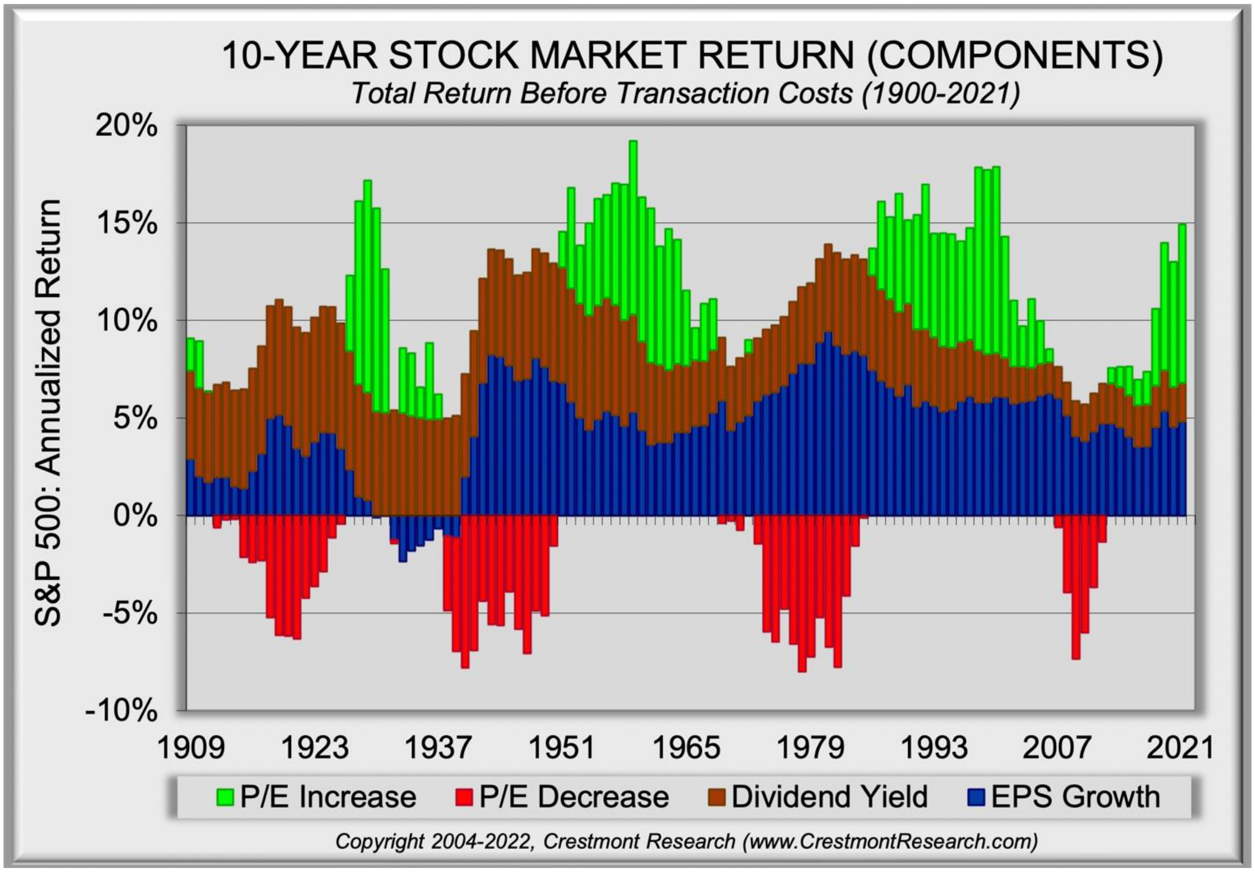
What makes 2022 especially painful though is the fact that there has been nowhere to hide. Bonds are down about 10% making the return on a 60/40 stock/bond portfolio one of the worst ever.

S&P 500 Down Years (1977 - 2022)			
Year	S&P 500 Total Return (Stocks)	Bloomberg US Agg Index TR (Bonds)	60/40 Portfolio (S&P 500 / Bloomberg Agg)
1977	-7.2%	3.0%	-3.1%
1981	-4.9%	6.2%	-0.5%
1990	-3.2%	9.0%	1.7%
2000	-9.1%	11.6%	-0.8%
2001	-11.9%	8.4%	-3.7%
2002	-22.1%	10.3%	-9.2%
2008	-37.0%	5.2%	-20.1%
2018	-4.4%	0.0%	-2.6%
2022 YTD	**-20.0%**	**-10.4%**	**-16.1%**

Ok, so it’s been a tough start to the year, now what? One of my favorite ways of looking at the markets is to break returns down into their basic components; starting dividend yield, earnings growth, and the change in P/E (or how much are investors willing to pay for those earnings and dividends).

$$Predicted\ Return = Starting\ Dividend\ Yield + Earnings\ Growth\ Rate + \%\ Change\ in\ ^{P}/_{E}$$

The chart below shows the market's returns broken down into these components over rolling ten-year periods. Great bull market periods (10-year annualized returns in the mid-teens) had positive dividend yields, positive earnings growth, and expanding P/E ratios (highlighted in green). Bear markets generally coincided with low or negative earnings growth and contracting P/E ratios (highlighted in red).

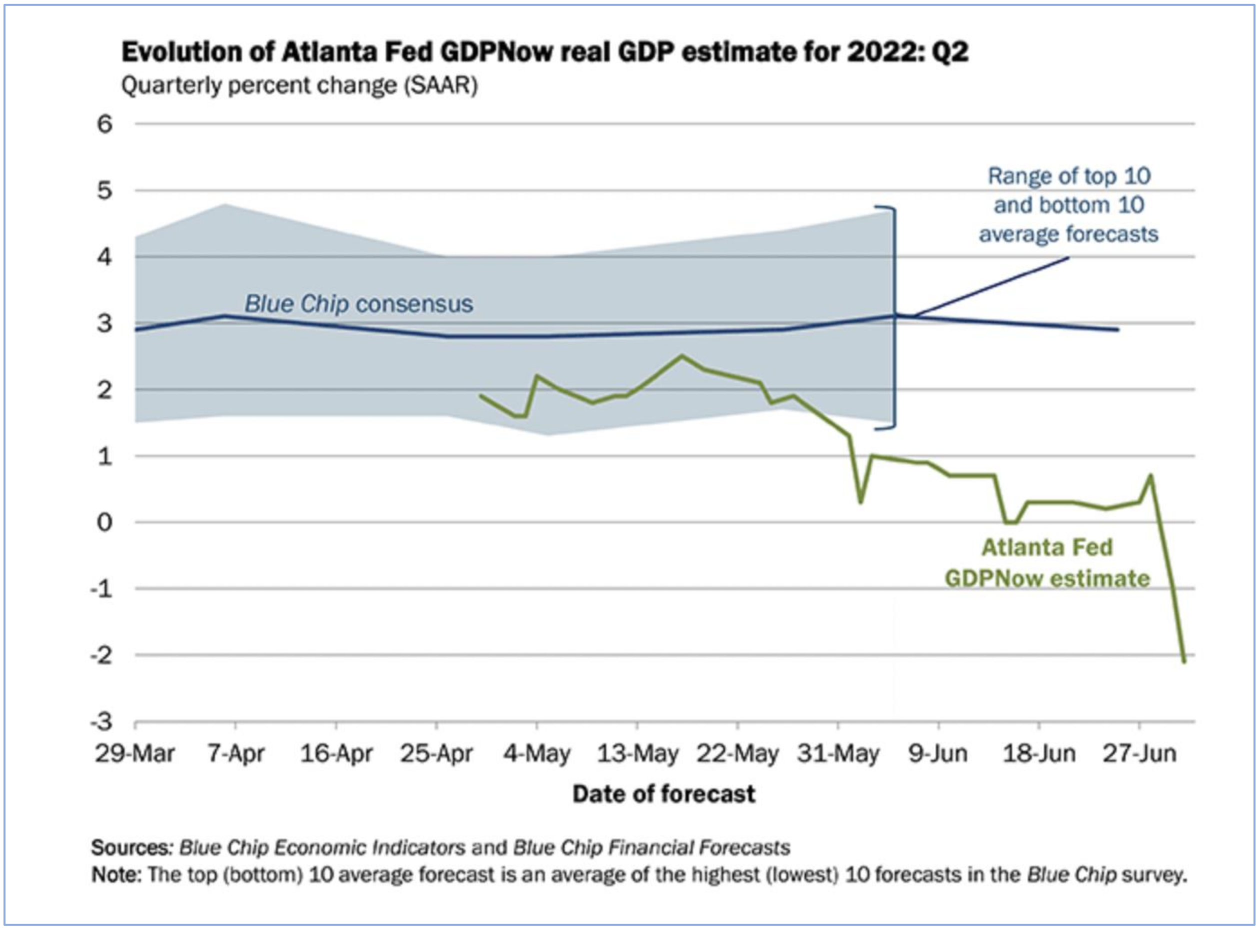


So far this year the S&P 500 is down about 20%. Six-month dividend yields are about 0.60% and earnings have grown about 7% so the real damage to the market has been in the decline in P/E ratios. Forward P/Es have shrunk from about 22x to 16x, which is about a 27% decline. This explains the 20% year-to-date drop in the S&P 500.

The more important question now becomes how much will earnings growth decline (will it actually turn negative in a recession), and how much will P/Es continue to contract? Investors aren't very willing to pay much for earnings if the Fed is raising rates to combat rapid inflation and getting ever so close to pushing the economy into recession.

It's (Unofficially) a Recession!

Last week, 1st quarter GDP was revised down to -1.60% and then on Friday, July 1 the Atlanta Fed revised its outlook for 2nd quarter GDP down to -2.1%. If that proves to be a correct forecast then we would have two consecutive quarters of negative GDP growth, which is the official definition of a recession.



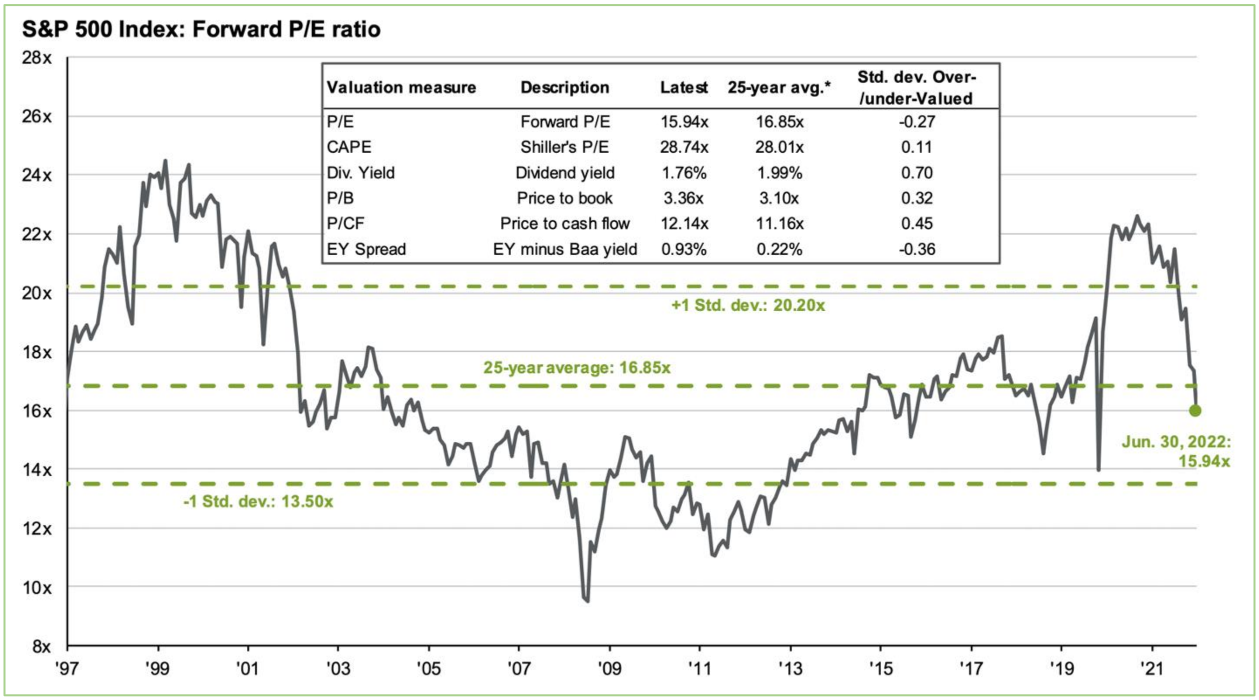
As usual the markets tend to be very good at looking forward. The yield on the 10-year Treasury peaked at 3.48% on June 14th, and has since fallen to about 2.80%. Even though the Fed is still expected to raise the Fed Funds rate from 1.75% to 2.50% in the next month, yields are dropping.

So here we sit, most likely already in a recession.

- The dividend yield on the S&P 500 is about 1.55%.
- Earnings are still being forecasted to grow about 7% over the next year. I'll take the under on that, but earnings growth may not actually go negative because they are measured nominally and with inflation running hot and unemployment staying low it's hard to see them actually dropping.
- As always, the key comes down to what is going to happen with P/E ratios. It's probably safe to assume that forward P/Es might continue to contract a bit more, depending on how much the Fed will need to raise rates to rein in inflation. But unless you foresee the

need for steep hikes in rates before inflation slows, a trough P/E around 13 or 14x might work.

- The math would work out to something like this: a 1.55% dividend yield plus say 4% earnings growth and P/Es dropping from 16 to 13x (-18%), gives us continued downside of about 13%. Of course, this is just a guess, somewhat educated, but a guess nonetheless.



The problem with trying to do any real forecasting is the sheer number of unknown unknowns. As I mentioned in my last update we live in some pretty strange times, we've never had a period of time where the Fed has kept rates at zero percent during an economic expansion, while also buying mortgage bonds. We've never seen the Treasury just hand out checks to the entire population.

We simply do not know the ramifications of these unprecedented economic policies. Strange things are happening. Here's an example; generally, consumer sentiment tracks along with unemployment, when more people are unemployed sentiment falls and when unemployment is low sentiment is ebullient. Until today. Today we have the lowest consumer sentiment on record, but unemployment is near record lows. Strange indeed. What will happen with sentiment if the employment rate actually starts to decline?

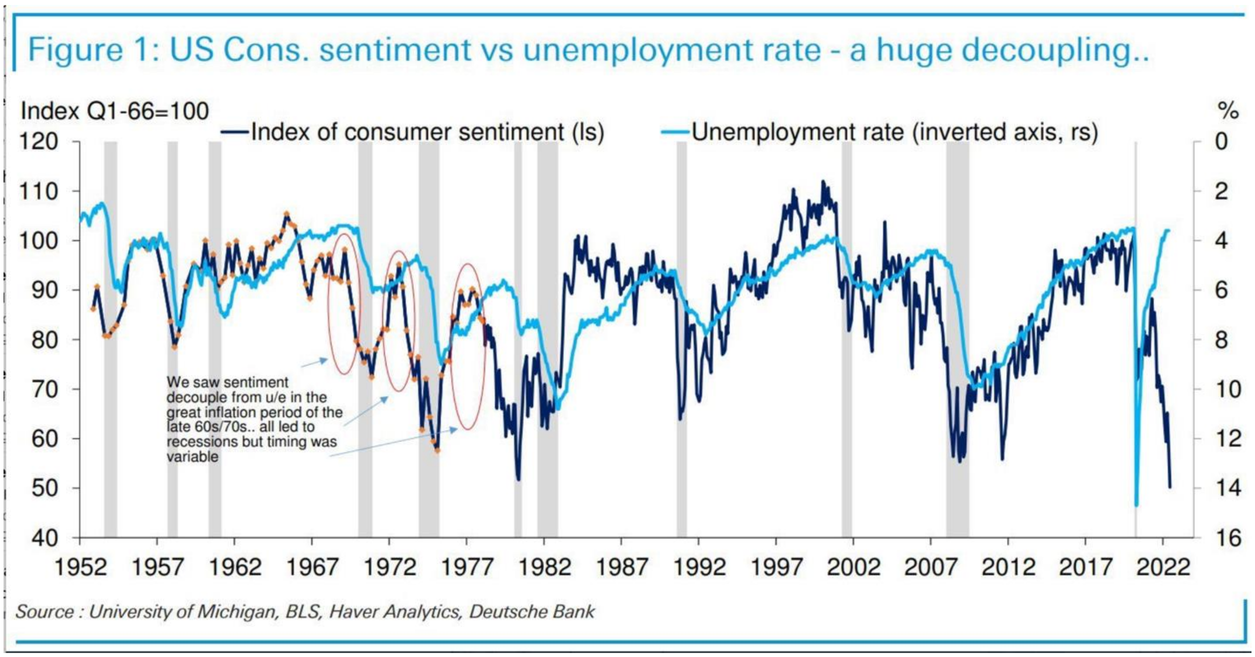


Figure 1: US Cons. sentiment vs unemployment rate - a huge decoupling..

Source : University of Michigan, BLS, Haver Analytics, Deutsche Bank

Strange times indeed.

As always, be careful out there.

Chris Wiles, CFA

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