ALTMAN
INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

MAY, 2022

"Using technical analysis for market timing is especially dangerous. Because there is a long-term uptrend in the stock market, it can be very risky to be in cash."

Burton G. Malkiel- "A Random Walk Down Wall Street".

IN FOCUS:

The macro environment so far this decade has been unprecedented, with several major shocks including a pandemic, massive offsetting policy stimulus, and the Russian invasion of Ukraine. However, global equities and other risk assets have repeatedly managed to shrug off much of the uncertainty until recently, propelled by the powerful economic and earnings rebound, enormous fiscal and monetary stimulus, and deeply negative real bond yields. However, the traditional equity supports have now been removed. Despite this solid growth once the Fed and bond investors recognized a more hawkish Fed stance, investors abruptly capitulated on the transitory inflation narrative and government bond yields continue to march higher. For the most part, equity weakness has largely been driven by multiple compression, rather than concerns of material earnings weakness.

That said, the market narrative has recently shifted towards concerns about the growth outlook, now that China has again forced widespread COVID-related lockdowns, at a point when the European economic outlook is being clouded by geopolitics. To be clear, we are not expecting a recession to materialize anytime soon. The U.S. economy is in solid shape with ample underlying support, the euro area service and tourist sector has already experienced a material boost from reopening, and the Chinese authorities appear to be poised to provide some offsetting stimulus. Nonetheless, a brief growth scare has been developing and could continue until China re-opens its economy and European geopolitical tensions ease from current levels. In light of these developments, some near-term caution is warranted. Already, the equity shakeout continuing in April and spike in volatility has triggered a more defensive approach in the near term. However, we maintain our growth cyclical bias at this time.

Since the Fed has moved from supporting the economic recovery to fighting inflation, and since private domestic demand (incl. consumer spending and capex) remains strong, we do not expect the negative print on Q1 real GDP growth to detract the Fed from moving aggressively by 50 bp at the next several FOMC meetings and move the rate closer to 3.0% over time.

A Closer Look at GDP against a Backdrop of Better Inflation News:

As growth concerns have increased, recent inflation data show evidence of improving. Such a pause, in turn, should allow the recent risk-off phase to fade once investors realize that the economic "wheels are not falling off". The latter awaits an easing in Chinese economic restrictions, some calming in new-found central bank hawkishness, and perhaps less bearish headlines from Russia/Ukraine. The foundations under the global economic expansion are still solid, but the liquidity boom is unwinding, and financial market returns most likely will be less than in recent years, with bond yields moving higher in the initial phase.

Q1 real GDP contracts, but recession is still off the table. Real GDP declined at a 1.4% annualized rate in Q1, down for the first time since Q2 2020, and contrary to the consensus of a 1.0% gain. Net exports took a big bite out of growth. Inventory investment and government spending also fell. But consumer spending, capex, and residential investment increased, a sign that underlying domestic demand remains solid. On a y/y basis, real GDP eased to 3.6% from 5.5% at the end of last year.

Notwithstanding the negative Q1 results, in our opinion the real GDP contraction is not broad-based and still does not meet the NBER (National Bureau of Economic Research) criteria for recession. In our view, there is enough economic momentum built-in to sustain the expansion in 2022. But while we do not expect a recession this year, we acknowledge that the downside risks to the growth outlook have increased due to the end of fiscal stimulus, the start of Fed tightening, the Russia/Ukraine War, and more Covid lockdowns in China. We continue to monitor leading economic indicators for a material shift in the data that points to recession in the near-term.

Real imports shot up at a 17.7% annual rate in Q1. The surge in the trade deficit to a fresh record was facilitated by a strengthening U.S. dollar - but also reflects stronger demand in the U.S. than abroad and some easing in supply chains. Nevertheless, the record widening in the trade gap subtracted from real GDP growth in Q1 for an estimated seven consecutive quarters. It's important to note that this is the longest such stretch since Q4 2000 which, similar to today, came on the back of a strengthening U.S. dollar.

Businesses continue to accumulate inventories, but at a slower pace than in the previous quarter - subtracting from real GDP growth during the first quarter along with government spending. The latter decline was led by a sizeable drop in defense spending and a continuation of rollbacks in Covid-related assistance.

Net exports and inventory investment are relatively small but volatile GDP components that can swing the headline growth number and obscure the underlying strength or weakness of the economy. Real final sales to domestic purchasers, which exclude these two components, paint a better picture of the economy in Q1 than the broader GDP. They rose at a 2.6% annualized rate that matched the historical average since 1980.

According to Morgan Stanley's economics department, real final sales to private domestic purchasers, which excludes government spending as well, rose at a 3.7% annual rate and was the best in three quarters. It shows that consumer spending and business investment held up well in the face of waning fiscal stimulus, Omicron-related uncertainty early in the quarter, the Russia/Ukraine War later in the quarter, and the start of Fed tightening.

Lastly, real personal consumption expenditures (PCE) increased at a 2.7% annual rate, slightly better than expected. This contributed almost 2% to Q1 real GDP growth, and services spending increased at a 4.3% annual rate. The pickup in services spending is encouraging, as Covid restrictions continue to be lifted, consumer demand has begun to normalize towards more services and fewer goods. At this point, however, the overall services' share of PCE continues to track below its pre-pandemic level, while the durable goods' PCE is tracking above its pre-pandemic level.

Nonresidential fixed investment, or capex, jumped at a 9.2% annual rate, and contributed positively to Q1 real GDP growth. Equipment spending rose at a 15.3% annual rate, the most in two years, led by information processing and industrial equipment. Intellectual property spending such as software and R&D contributed in the high single digit annual rate.

Inflation pressures continued to build. The PCE Price Index increased at a 7.0% annual rate, comparable to the first quarter of 1981. Core PCE prices advanced at a 5.2% annual rate compared to the rate experienced in the first quarter 1985. The increase in inflation and decline in real output growth amounted to a 6.5% annual rate of growth in nominal GDP, providing further evidence that inflation is already having a marked effect on slowing down this expansion.

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Is the Uptrend in Earnings Enough to Support Markets?

U.S. stocks have corrected sharply year-to-date, with the rise in corporate earnings more than offset by a sharp multiple compression as bond yields have surged in recent months. Though, we would expect a near-term bounce probable with equity prices now oversold and investor sentiment at a bearish extreme. The government bond market is also oversold, and due for at least a pause in the interest rate normalization process. Ultimately, we believe for markets to establish a low in equity prices will require greater clarity on the inflation outlook and/or evidence that the Fed can curtail inflation without triggering a recession. Investors remain skeptical that such an outcome can be achieved given that monetary policy appears to be behind the curve, and events such as the war in Ukraine and China's COVID lockdowns have added to supply chain disruptions, thus complicating the Fed's task. Until these concerns ease, equity performance is likely to remain choppy.

We still maintain a 20% likelihood that the U.S. has a recession in the next 12 months. The U.S. economy entered the year with considerable momentum coupled with healthy household balance sheets, strong labor demand, and the lack of excesses in corporate behavior. This should provide the cushion to offset recession risks.

Although the pace of the rise in bond yields over the past 4 months has certainly exceeded our expectations, long-term interest rates remain low by historical standards. A sharp rise in the cost of capital in shortened periods can nevertheless be quite disruptive, especially when investors start extrapolating the pace of rising yields and policy rates. If the government bond market doesn't calm down soon in the months ahead, rapidly rising bond yields could lead to a more pronounced slowdown in economic growth, especially if Europe falls into a recession.

While our constructive economic outlook of GDP at 3.5% comes with some risks, we expect the uptrend in corporate earnings to persist, albeit at a more moderate pace than in the past 18 months. The combination of rising earnings and easing downward pressure on valuation multiples as inflation peaks should enable equities to produce more moderate gains on a 6–12-month horizon. Against this backdrop, we remain positioned with a an overweight in equities. In terms of our sector preferences, we favor Financials, Industrials and Cyclicals, offset by a defensive exposure in Healthcare.

Not Every Fed Tightening Cycle Ends in Recession:

The Federal Reserve began hiking interest rates in March. While many investors are concerned that this could lead to a recession, Goldman Sachs Research concluded a study that shows that 6 (or 40%) of the past 15 tightening cycles post-WWII period did not lead to recession. And they went further to add that even hiking cycles that lead to a recession took time. The study showed that 9 hiking cycles led to a recession that took about 30 months from the first hike to the onset of recession - and an average of 24 months until the peak of the S&P 500. Therefore, we believe it would be premature to move to an underweight position in equities in response to that timeline, given that the average total return from the first hike to the market peak was 36%.

No one has a crystal ball on shifting investor sentiment, so we focus our research efforts on stock selection, sector exposure and intrinsic value characteristics, rather than reacting to negative news and adjusting asset allocations accordingly. Since 2017, our above average (60/40) stock exposure historically in balanced accounts has been an effective overall allocation for the longer term, reflecting real and absolute yields at 40-year lows. The recent shift in this secular interest rate story coupled with some material events has increased the volatility of markets and lowered returns of financial assets in the near term. We recommend that our investors exercise patience and vigilance as these markets adjust - and stay the course.

A Cautionary Note on Market Timing:

A study by Band of America's Global Research helps quantify our long-time view against market timing. Data reveals that missing the best 10 trading days each decade going back to the early 1900s lowers an investor's hypothetical price return to just 45% - as compared to nearly 20,000% had they remained fully invested. Further analysis shows that gains realized pre and post market peak (both on a 1- and 2-year basis) were enough to offset the losses incurred off the peak. Absent any guaranteed method of predicting market peaks and troughs, an investor is better off riding out the volatility and staying invested.

Perils of market timing

Exhibit 5: Market timing can lead to missing out on the best days
S&P 500 returns by decade excluding the 10 best and 10 worst days, as of 3/1/22

Decade	Price return	Excluding best 10d per decade	Excluding worst 10d per decade	Excluding best/worst 10d per decade
1930	-42%	-79%	39%	-50%
1940	35%	-14%	136%	51%
1950	257%	167%	425%	293%
1960	54%	14%	107%	54%
1970	17%	-20%	59%	8%
1980	227%	108%	572%	328%
1990	316%	186%	526%	330%
2000	-24%	-62%	57%	-21%
2010	190%	95%	351%	203%
2020	33%	-24%	153%	44%
Since 1930	**19,975%**	**45%**	**4,275,143%**	**30,678%**

Source: S&P, BofA US Equity & Quant Strategy

BofA GLOBAL RESEARCH

CONCLUSIONS:

As always, imbalances in the economy and financial markets create vulnerabilities and can increase the likelihood of a recession. However, while valuations and debt levels are extended in a few sectors, the imbalances that exist today are modest as compared to previous downturns like the dot-com bubble and Global Financial Crisis. Overall, we conclude that these measures still show the U.S. economy is reasonably well balanced and the Fed appears to be committed to bringing the policy rate to its estimate of the economy's neutral rate (which we believe is around 2.5%) as soon as possible. We agree with the Federal Reserve's view that the U.S. economy is on solid footing and that it's reasonable to downplay recessionary fears at this time. We believe that the Fed can achieve a soft landing of the U.S. economy in the near term.

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