From Irrational Exuberance To Deep Pessimism!

24 May 2022

After hitting an all-time high on January 3, 2022, the S&P 500, a broad measure of the stock market, lost 18% as of Friday, May 20th. The technology-heavy NASDAQ tumbled 28% from its recent peak on November 22, 2021. Technically, a correction is a decline of 10% but less than 20% in a security price from a recent high. A bear market is a drop of 20% or more.

Growth and technology, in particular, led markets in both directions. Small stocks were hit harder than large company stocks during this market selloff. All sectors lost money except energy and utilities, with energy stocks soaring 49% year-to-date. The Bloomberg U.S. Aggregate Bond Index, a broad measure of the bond market, is down 9% for the same period.

This substantial decline in financial assets was primarily due to the Federal Reserve (Fed) monetary policy tightening. The Fed voted to kick off a cycle of tightening credit to tame inflation. The Consumer Price Index (CPI) surged 8.3% year-over-year, a level not seen since 1982. This surge was fueled by high energy and food prices, supply chain bottlenecks, wage growth, and strong consumer demand.

The Fed is walking on a tightrope, trying to reign in high inflation without triggering a recession. The Fed governors chose to prioritize inflation over economic growth. They believe they can engineer a soft landing because “the economy is very strong” and can handle higher interest rates.

The economy’s strength rests on a resilient consumer with strong household finances, including healthy balance sheets, low debt service ratio, elevated personal savings, and higher home prices.

With a strong job market, rising wages, and substantial pent-up demand for services (travel, restaurants, etc.), consumer spending, which accounts for two-thirds of the economy, will likely be a tailwind for any economic growth. However, consumer sentiment is at a decade-low because of high inflation.

Both business investment and industrial production are improving, but the ballooning trade deficit continues to be a drag on Gross Domestic Product (GDP) growth. Solid domestic demand increased imports substantially in the first quarter of 2022, while weaker economic growth abroad weakened exports.

Additionally, the dollar's strength versus our major trading partners, which is due to higher domestic interest rates and a relatively more robust economy compared to the rest of the world, played a substantial role in widening the trade deficit, making imports cheaper and exports more expensive.

In our view, U.S. economic growth should moderate. We believe the sources of market volatility have shifted from concerns about Fed tightening to corporate earnings and a possible recession. However, we do not see a recession in the near term as consumer spending and a robust labor market will continue to support the economy. Furthermore, we see inflation moderating by the end of the year as aggregate demand cools down and supply chain bottlenecks ease.

From a market perspective, we believe the stock market is oversold and investors are too pessimistic. Additionally, in the past several weeks, we have seen a number of our contrarian indicators signaling a stock market rally may be in the near term. However, we believe the volatility will continue as the Fed continues to tighten monetary policies. With this backdrop, we have adopted a tactical approach, selling rallies and buying strong companies we see as undervalued due to excessive pessimism. We are not changing portfolio allocations to equities at this time.