2Q2022

Maclura Investments

2Q22 Review - Will The U.S. Economy See Its Shadow on July 28th?

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Every February 2nd, weather pundits anxiously wait on Groundhog Day to see whether Punxsutawney Phil will see his shadow or not to proclaim that either winter will continue for six more weeks or spring will arrive early. On July 28, the second quarter GDP estimate will be announced, and in similar fashion, market watchers will be waiting to see if the economy sees its shadow (i.e., shows positive growth for the quarter) or not. If the U.S. economy has a second consecutive quarter of negative growth, it will be officially declared as a recession. From a market perspective, this date will be significant as it will be right after the July Fed meeting and could set the stage for the Fed to either continue to increase rates aggressively to combat inflation or mitigate future increases to accommodate the slowing economy. That date will determine whether the market continues to have a downward bias or be a catalyst for investors to start to look beyond a recession to a recovery and provide a floor to the market.

Markets are typically characterized by two emotions, greed and fear, which alternate between each other depending on where the economy is in its life cycle. In the fourteen years since the Great Recession of 2008 and the ensuing world-wide experiment by central banks of easy money monetary policies, negative interest rates, and quantitative easing (QE), greed has been the prominent emotion in the markets. But as always, fear is never far away from the party. It has been the emotion of choice throughout most of the first half of 2022 as both equity and fixed income markets have significantly struggled as the central banks attempt to end the era of easy monetary policies.

Exhibit 1. Investment-Style Returns

	Morningstar Index Market Returns	2015	2016	2017	2018	2019	2020	2021	2022 1st Qtr.	2022 2nd Qtr.	2022 ytd
Growth	U.S. Growth	5.54%	3.16%	29.52%	0.78%	35.90%	44.65%	24.79%	-11.97%	-25.33%	-34.26%
	Large Growth	7.71%	1.79%	31.15%	2.94%	33.81%	38.86%	21.47%	-13.55%	-29.81%	-39.32%
	Mid Growth	-0.71%	6.46%	25.67%	-3.16%	36.01%	46.17%	14.97%	-16.01%	-21.33%	-33.93%
	Small Growth	-0.18%	9.61%	23.77%	-5.67%	27.60%	43.52%	-1.00%	-13.37%	-22.41%	-32.79%
Value	U.S. Value	-2.16%	20.79%	14.23%	-7.51%	25.09%	-1.31%	23.98%	2.35%	-9.44%	-7.31%
	Large Value	-1.43%	18.91%	15.09%	-5.90%	25.70%	-0.62%	21.49%	1.63%	-8.16%	-6.66%
	Mid Value	-2.57%	25.21%	13.02%	-10.63%	24.81%	-3.76%	29.02%	4.85%	-12.65%	-8.41%
	Small Value	-8.65%	27.96%	8.40%	-16.61%	19.96%	1.01%	31.79%	1.80%	-12.78%	-11.21%

Source: *Morningstar*

For the quarter, the market recorded its worst quarterly performance since the initial pandemic concerns in the first quarter of 2020, and it also logged its worst first half performance since 1970. Usually, market moves for the past decade have been determined by a handful of stock movements, but what has transpired so far this year is a broad base valuation compression. The broad market, as measured by the Morningstar US market index, was down 16.85% and 21.28% for the second quarter and year-to-date, respectively. In the table above, the growth indexes were down more than value indexes as a result of the relative overweight and underweight of the technology and energy sectors, respectively, when compared to the value indexes. For the quarter, every sector was down, and for the year-to-date, only the energy sector had positive returns. Additionally, the increase in interest rates has had an adverse impact on the higher valuation growth stocks, particularly those companies not expected to reach profitability until later years.

The rapid increase in interest rates has been felt not only in stocks but also bonds. The broad bond market, as measured by the SPDR Barclays Capital Aggregate Bond ETF, was down 3.8% and 9.4% for the second quarter and year-to-date, respectively. Historically, a balanced portfolio of 60% stocks and 40% bonds has been deemed conservative, but this year has proved to be an anomaly, proving that year-to-date, a safe haven has been elusive to investors.

In our 2022 outlook published in January, we discussed that we would not be surprised if the market was down 15% at some time during the year. This was based upon the premise that the Federal Reserve was beginning to tighten its monetary policy, and typically the markets have an increase in volatility during that time period with the uncertainty of the cadence of policy moves.

What caught the markets by surprise was the sheer speed of the rate increases that the Fed was implementing in its attempt to slow down inflation. More on this later, but first, why do interest rates matter to stock prices? Without going into academic detail of the merits of required rate of returns or market risk premiums, an example that most can comprehend is using a mortgage to acquire a home. The chart below graphs the average 30-year fixed mortgage rates in the United States for the past 13 years. Since the start of this year, mortgage rates have increased nearly 300 basis points -- the fastest increase in recent history. The residential markets have been rife with stories of homes selling well above asking prices as buyers try to secure housing in a short-supplied market.

Exhibit 2. Average U.S. Fixed Mortgage Rate - 30 year

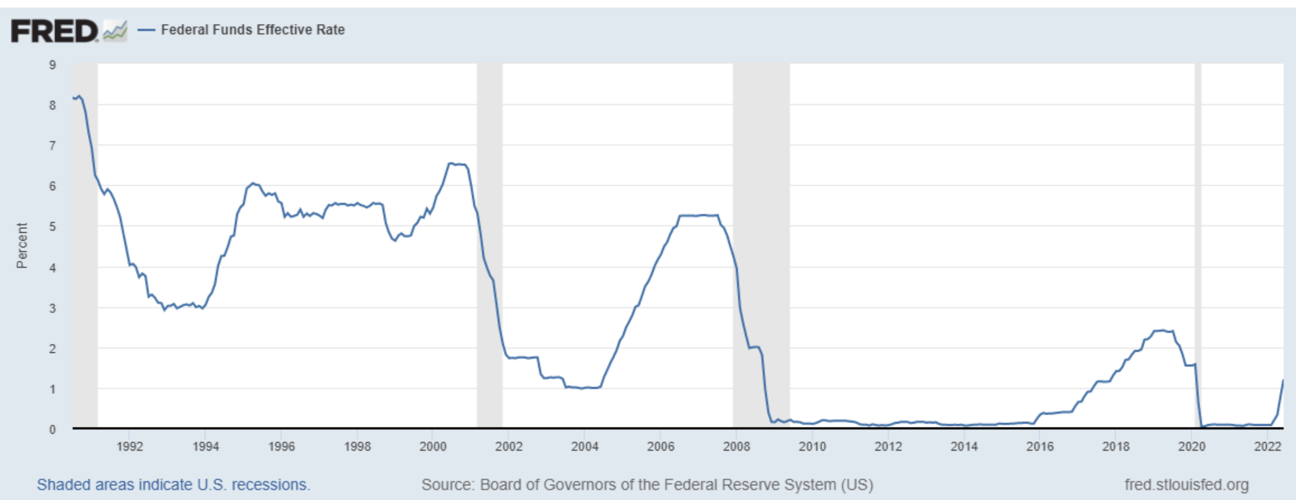
If a buyer was in the market for a new home at the end of 2021 and wanted to finance $300,000 of the purchase with a 30-year fixed mortgage, the average interest rate at the time was near 3.0%. The monthly payment to service the loan would have been $1,265. If the buyer was unable to purchase a home because of the tight market, that same $300,000 mortgage at the current average interest rate of 6.0% would have a monthly payment of $1,799, an increase of $534 (42%) per month. With the higher interest rates, the total payments to acquire the home over the life of the loan increase by $192,240. If the buyer was limited by the monthly payment as calculated at the lower rate of $1,265, then the maximum capital the buyer would be able to borrow at the higher rate would be $211,000, a drop of 30%.

Conceptionally, that provides a framework for what has taken place in the market so far this year, as multiples (valuations) that investors are willing to pay for companies have compressed. Though stocks are more complex assets than a home and aren't purchased with a mortgage, interest rates are a component in valuing them. Changes in interest rates impact a manifold of assumptions, which result in the variability of valuations that investors are willing to assign to investments.

Central banks' policy changes:
The reason for the increase in interest rates throughout the world is that central banks are raising short-term interest rates in the most widespread tightening effort in more than two decades. The three exceptions are China, Japan, and Russia. This comes after 14 years of the world's central banks engaging in a relatively new monetary policy, quantitative easing (QE), which was used alongside lower short-term interest rates to help spur local economies back into a self-sustaining growth trajectory.

The Federal Reserve's main goal is to help the United States' economy achieve maximum employment and price stability. The Fed has a number of tools with which to help coerce the economy to achieve this, with the main tool being adjustments to the short-term interest rate: the Fed fund rate. With the economy experiencing the highest inflation in 40 years, the Fed has raised its target for short-term interest rates to the current range of 1.50 to 1.75% and will likely raise it another 75 basis points at its July meeting to a range of 2.25 to 2.50%, totaling an increase of 225 basis points (2.25%) in the first seven months of the year. Prior to this, it took the Fed three years to increase the same amount from December 2015 through December 2018. (see chart) Additionally, the last time the Fed raised short-term interest rates by 75 basis points was in November 1994 when Alen Greenspan was the Fed Chairman and the Fed fund rate was at 4.75%. For the most part, since the 1990s, the vast majority of rate hikes by the Federal Reserve have been 25 basis points. To have the prospect of two consecutive 75 basis point hikes at such a relatively low starting Fed funds rate has significantly weighed on the market.

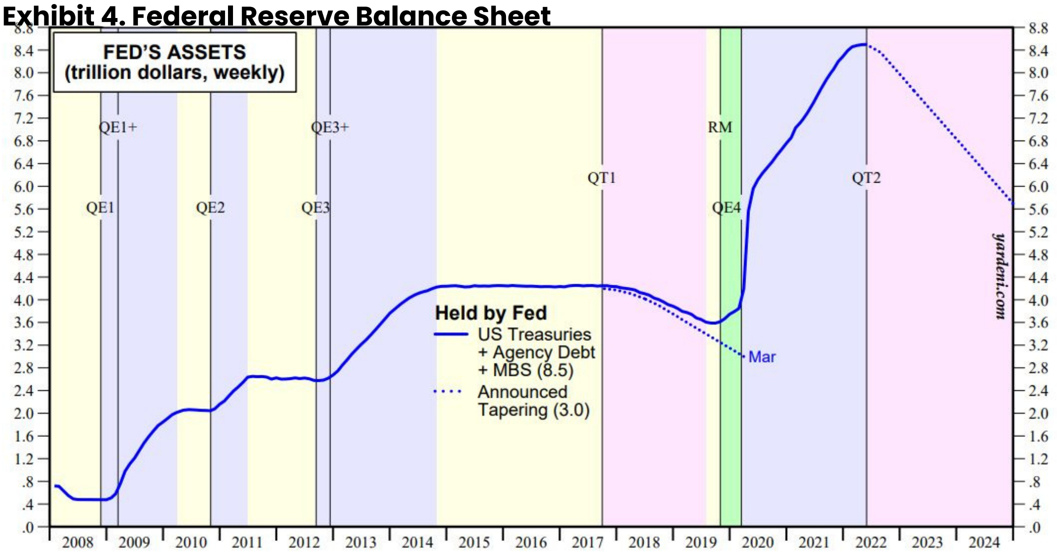
Exhibit 3. U.S. Federal Funds Target Rate



Short-term interest rates are estimated to finish the year around 3.0% to 3.5%. While at that level they will be the highest since 2007, historically it is a reasonable level when compared to the era before central banks implemented their QE monetary policies and zero interest rates. But there is one more relatively new tool in the central banks' tool box that has been widely used, and perhaps excessively, since the Great Recession of 2008, and that is its balance sheet. The Federal Reserve, and other central banks throughout the world, issued capital to themselves and bought local securities (US Treasuries and mortgage-backed securities in the United States) to inject capital into the economy to spur economic activity. The Federal Reserve has implemented its reduction plan starting in June to lower its balance sheet by allowing the securities that it owns to mature and not be reinvested into other securities, thus taking capital out of the economy.

The following chart shows the Federal Reserve's historical balance sheet with notation of different quantitative easing programs (QE – putting capital into the economy) and quantitative tightening programs (QT – taking money out of the economy) since its implementation as a policy method in 2008. This past month, the federal reserve started its second QT program, with the intention that once it is up-to-speed, it will reduce its balance sheet by $1.14 trillion over 12 months, with the intended pathway noted on the graph as a dotted line. This will keep upward pressure on interest rates.

Exhibit 4. Federal Reserve Balance Sheet



Note: QE1 (11/25/08-3/31/10) = $1.24tn in mortgage securities; expanded (3/16/09-3/31/10) = $300bn in Treasuries. QE2 (11/3/10-6/30/11) = $600bn in Treasuries. QE3 (9/13/12-10/29/14) = $40bn/month in mortgage securities (open ended); expanded (12/12/12-10/1/14) = $45bn/month in Treasuries. QT1 (10/1/17-7/31/19) = balance sheet pared by $675bn. RM (11/1/19-3/15/20) = reserve management, $60bn/month in Treasury bills. QE4 (3/16/20-infinity). QT2 = balance sheet pared by $95 billion per month. Source: Federal Reserve Board.

All of the Federal Reserve's actions are an effort to contain inflation, and as admitted by Fed Chairman Powell in his June press conference, there are a multitude of inflation drivers that cannot be influenced by rate hikes, such as continued global supply chain disruptions and Russia's invasion of Ukraine. The most effective tool for high commodity prices is high commodity prices. Major retailers are finding themselves sitting on too much inventory, particularly seasonal and discretionary items, as increased housing and energy prices are taking more of consumers' wallet share. Shortages of certain items, such as new cars and rental properties will continue to see inflation until supply catches up, but the world will start to see relief from inflation not from the rate increases, but the coming recession impacting world economies.

Copper prices, commonly viewed as the "canary in the coal mine" for the health of the economy, are down 25% since mid-March. With the first estimate for GDP growth for the second quarter to be released on July 28, there is a distinct possibility that the GDP will be a negative number. If negative, this will be the second consecutive quarter of negative GDP growth, which is the definition of an "official recession declaration". The importance of this data point is that in a recessionary environment, the Federal Reserve will slow down the cadence of rate increases, which will be viewed positive by investors.

Current positioning:
As companies start to report their 2nd quarter financial results in the coming weeks, it is generally anticipated that guidance and estimates will need to be revised downward due to multiple factors: a stronger than anticipated dollar, continued supply chain disruptions, high transportation costs, and bloated inventories. The downward pressure on stock prices has already incorporated much of these perceived adjustments for future results as analysts that follow the companies tend to be late in adjusting their forecasts. In June, all Maclura Investments' client portfolios exited their Energy holdings (with the expectation of revisiting those positions over the next 12 months at lower stock prices), as commodity prices find a floor as the recession dents demand. If Russian crude oil is actually removed from the market, there may be upward pressure on oil prices, but for now, those barrels continue to be on the world markets and going to China and India.

Current Maclura Investments portfolio allocations continue to be weighted towards a blend of large cap durable growth and value companies, prioritizing profitability, the ability to self-fund internal growth opportunities with internal free cash flow, prudent debt levels in fixed interest debt, and strong secular trends to provide a runway of growth for the company. With the market resetting valuation parameters for all companies, it will be the companies that are able to grow earnings that will perform best as the Fed takes less aggressive interest rate hikes in the future to accommodate the slowing economy.

The Fed meeting on the 27th of July and the GDP economic news the following day will likely set the tone for the remainder of the year for the stock market. There continues to be a significant amount of cash on the sidelines waiting to be invested. There have been three weeks of strong upward performance of the market this year where the market advanced over 5% each week, indicating that when the market does find its floor, it will move upward quickly once it has a catalyst. We believe that catalyst will be the declaration of a recession and will lessen the ability of the Federal Reserve to aggressively raise rates.

The one unknown facing the world markets is how the central banks' reduction of their balance sheet will influence the markets. During the last Federal Reserve balance sheet reduction (October 2017 – July 2019), only the U.S. central bank reduced its holdings. Over the next several months, it is anticipated that other central banks throughout the world will join the Fed in reducing their balance sheets. While central banks' balance sheets were expanding since 2009, the lack of inflation during that time period left central banks perplexed as it defied all academia theory. And while I'm not an economist, I believe a major portion of the lack of inflation during that time period was because the velocity of money dropped precipitously. (see chart on following page)

The velocity of money is an economic measure of how many times one dollar is spent to buy goods and services per unit of time. While there was a significant amount of capital that went into the economy, it wasn't moving. Over this time period, there was reluctance by corporate America to invest in projects, given the uncertainty facing them. This might actually be the saving factor of returning the U.S. economy back to a strong position; there isn't a lot of excess capacity for an economy that has spent the last 12 years with interest rates near zero. Unlike China that has built cities that remain empty and state companies that aren't held accountable for acceptable returns of capital, the U.S. economy is actually in good shape. Over the past several months, there has been an increase in companies announcing internal investment in projects to fuel future growth, so it is our expectation that as the Fed reduces its balance sheet that the velocity of money will start to improve and spur on economic activity in the coming years.

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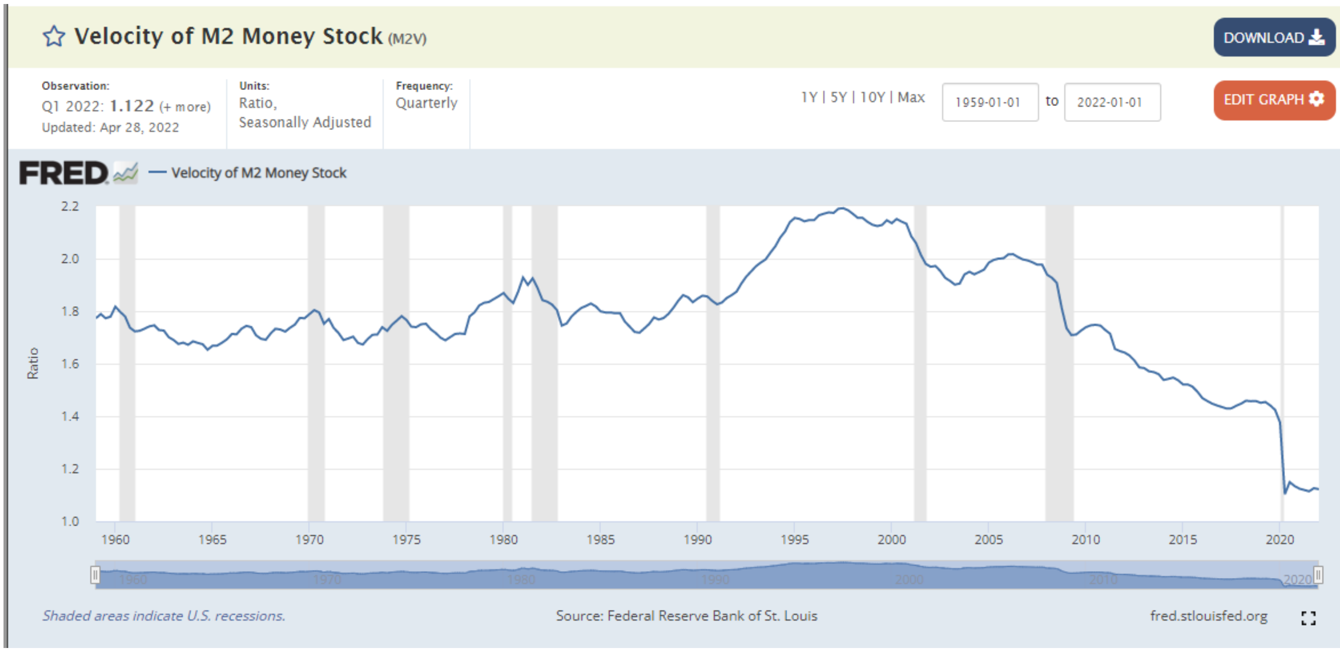
Exhibit 5. Velocity of Money



Recessions and a prudent level of borrowing costs are healthy for an economy and should be accepted as a normal course of building businesses. The resetting of valuation multiples has provided an excellent opportunity to participate in future growth in the coming economic cycle if the Federal Reserve remains disciplined in how they approach monetary policy. Greed and fear can overinfluence sound decision making, but patience and confidence in what you own drives long-term performance. If the economy enters into an official recession in July, the market likely will have found its bottom and will start to recoup some of its losses. If the GDP estimate is a positive number, there will be uncertainty surrounding future Fed actions which will result in continued volatility, and it may take longer to recoup a portion of the losses incurred so far this year. Either way, the markets are closer to a floor than not.