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REVIEW & COMMENTARY

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"Contemplating the positives and negatives of the U.S. economy brings up the famous Dickens' opening line: It was the best of times; it was the worst of times."

It Could Have Been Worse

We are now approaching the mid-point of what is proving to be a challenging year for most equity markets. With a month-end rally mitigating earlier losses, the S&P 500 Index ('S&P 500') fell 0.18% in May, putting the index down 12.76% year-to-date. Smaller stocks fared better in May with the S&P MidCap 400 Index rising 0.75% and the S&P Small Cap Index rising 1.86%, although both remain down significantly for the year. Value stocks continue to outperform their growth brethren with the S&P 500 Value Index up 1.64% in May versus a loss of 1.36% for the S&P 500 Growth Index, putting the value index down 3.49% year-to-date versus a 21.09% drop for the growth index.

Sector performance was mixed: Energy remained the top sector with a gain of 15.77% in May making the year-to-date figure 58.47%. Utilities, financial stocks, communications stocks, health care and materials stocks also rose. The weakest performance came from real estate stocks which fell 5.02% in the month, followed by consumer discretionary stocks which fell 4.85% and consumer staples stocks which fell 4.61%.

The S&P 500 reached official "bear market" territory on May 20, finally falling 20% from its high price on January 3, 2022. Many other indices had actually reached bear status far earlier than the S&P 500. However, since that time, there has been a sizeable rally with the S&P 500 up about 6% to current levels.

Contemplating the positives and negatives of the U.S. economy brings up the famous Dickens' opening line: It was the best of times; it was the worst of times.

Although it might not seem like it at the moment, there are some positive aspects to the current situation.

The U.S. economy is strong with continued job growth, a low unemployment rate and meaningful wage growth. According to last week's data, the U.S. economy added 390,000 jobs in May down from 436,000 in April, but enough to keep the country's unemployment rate at 3.6%, close to a 50-year low.

U.S. equity markets are no longer overvalued compared to historic norms. As of today, the S&P 500 is selling for 18.6x estimated 2022 earnings. According to Factset, this is exactly the current average for the p/e (price/earnings) ratio in the past five years, although still higher than the 10-year average of 16.9x.

After a year of steadily rising inflation figures, we have just seen a month of figures lower than the prior month.

But there is a lot to worry about as well. We are basically in see-saw mode of worrying about inflation and recession at the same time.

Inflation is easy to spot.

We are seeing record prices at the pump for gasoline. (over)

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Money consumers spend on gasoline is money not getting spent on other items, possibly hurting the economy. Money producers pay on gas and diesel fuel to transport their wares adds to the cost of those goods and thus to inflation.

The same is true for food prices. They have behaved in a similar manner. Inflation in other consumer products can be more subtle – the price for a package of paper towels, for example, might be the same as last year, but each roll only contains 385 sheets versus 435 last year.

Several leaders of significant companies (Jamie Dimon of JP Morgan, Larry Fink of Blackrock and Elon Musk of Tesla) are warning of upcoming economic stormclouds, or in Dimon's case a "hurricane." They bear listening to. If more of their brethren say the same thing and act on their concerns, it could become a self-fulfilling prophecy and lead to a slowdown.

Federal Reserve Bankers have begun raising short term rates and shrinking the Fed's balance sheet in order to slow growth in the U.S. economy and, hopefully, stem inflation. Higher mortgage rates are already having an effect on the housing market in the U.S. Hitting it right and having a "soft landing" with inflation slowing but the economy still growing modestly would be far better than a "hard landing," curbing inflation but causing a recession or stagflation which is usually defined as high inflation accompanied by slow economic growth and rising unemployment.

Energy price "shocks" such as the one we are having now, have led to recessions in the past, most notably in 1974 when oil prices went from about $3 per barrel to $15 per barrel and again in 1979 when oil went from about $15 per barrel to $40 per barrel.

Lastly, the Ukraine-Russia war and the saber rattling in China about Taiwan are major geo-political issues that will affect markets either in a positive way if they cool down, or a negative way if they get worse.

What the second half of the year might bring is anybody's guess. Despite plentiful evidence of some slowdown in the economy, analysts still expect the S&P 500 to earn about $223 per share in 2022. This is actually up from the $218 consensus estimate on January 3, 2022. Falling earnings estimates could bring about a falling market.

It is important to remember the long-term direction of markets is up and timing when to get in or out of markets is extremely difficult. Staying in equity markets when they look risky can be challenging. This is why developing an asset allocation (the mix of stocks, bonds, cash and other assets in one's portfolio) plan that addresses a client's various goals (growth, income, etc.) and tolerance for risk is critical. Consider it a roadmap to successful investing. In addition, with the increase in interest rates so far this year, holding cash and bonds isn't as painful as it was a year or two ago. As always, we are happy to discuss markets, asset allocation or whatever financial concerns you might have.