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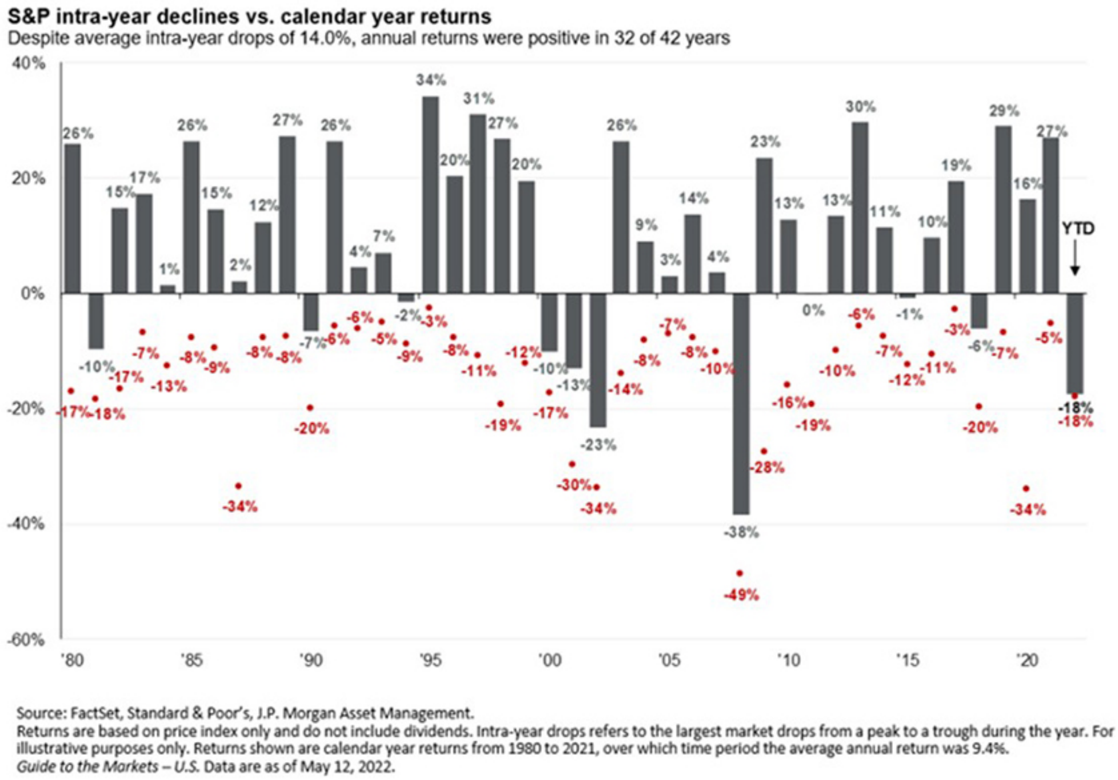
Markets Have Priced in a Lot of Bad News

Hello,

With the turmoil experienced in both stocks and bonds through May, we would like to update you on our outlook for both markets.

This year, the S&P 500 has pulled back 18%, a bit more than the 14% historic annual correction average experienced since 1980 and in line with the correction experienced in 2018 when the Federal Reserve raised the Federal Funds rate four times. Other indexes, such as the tech stock heavy NASDAQ and the small cap Russell 2000 have experienced a "bear market" (down 20% or more) as high valuation stocks have been hurt by rising interest rates and inflation. The war in Ukraine has led to additional geopolitical concerns that have adversely affected international markets as well. A strong U.S. dollar (the highest level in 20 years) has also contributed to pressure on international stock prices when held in U.S. dollars. Additionally, the bond market has provided no relief this year as bonds have declined 10% in value thus far in 2022.



In our year-end outlook, we forecasted a positive year for stocks in 2022 but cautioned that volatility would likely be higher this year and that bond performance would likely be challenged by a less accommodative Federal Reserve policy. While the stock market is down YTD, our forecast of greater volatility and poor bond performance was right on target and our below-market duration (interest rate risk) in client accounts has helped to somewhat mitigate the damage done to bond portfolios.

In our first quarter report, we highlighted three risks to our forecast that stock prices would rise in 2022:

> **RISK NUMBER 1: We said that COVID variants might continue to stall the global economic recovery**.
>
> While China (a key part of the global supply chain for goods) is still reacting to COVID cases by enforcing periodic lockdowns, most of the world is seeing dramatic declines in Omicron cases and economies are opening back up. This is certainly a positive for future global earnings despite the uncertainties caused by the Russia-Ukraine war.
>
> **RISK NUMBER 2: We said that high inflation might be more persistent than we expect**.
>
> Headline inflation data is currently running at over 8%, well above the Federal Reserve's 2% long-term target and at a 40-yr. high as reopening

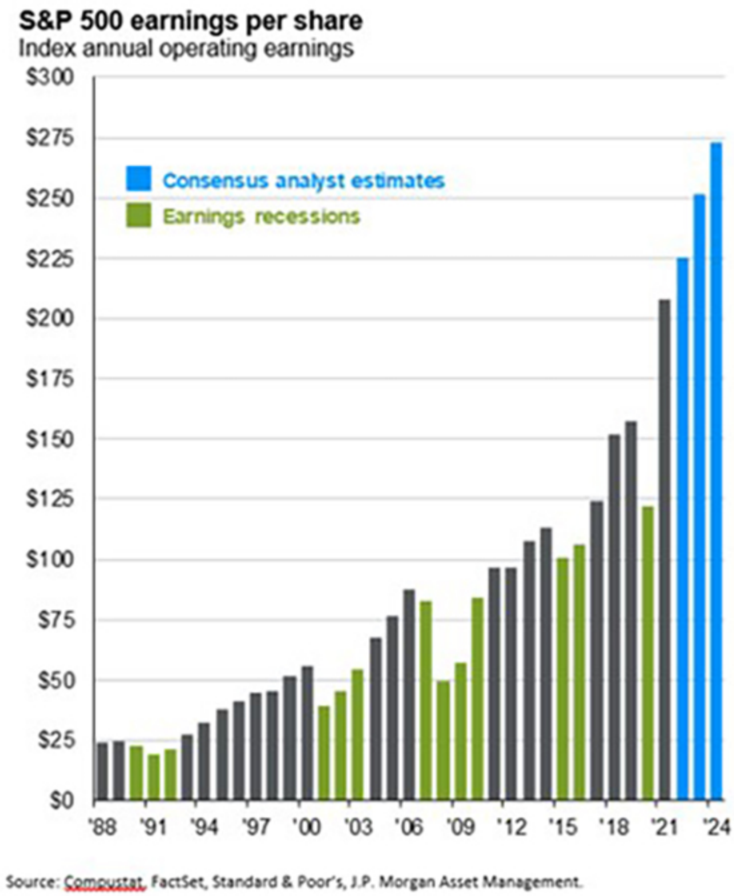
economies around the world are seeing sharp pent-up demand for goods and services that, in many cases, remain in short supply (for a broader discussion about inflation, please view the video link below or click here).

While elevated inflation can be found in many goods and services, there is some evidence that overall inflation may be peaking. The Consumer Price Index increased 0.3% in April on a seasonally adjusted basis after rising 1.2% in March. Over the last 12 months, the index increased 8.3% compared to last month's 8.5% annualized increase. Though the number remains quite high, we believe overall inflation will peak this year and that markets will react positively to that news.

Energy prices remain very high with oil, gasoline, natural gas, and coal prices still reacting to geopolitical tensions (as are wheat prices), but over the past month, many commodity prices have fallen by more than 10% such as silver, copper, iron ore, rubber, lead, aluminum, tin, zinc, nickel, oats, and hog prices. As the markets are discounting mechanisms, we may be seeing the first signs of an easing of inflationary pressures.

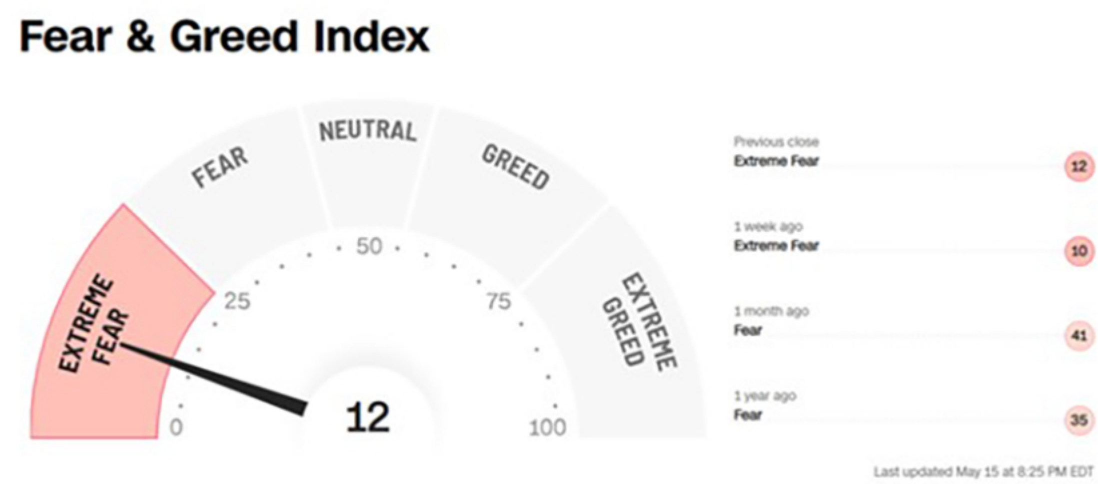
AND RISK NUMBER 3: We said that earnings growth could be more than offset by valuation contraction if interest rates rise more than expected.

S&P 500 earnings projections for 2022 are for a 9% increase. Despite this positive forecast, valuations have indeed corrected sharply as the Price/Earnings (PE) ratio of the index has dropped to 16.6X earnings from the high of nearly 23X earnings experienced at the end of 2021. The interest rate on the 10-yr. Treasury bond has doubled this year to 3.00% while the rate on the 2-yr. Treasury bond, a good indicator of projected Federal Reserve policy, has risen by almost 1.9% this year to 2.6%. These increases have certainly put pressure on stock prices as rising interest rates tend to dampen enthusiasm for stocks as investors worry about the impact of higher rates on consumers and the overall economy. While the Federal Reserve has indicated that they plan to raise the Fed Funds rate several more times this year, the bond market has already factored in many of those projected increases.



Despite the current contraction in the PE ratio that has led to double-digit declines in the stock market this year, the good news is that valuations are no longer expensive. ***In fact, excluding the valuations of the top ten market value stocks found in the S&P 500 (e.g., Apple, Microsoft, etc.), the index is trading at less than 15X earnings, a discount to the historic average of 16X.*** Analysts' earnings estimates remain solid as results continue to exceed projections. Bolstering these projections, we feel the odds of recession in the next year are low with historically low unemployment and the number of severe COVID cases falling.

In sum, while our forecast for a modest increase in stock prices this year is in jeopardy, we believe that still strong corporate earnings, low unemployment supporting a healthy consumer, and likely peaking inflation this year create a positive risk/reward in the U.S. stock market after the sharp declines experienced thus far in 2022. Also, investor sentiment, a contrarian indicator at extremes, shows heightened level of fear. Historically, at high levels of fear, markets have discounted much of the bad news present in media reports.



Source: CNN Business

Additionally, while we still want to have exposure to the less expensive valuations found in international markets, we have recently reduced our foreign stock exposure due to a robust U.S. dollar and concerns over economic growth in Europe and China.

We continue to believe that bond prices will remain under pressure this year as the Federal Reserve moves to raise short-term interest rates at their upcoming meetings to bring inflation under control. Also, as the Fed looks to begin shrinking their balance sheet by no longer buying Treasury bonds and mortgage bonds, longer-term interest rates may remain elevated.

Sincerely,

Dave

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