Haven Global Partners, LLC.
Market Outlook: July 2022

2022: Tug of War

The reason for the dramatic correction in global stock markets has not been because analysts have lowered their earnings expectations for companies, as one would expect. Rather it has been a markdown in multiples which has caused this correction. Top-down strategists are calling for a significant decline in earnings, but bottom-up analysts are not yet seeing that (nor are they predicting it) as they focus on company fundamentals. Seventy percent of the recent three-year bull market was due to the expansion of multiples, while earnings growth accounted for the other 30%. Typically, that situation is reversed: with approximately two thirds of market gains normally coming from increases in earnings, while the other third is due to multiple expansion. In fact, bottom-up analysts have shown signs of being increasingly convinced of the validity of their earnings estimates. In many cases those estimates are actually still going up. So, who is right? Is it the top-down strategists with their dour predictions or the bottom-up company fundamental analysts who see clear skies ahead? Well, the answer will certainly depend upon what happens with the economy, and the economic outlook at this point, remains highly uncertain. It could just be that those bottom-up analysts' earnings expectations are being measured nominally, and we are today living in an inflation-adjusted world. Also, stock analysts actually have a pretty poor track record when it comes to calculating how inflation and recession risks will weigh on the earnings of the companies they cover. Revision momentum may ultimately surpass interest rates as the key driver of stock price performance in the coming quarters.

Since it stands to reason that the answer as to which group, top-down strategists or bottom-up analysts is right will depend on how the economy turns out, we should take a closer look at how the global economy is doing, and which way it is more likely to go. Some of the economic data is getting less consistent. That is most likely what has top-down strategists and many investors questioning the viability of earnings. But it is truly written that until there is a problem in the credit markets, a recession just isn't very likely. If families weren't paying their bills or if statistics for companies declaring bankruptcies were going up, those would be signs that we were moving towards a recession, but that is not yet the case.

Signs from the Treasury market are not yet clear as expectations for further Fed tightening collide with fears that the world's largest economy may slip into a recession. Rising rates mean a bigger chunk of corporate cash will now go to creditors. That will make highly indebted businesses much less attractive. Those calling for a serious slowdown in the global economy believe that margins are key. If interest rates continue going higher and inflation eats into consumer budgets that will show up in company margins. The next step is to see concerns about margins reflected in forward earnings, that is how the trouble will first be perceived. Then there will be a hit to employment and wages. After that it starts to feed on itself and creates a vicious circle. Or at least that is what those calling for a serious slowdown believe will happen.

On the other side, there are factors which buoy those believing that economic activity will strengthen over the months to come. They believe the reopening of the sectors of the economy most affected by the pandemic as well as a strong labor market, with more people in jobs, will continue to support incomes and consumption. In addition, savings accumulated during the pandemic provide a buffer. Another factor supporting those who believe the economy will not fall into recession is the point that when the Fed itself starts mentioning the possibility of a recession, it is probably reasonable to conclude that the impulsive bond-market sell-off that we observed in the first half of this year is behind us.

The change in interest rates will be a key driver in how the economy performs going forward. Both the direction that interest rates move and the magnitude of those moves will be key in determining how the global economy fares in the months and quarters to come. The magnitude of each of the factors mentioned above is open to debate. How great of an influence will the discussion of inflation change consumers expectation of what prices will do? Has the talk about the Fed's intent to thwart inflation already sent interest rates high enough to slow the economy? There are those on either side of these issues investing based upon their respective beliefs and the direction of the global equity markets will not be clearly determined until this debate is resolved. Then there is the lingering COVID-19 pandemic as well as the outcome of the Russia-Ukraine war. Will either of these issues remain important to market outcomes? Market participants for the most part believe that COVID is behind us and that the war is contained and that its effect is mostly just related to commodity prices. Of course, whenever a nuclear power is involved a military conflict, there are very frightening outcomes which ought not be dismissed out of hand.

The U.S. and European economies slowed sharply in June as surging prices of energy and food weakened demand for other goods and services, Europe faces additional pressure from a possible energy shortage this winter. Germany triggered the second stage of its three-step plan moving closer to possible rationing this winter, which would deal a severe blow to manufacturers there.

However, the US economy is not in a recession. The US economy has problems, but inflation is not the same thing as a recession. GDP has risen rapidly since the start of 2021. The market for goods and services is booming. Output rose in the first quarter. Domestic demand has continued to be strong, and it is likely that this expansion will continue through the second quarter. The labor market is booming. The unemployment rate is 3.6%, close to the lowest it has been in 50 years. There are currently almost two job vacancies for every unemployed worker, the highest this ratio has been since the data were first collected. The idea that the U.S. is already in a recession or is destined to tumble into one is nowhere near as high as some investors seem to think.

Yet it is also true that while consumers will continue to spend freely on leisure, travel & hospitality over the summer, a persistently elevated inflation backdrop, surging interest rates and plunging stock prices will likely tend to erode spending power, severely curtail housing activity, and constrain business investment in the coming months.

What to Do

We are entering a period of heightened uncertainty between the ongoing pandemic and the war abroad, together with a newly hawkish Fed. These conditions can make it difficult for even professional investors to stay calm, disciplined and continue to practice their investment strategy. Rising interest rates are chipping away at the TINA mantra (after all US Treasury bonds at yields above 3% and corporate bonds with 5% represent a very reasonable alternative to stocks).

Our objective is to focus on Quality stocks. We maintain that objective irrespective of whether market conditions are marked by falling PMI's falling or PMI's heading to peak levels. That is because in our experience a strategy of owning Quality companies at reasonable prices leads to investment success, whether the economy is improving or deteriorating. And as global investors engage in this latest tug-of-war to find out where global equity markets are headed next, we intend to continue to practice our process, confident in its long history of success.