Blowing the Froth

Weekender

June 18, 2022

Good morning and welcome to the *Weekender* for Saturday, June 18, 2022. In an "almost everything is down week," the equity market, as measured by the S&P 500, was lower by -5.8%. It was the worst week since the height of the coronavirus-fueled sell-off in 2020. Stocks entered a bear market on Monday, which is defined as a negative return from a high of at least 20%. On a year-to-date basis, the S&P 500 is lower by -22.9%. By comparison, the tech heavy NASDAQ is lower by -30.9%

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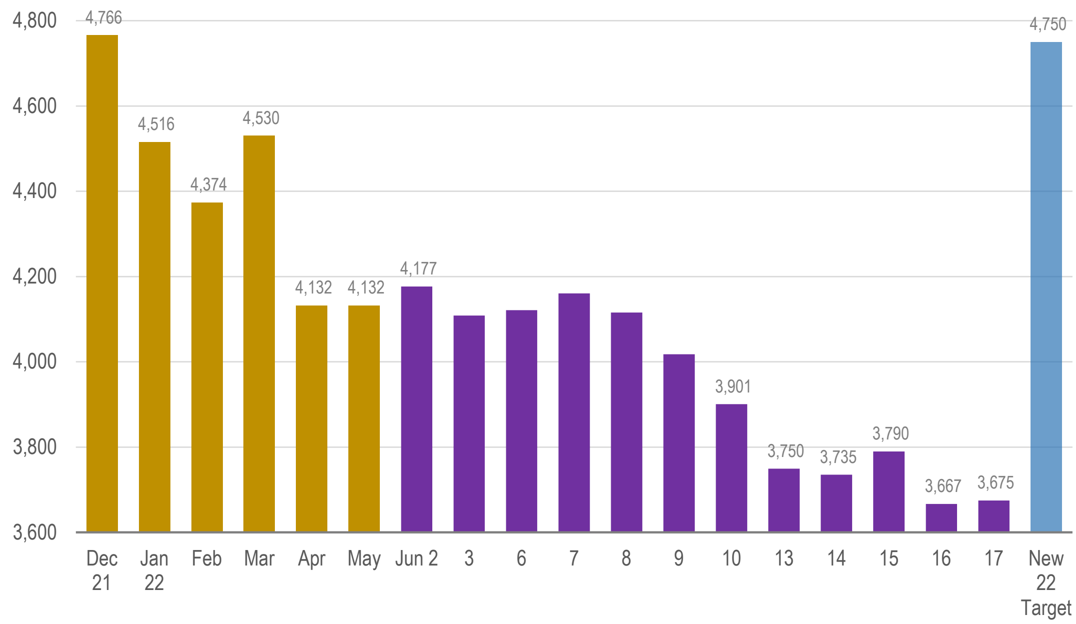
S&P 500 Daily Levels

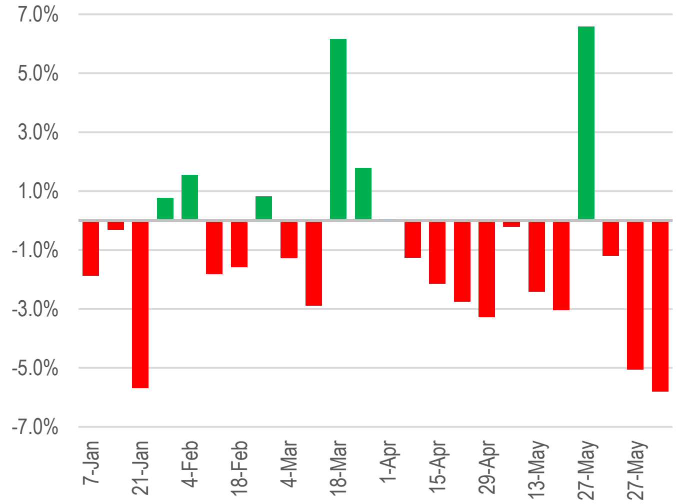
December 2021 - June 17, 2022



This week, markets were gripped by fear. A different fear than that experienced over the past two years. Since the pandemic goodie bag was dropped by the Biden Administration and the flow of monetary excess breached the levies of discretion, financial markets have been rising on the backs of FOMO, the fear of missing out. Perhaps one of the most dangerous emotions. The prevailing fear is fear of the future.

Looking at the S&P 500's weekly gains since the beginning of the year, it's looking like a sea of red. Certainly inflation and interest rates are on center stage, resulting in a blow off of the froth of the pandemic stimulus-laced financial markets. Its starting to look a lot like the beginnings of capitulation. But it doesn't mean the end of drawdowns. Selling is occurring across sector, company size, and geography. The exception is China, which is the only major economy with a central bank in a stimulating stance.

S&P 500 Weekly Returns
January 7 - June 17, 2022



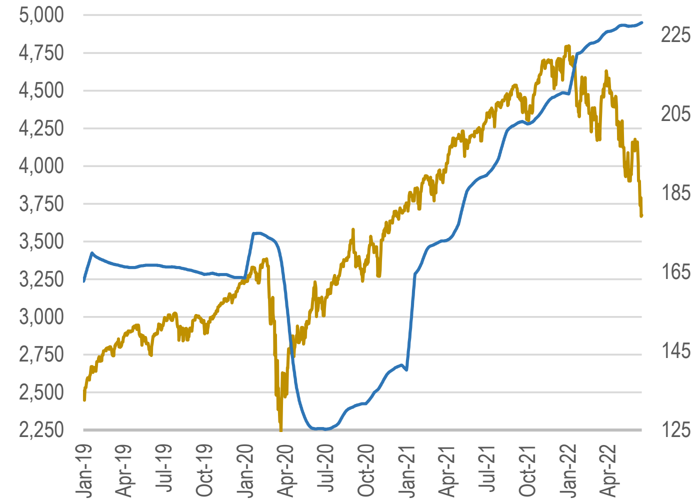
Financial markets began the week concerned with inflation. After the Fed raised its target interest rate by the most in a generation, concerns shifted to the prospects of economic growth in a rising rate environment. By Friday, program traders came in to nibble away at the dip.

For most analysts, economists, and investors, the prospect of a coming recession is increasingly a foregone conclusion. How long and how deep it will be requires some prognostication. Given the degree of inflation and the strength of the labor market, it's likely the Fed will need to lean hard on the economy in order to get inflation to heel. At this point, any prospect of a soft landing is more likely to be determined by luck than skill. But luck is normally distrubuted, like market returns, so a soft landing is still a possibility.

While markets are actively discounting the effects of inflation and higher interest rates on economic growth, for some reason markets seem to be ignoring the relative certainty of an earnings recession.

At present, analysts have not reduced their earnings estimates for the S&P 500 at all. Its important to highlight that analysts' abilities to predict declining earnings during recessions is suspect at best. Even so, while the S&P 500 has been falling, the gold line and left axis, earnings projections for the S&P 500 are steady. This is the other shoe to drop. Corporate earnings will fall and equity values will follow. But earnings estimates are a bottom-up phenomenon, impacting one stock at a time.

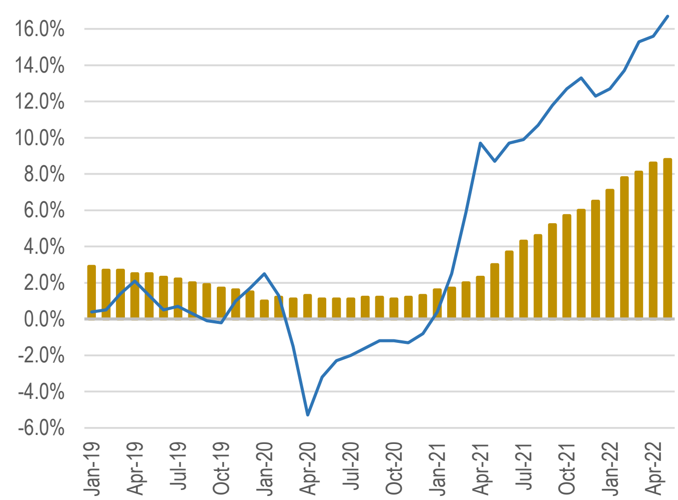
S&P 500 Daily Levels (Gold and LH) and S&P 500 Earnings Per Share (Blue and RH)
January 2, 2019 - June 17, 2022



Market Narrative

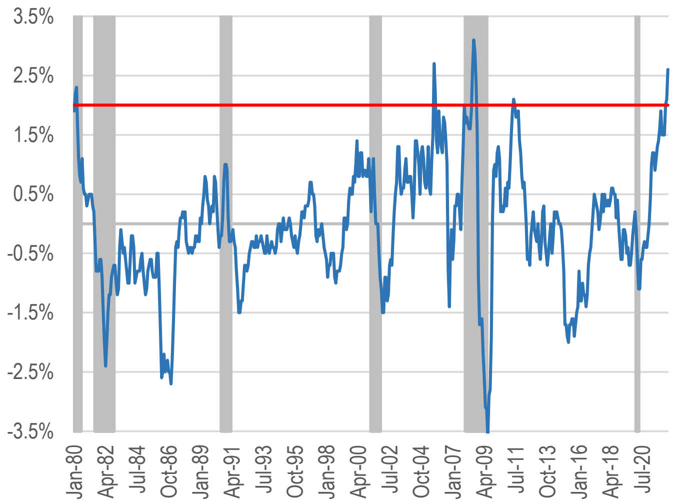
Another inflation gauge was released this week, the producer price index or PPI. At the headline level, producer prices were 16.7% higher than last year. That's stunning. The PPI is an important data point becasue producer prices will eventually be transmitted to consumers through higher prices and will be registered in the consumer price index (CPI) or to investors by way of compressed corporate margins and lower share prices. Those are the only two choices.

Headline (Blue) and Core (Gold) Producer Price Index
January 2019 - June 2022



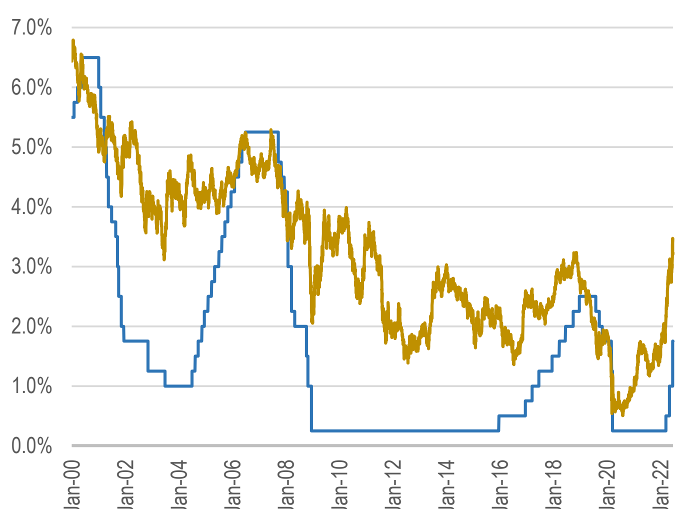
Going back to last week's consumer price index, the spread between headline and core inflation widened to 2.6% in May. Such gaps are unusual and usually a harbinger of recession. This decoupling of core and headline inflation highlights the demand destruction going on at the consumer level due to the extraordinary rises in prices of necessities like food and energy, which are in headline and not core. The persistence of this gap provides support to our view that inflation continues to carry the water for the Fed by slowing real consumption.

Headline and Core Inflation Gap
January 1980 - May 2022



Earlier this week, the Fed moved their benchmark interest rate higher by 0.75%, the biggest move since 1994. At the press conference following the increase, Jerome Powell came off a lot more dovish than expected, causing markets to breathe a bit easier. But as Fed board members made their post announcement press rounds following the official announcement, Powell and most other members of the central bank pressed home the point that they will do whatever is necessary

Fed Target Rate (Blue) and US 10-Year Yield (Gold)
January 2, 2000 - June 17, 2022



to inflation down to their target level of 2%. A much more hawkish after party tone kept markets on edge. Friday's gains were driven by profit taking.

There are three possible Federal Reserve-related outcomes in our view. If Powell is serious about pushing rates higher and destroying enough demand to get inflation down to 2%, we will most certainly find ourselves in a recession. If he chickens out and slows down as he sees the wheels coming off the economy, we are likely to have inflation higher for longer. The more likely option is the bobble head monetary policy where policy is continually altered based upon changing conditions. The primary outcome of the bobble head approach is continued uncertainty.

The Federal Reserve's sub-optimal position has been a creature of their own making. They painted themselves into a corner. They spent a year convinced of and trying to lull the markets into the view that inflation was transitory. All during their "transitory" period they continued monetary stimulation. In fact, even after the beginning of 2022, when the Fed finally capitulated and determined that inflation was real and was likely to persist for a while, the Fed continued to stimulate. It's a bit like an alcoholic who knows the problem but can't throw away the bottle. They start believing they have no problem. Then they assure themselves they can quit anytime. Then they realized they are hooked, and thanks to AA admit their altered view. Finally, with enough cojones, they seek help and take the consequences.

So what are the consequences. First a slowing economy. On Friday, data for industrial production came in weak, capacity utilization was lower than expected, manufacturing production was actually negative, and the index of leading indicators showed contraction ahead. On a regional basis, the Empire manufacturing index remained in negative territory from last month. The Philadelphia business outlook index fell into negative territory. Next week we get some additional economic data that will be useful to determine how quickly the slow-down will be felt. As we mentioned last week, residential real estate is the poster child for demand destruction, the knock-on dynamics of which, will certainly slow the economy.

Second, valuation declines. Many market watchers suggest that financial markets are looking for a bottom.

They are. That's their job. But a bottom from what? All markets have done, since the beginning of the year, is give back the froth from pandemic monetary and fiscal stimulus. Fiscal stimulus created artificial consumer demand which spiked corporate earnings. Some of the found money of stimulus payments trickled directly into stock market bets, which pushed equity valuations to frothy levels which is currently being removed.

Third, liquidity falls. Over the course of the pandemic, individuals, corporations, state and local governments, and the global monetary system, generally, have all experienced record levels of liquidity. Mopping it up is necessary but its going to be painful. Inflation accelerates the process and the pain of resetting liquidity.

Private equity investors are finding the current inflationary environment hard to navigate. Playbooks from the dot com boom and the Credit Crisis are poor guides for current market dynamics. But some similarities exist. A majority of venture and private equity funding rounds are coming in at valuations lower than previous rounds. At the same time, the monthly value of acquisitions by private equity has fallen from $170 billion in June of last year to $31 billion last month.

At a recent private equity conference, Nikos Strathopoulos, chairman of Europe at BC Partners said, "we have never experienced inflation and I am in this industry for 25 years." After a decade of buoyant fundraising and loose monetary policy, venture and private equity deals became ultra-competitive leading to valuations that were just nuts. Multiples paid at the top of the market a year ago were three to four times what a private equity firm would be willing to spend today.

Private equity firms that have not adjusted their underwriting doctrines are going to have a terrible hangover. All this being said, the value of private equity dealmaking remains high against historical averages. But the conditions upon which the capital is deployed has changed dramatically.

We believe its critical to understand that the lost returns of 2022, although significant, are nothing more than returns we never deserved. Still painful. From January 1, 2020 to Friday, the total return of the S&P 500 is 17.0%, an annualized return of 6.6%, slightly higher than the average annualized return of 6.3% from January 1, 2000 to Friday's close. The path forward presents some once-in-a-generation opportunities to find entry points in fantastic names. It also leaves exposed worrisome areas where froth remains.

Countries

Russia was the best performing equity market among major global players. But among investable countries China was the best performer. Most global equity markets were lower on the week as global central banks around the world locked arms in a chorus line farewell to the age of free money.

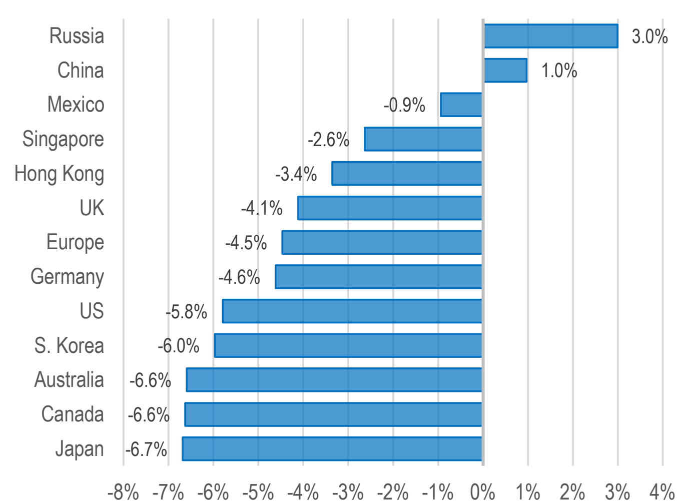
Important for so many, the onslaught of Russia continues. Over the weekend the country began increased attacks on Syria which puts its weaponry and targets in closer proximity to American troops. Russia also announced that it would use nuclear weapons is necessary to guard against encroachment of its territorial boundaries. Exactly what those boundaries are remains the subject of conflict.

Putin has clearly taken a few pages from Adolf Hitler's playbook. Those being read at present include keeping all global leaders on their heels, never certain of the rules of engagements.

Outside of the travesties of Russia's Ukraine invasion, every major global central bank, except China, is involved in the early skirmishes in a battle against inflation.

Country Returns

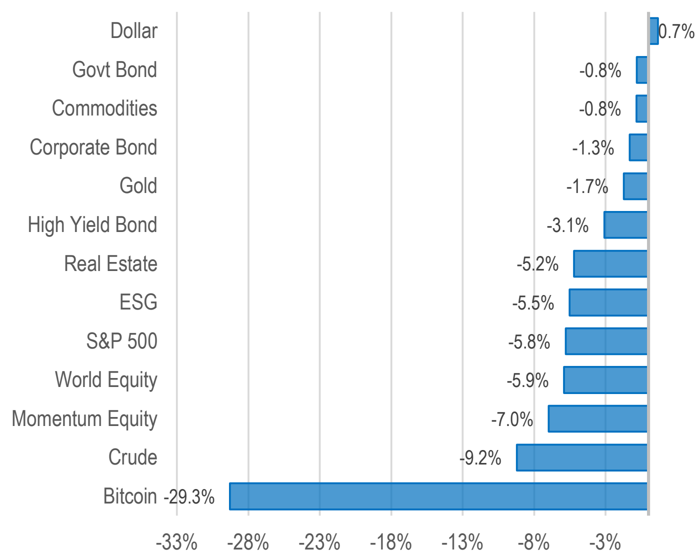
June 13 - 17, 2022



Instruments

Other than the dollar, every major investment instrument was lower on the week.

Instrument Returns
June 13 - 17, 2022



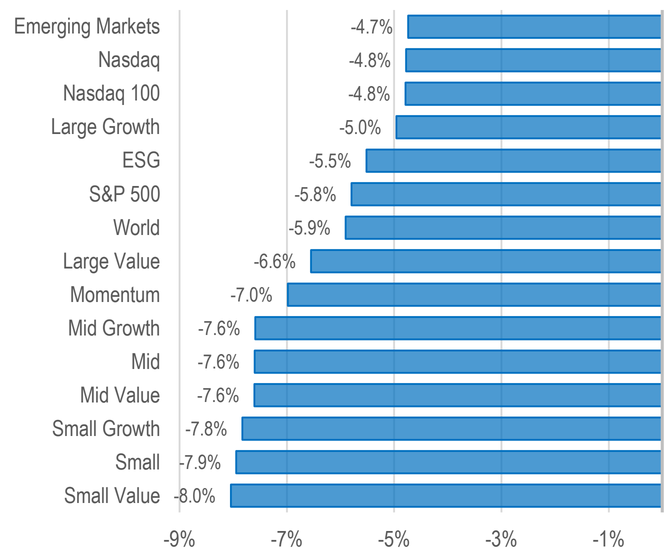
Bitcoin was the worst performer by a large margin. Another stable cryptocurrency peg came unloose this past week. In May, TerraUSD's stable coin, which promised but could not hold on to its dollar peg, failed. Crypto lender Babel froze withdrawals, telling its clients it is facing unusual liquidity pressures. Babel's liquidity issues came just a couple of days after Celsius Network, another crypto lending platform, paused its withdrawals. Separately, Three Arrows Capital, a crypto hedge fund, alerted investors about financial troubles at the firm. All told, the total value of crypto assets, broadly measured, fell below $1 trillion, a meaningful drop from its highs of $3 trillion at the end of last year.

Bitcoin Value in US Dollars
January 2, 2019 - June 18, 2022

As of the moment of this Weekender was published, Bitcoin dropped below $19,000.

Among equity instruments, all of them were lower. Small caps and value were the worst performers which is consistent with the week's economic narrative that recession is on the horizon.

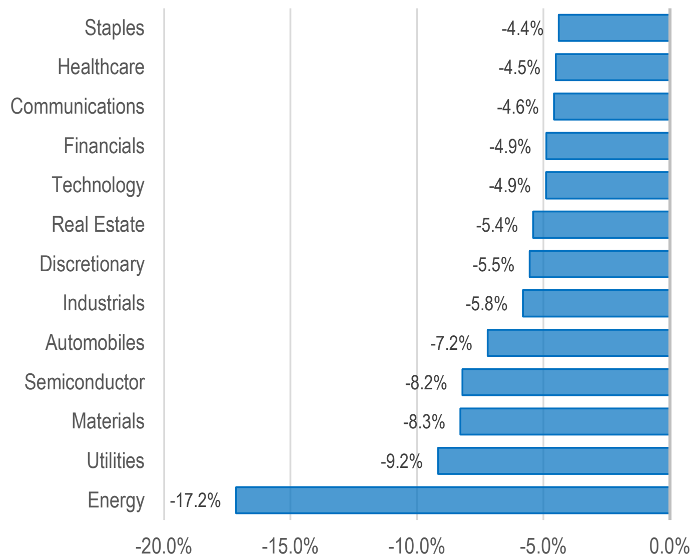
Equity Instrument Returns
June 13 - 17, 2022



Sectors

Consistent with broader moves, all sectors were lower. Energy was the worst performer on the back of a drop in crude oil. To the extent that any protection was possible last week, protective sectors fell the least.

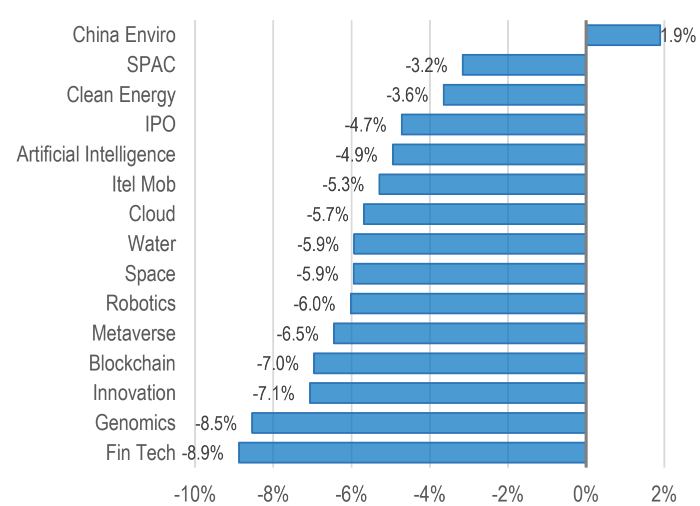
Sector Returns
June 13 - 17, 2022



Themes

China's environmental sector performed well and the rest were lower. As mentioned previously, the cracks in the cryptocurrency wall are becoming more visible. That is likely to continue for the foreseeable future.

Theme Returns
June 13 - 17, 2022



Conclusion

That's it for this weekender. Have a wonderful week.