



MEDALLION

WEALTH MANAGEMENT

Market Commentary - August 2022

A Horse with No Name



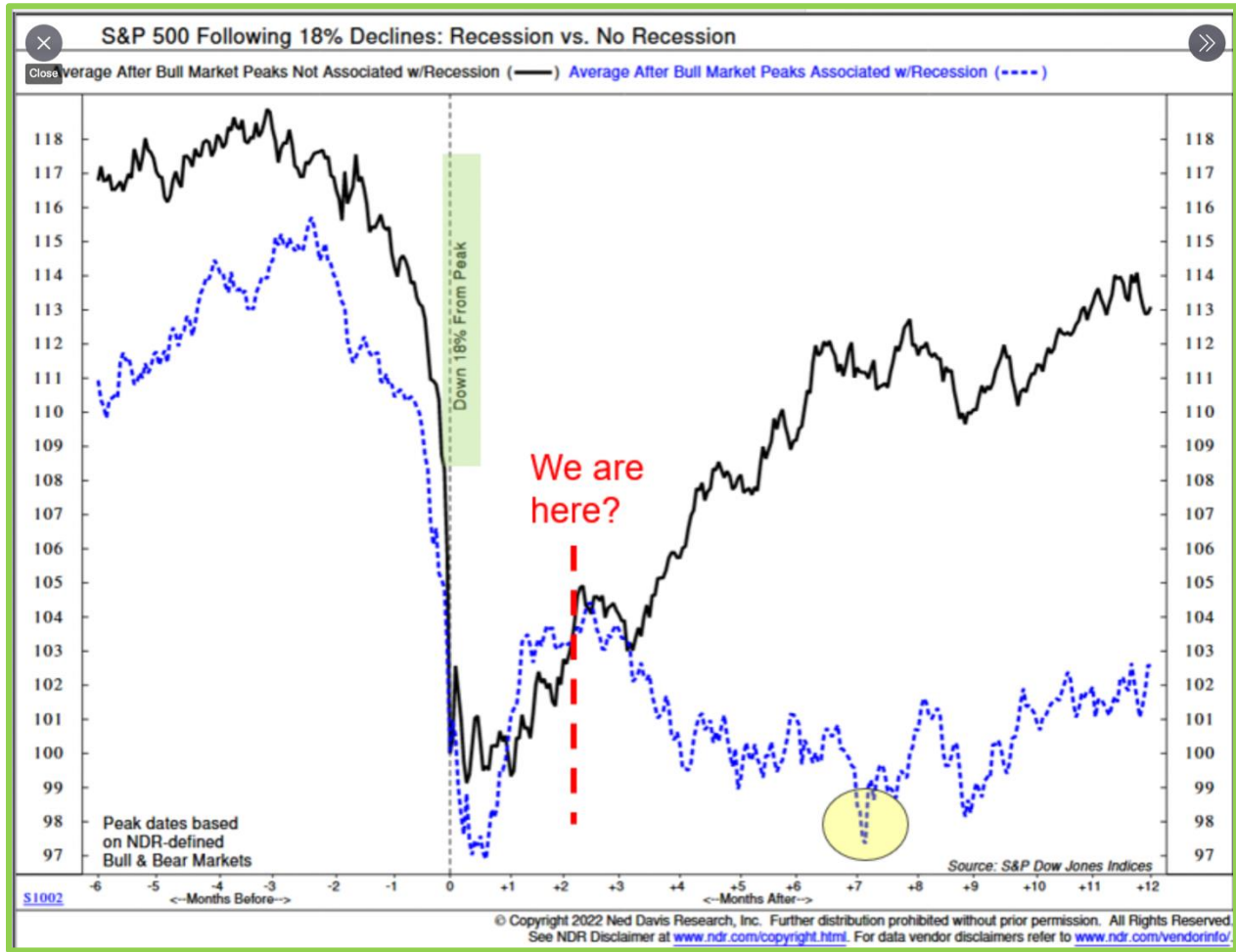
*I've been through the desert on a horse with no name
It felt good to be out of the rain
In the desert you can't remember your name
'Cause there ain't no one for to give you no pain*
<https://www.youtube.com/watch?v=ocLCLMZO6dc>

What's in a name? Call it a recession or stagflation or a slowdown or a transitory blip or even Mr. Ed—however you name it or don't name it, the U.S. economy described in the latest GDP report for the second quarter is struggling. That's distressing for the American families and businesses living through it, and a political liability for the Democrats presiding over it. No wonder they want to pretend it's not happening. The economy contracted 0.9% in the April-June quarter, following the 1.6% contraction in the first three months of the year. Some say that "technically" we are in a recession, as defined by two consecutive quarters of negative GDP growth. Not so fast, say others. With a surprisingly strong addition of 528,000 jobs in July and a 50-year low unemployment rate of 3.5%, how can we possibly be in a recession? I say that we're just starting this journey and it's going to be full of surprises.

*After two days in the desert sun
My skin began to turn red
And after three days in the desert fun
I was looking at a river bed.*

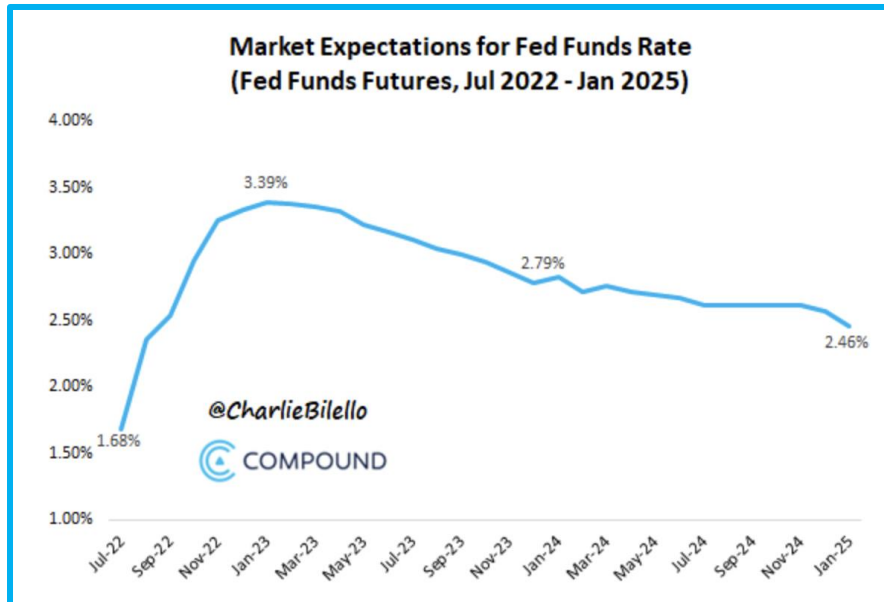
You may ask, what does it matter, recession or not? Well, as the chart below shows, historically whether or not we have entered a recession matters a lot to stock market participants. After the stock market has declined by 18% or more, the black line shows what the market has done (on average) if there was no recession accompanying the decline. The dotted blue line shows average market performance if there was a recession. Our current market peaked in early-January. It's now been about 2 to 3 months since the 18% decline into early-May, clearly a

pivotal time. Note the yellow circle at month +7. Historically, on average, a retest occurs about 7 months after the 18% decline if a recession is involved. And if we are in a recession, after 12 months the market has gone basically nowhere.



If we are not in a recession, the market bounce that we've experienced over the last 6 weeks can probably continue. However, if we are actually in a recession the odds favor at least a retest of the June lows.

After the second negative quarterly GDP report and the subsequent 75bp increase in Fed Funds rates, yields on longer dated Treasuries actually fell and stocks rallied. The thinking was that even though the Fed was currently raising rates the perceived slowing economy means that they will need to stop, and perhaps even cut rates early next year. As the graph below shows, the market expects the Fed Funds rate to peak early next year at 3.39% and then actually decline as the Fed is forced to cut rates to stimulate the economy.



Not so fast said numerous Fed officials, we are not pivoting from tightening to easing anytime soon, not with the labor market so strong and inflation so high. The beatings will continue until morale improves.

Until last Friday's job report, the S&P 500 was in rally mode up 13.3% since it bottomed at 3666 on June 16. Again, the thinking is that inflation and economic growth will slow quickly enough that the Fed won't need to raise rates much further and the economy won't weaken very much. The proverbial soft landing.

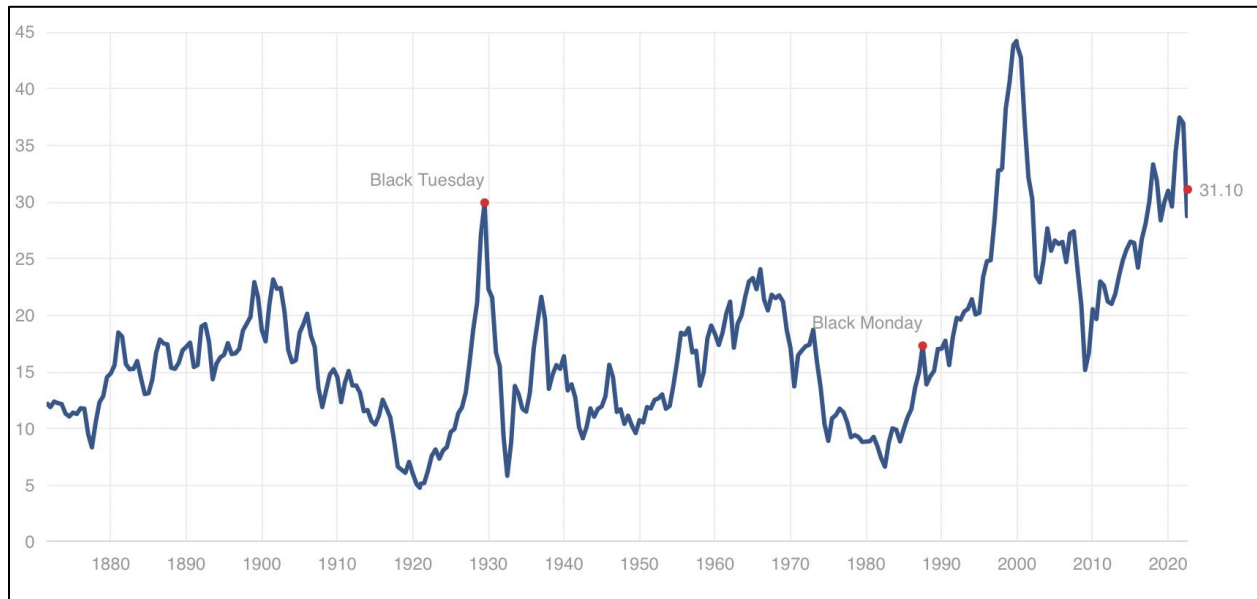
Last Friday's strong jobs report may have thrown a monkey wrench at that thesis. If we're adding 500,000 jobs in a month and unemployment is only 3.5%, have the recent Fed rate increases done anything to actually slow the economy yet?

While we're talking about jobs and a strong economy a question comes to mind, how has the stock market done when unemployment is so low? Glad you asked.

@CharlieBilello		S&P 500 Average Forward Total Returns (Annualized, 1948-2022)						
Quintile	Unemployment Rate	1-Yr	2-Yr	3-Yr	4-Yr	5-Yr	6-Yr	7-Yr
Quintile1	7.2 to 14.7	17.5%	15.3%	15.4%	15.4%	15.8%	15.5%	15.2%
Quintile2	5.9 to 7.2	16.2%	13.9%	13.7%	13.3%	14.0%	14.0%	13.7%
Quintile3	5.2 to 5.9	14.9%	14.4%	12.8%	12.2%	11.2%	10.3%	9.7%
Quintile4	4.3 to 5.2	10.0%	8.4%	7.0%	6.5%	6.6%	7.1%	7.5%
Quintile5	2.5 to 4.3	6.4%	9.4%	10.6%	10.7%	9.5%	9.4%	9.5%
All Values		13.0%	12.3%	11.9%	11.6%	11.5%	11.4%	11.3%

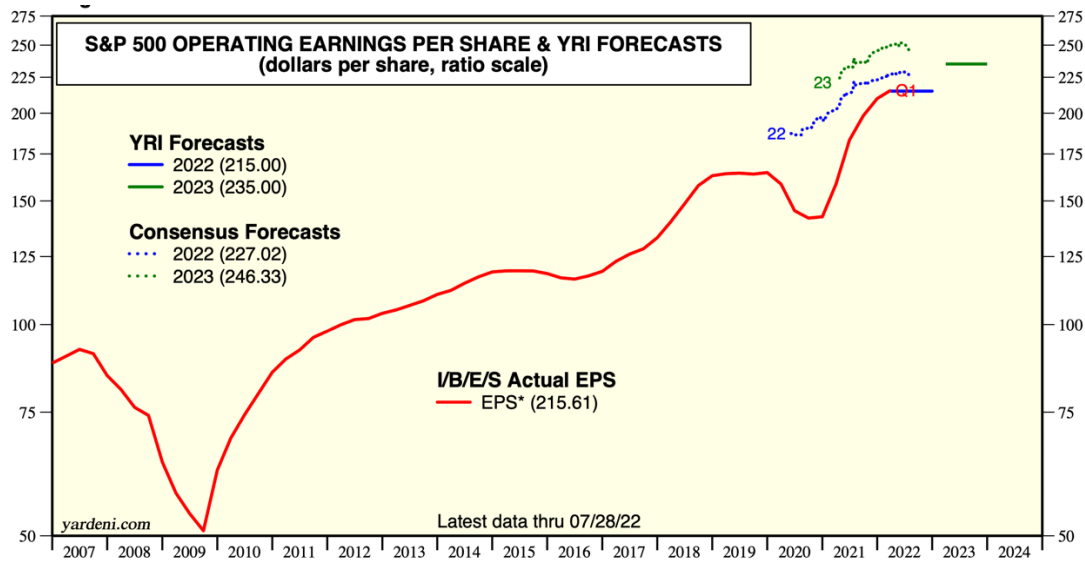
Historically not great. Low unemployment usually coincides with a strong economy and relatively high equity valuations. Our current CAPE Ratio is 31.1x (CAPE is cyclically adjusted price-to-earnings or 10-year average), which tends to be on the high side.

CAPE Ratio (10-Year average PE)



1948 - 2022		
Quintile	Unemployment Rate	Avg CAPE Ratio
Quintile1	7.2 to 14.7	14.6
Quintile2	5.9 to 7.2	17.1
Quintile3	5.2 to 5.9	20.1
Quintile4	4.3 to 5.2	24.3
Quintile5	2.5 to 4.3	22.5
All Values		19.7

This brings us to earnings. One week after it bottomed, S&P 500 forward earnings peaked at a record high. It's been edging down since then as industry analysts have turned more cautious on the earnings outlook for 2022 and 2023. It's not much of a decline in earnings forecasts but the numbers are coming down slightly.



* Four-quarter trailing sum of operating earnings per share.
 Source: I/B/E/S data by Refinitiv.

In general, the consensus view is that the outlook for the economy and the market aren't all that dire, and hopefully that's the case. Updating my handy spreadsheet on expected returns I come to the conclusion that the odds favor muted returns for equity investors.

S&P 500 Estimated Return Scenarios										
Estimated Forward Earnings S&P 500										
	\$ 200	\$ 210	\$ 220	\$ 230	\$ 235	\$ 240	\$ 250	\$ 260	\$ 270	
	13	-37.28%	-34.14%	-31.00%	-27.87%	-26.30%	-24.73%	-21.60%	-18.46%	-15.32%
	14	-32.45%	-29.07%	-25.70%	-22.32%	-20.63%	-18.94%	-15.56%	-12.19%	-8.81%
	15	-27.63%	-24.01%	-20.39%	-16.77%	-14.96%	-13.15%	-9.53%	-5.92%	-2.30%
	16	-22.80%	-18.94%	-15.08%	-11.22%	-9.29%	-7.36%	-3.50%	0.36%	4.22%
Estimated	17	-17.98%	-13.88%	-9.77%	-5.67%	-3.62%	-1.57%	2.53%	6.63%	10.73%
P/E Ratio	17.6	-15.08%	-10.84%	-6.59%	-2.34%	-0.22%	1.90%	6.15%	10.39%	14.64%
	18	-13.15%	-8.81%	-4.47%	-0.13%	2.05%	4.22%	8.56%	12.90%	17.24%
	19	-8.33%	-3.74%	0.84%	5.42%	7.72%	10.01%	14.59%	19.17%	23.76%
	20	-3.50%	1.32%	6.15%	10.97%	13.38%	15.80%	20.62%	25.45%	30.27%
	21	1.32%	6.39%	11.45%	16.52%	19.05%	21.59%	26.65%	31.72%	36.79%
	22	6.15%	11.45%	16.76%	22.07%	24.72%	27.38%	32.68%	37.99%	43.30%
	23	10.97%	16.52%	22.07%	27.62%	30.39%	33.17%	38.71%	44.26%	49.81%
Current (8/5/22) S&P 500 Price \$4,145.19										
Current 12-month Forward Earnings Estimate \$235										
Current S&P 500 P/E 17.64x										

I arrive at that prognostication by taking our current market value of \$4,145.19 and dividing it by an earnings estimate of \$235, which gives us a current forward PE of 17.6x. If you believe that the Fed is going to continue raising rates to reign in inflation (as I do) then you should expect PE ratios to fall some. Also, even if you think we'll have a soft economic landing you should expect earnings numbers to decline somewhat. This scenario leads me to believe that we might be heading deeper into the desert landscape.

*After nine days I let the horse run free
'Cause the desert had turned to sea*

That's the macro story and it's anything but clear. As a portfolio manager the best thing that my colleagues and I can do in periods of such uncertainty is focus on our individual holdings, and that is exactly what we have been doing.

Regulations/Compliance forbids me to talk about individual holdings but I can make some generalities.

- Earlier this year, in our Global models we reduced our exposure to Emerging Markets, specifically China. More recently we've lowered our exposure to Europe. While the jury is still out on the whether or not the U.S. is in a recession the outlook for Europe is much more dire.
- On the Fixed Income front we have generally been very focused on the more conservative higher quality short-end of maturities. While that still remains our strategy, we are watching high-yield spreads as they widen out, there may be an opportunity to become a bit more aggressive in fixed-income as rates rise.
- In the U.S. equity market, we are really focused more on individual names. We still like the earnings power in the Energy sector. In Finance we still prefer asset management over traditional banks. And in Technology we tend to be a bit overweight in semiconductors.

Investing is mostly about survival, making fewer mistakes than the market in general, and as we ride this no-name horse into to the desert that is exactly what we should be focused on. A multitude of unknowns favors the cautious here, no time for bold bets.

As always, be careful out there.

Chris Wiles, CFA



Where Trust is Earned

This is intended for informational purposes only and should not be used as the primary basis for an investment decision. Consult an advisor for your personal situation. Asset allocation and diversification strategies cannot assure profit or protect against loss in a generally declining market. Indices mentioned are unmanaged, do not incur fees, and cannot be invested into directly. Past performance does not guarantee future results. These are the opinion of the author and not necessarily those of Cambridge Investment Research, Inc.

Securities offered through Registered Representatives of Cambridge Investment Research, Inc., a broker-dealer, member [FINRA/SIPC](#). Advisory services offered through Investment Adviser Representatives of Cambridge Investment Research Advisors, Inc., a Registered Investment Adviser. Cambridge and Medallion Wealth Management, Inc. are not affiliated.

380941