July 15, 2022
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Todd Asset Management

# The Pound of Cure

*Todd Asset Management US Market Review and Quarterly Chart Pack*

| | Q2 2022 | YTD | 1 Year | 3 Year* | 5 Year* | 7 Year* | 10 Year* |
|---|---|---|---|---|---|---|---|
| S&P 500 | -16.1% | -20.0% | -10.6% | 10.6% | 11.3% | 11.1% | 13.0% |
| Russell 1000 Value® | -12.2% | -12.9% | -6.8% | 6.9% | 7.2% | 7.7% | 10.5% |

* *Annualized Total Returns through 6-30-22.*

The Fed is proving the adage "An Ounce of Prevention is worth a Pound of Cure." Their mistake (i.e.- policy error) in this case was being too complacent in their inflationary outlook despite incredible fiscal expansion over the past couple of years and allowing it to get out of hand. Supply shortages have complicated the picture and have market participants worried that higher inflation is getting baked into consumer expectations and may become structural. This has forced the Fed to drastically raise rates. The Fed has had to become aggressively hawkish to try and convince markets they mean business in the inflation fight, and higher rates await us over the near term. The market's reaction to higher rates has been to anticipate an economic slowdown (probably recession) and resulted in a bear market. Markets anticipate a Fed Pivot to lower rates next year as this plays out. The S&P price decline of 20.6% is worst first half return since 1962 and appears to be discounting a lot of bad news. It is one of the worst five starts on record for the S&P, and all the prior first half bear markets were followed by a second half rally.

**S&P Worst Performances In 1H**

| | | 1H | 2H |
|---|---|---|---|
| 1. | **1932** | -45% | +53% |
| 2. | **1962** | -27% | +20% |
| 3. | **1940** | -21% | +7% |
| | **2022** | -21% | ? |
| 4. | **1970** | -20% | +25% |
| 5. | **1939** | -18% | +16% |

Source: Evercore ISI

Points to note from the quarter:

- The economy is slowing despite employment remaining strong. Consumer sentiment has deteriorated on inflation concerns. The Atlanta Fed's GDP Now indicator is pointing to a second straight quarter of GDP contraction. First quarter GDP was negative on the back of lower exports, lower inventory build, lower government spending (expiration of child credit) and higher imports. These appear poised to repeat.

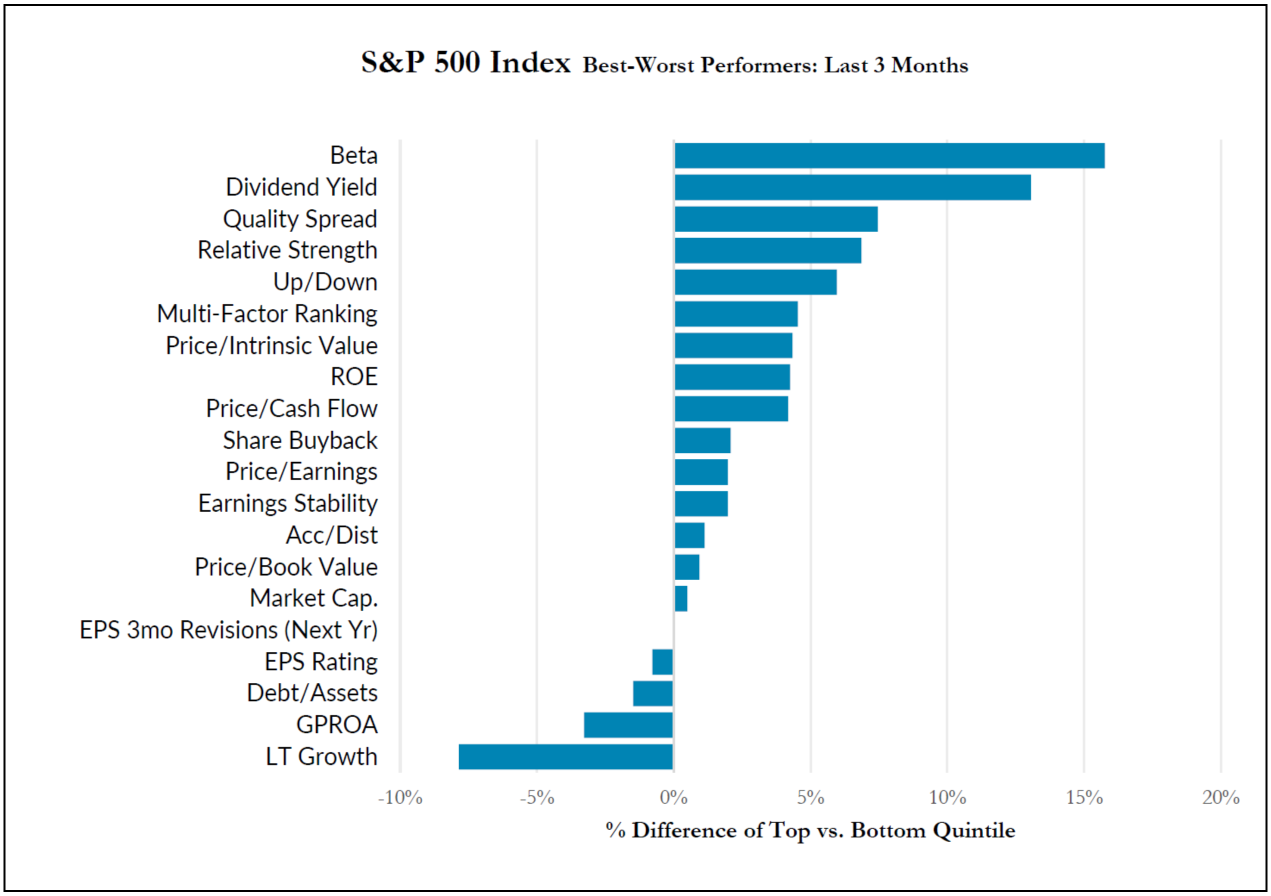
- Inflation remains high as the June CPI came in at 9.1% year over year led by shelter, food, and energy. Supply chain disruptions, caused by the war and Covid lockdowns, contributed to this.

- Some supply chain inflation should ease, possibly giving the Fed an off ramp later this year. Inventories have built and consumer prices could ease as retailers clear their shelves. The S&P GSCI commodity index (while volatile) is off 12% since early June.

- Market factor and sector action is decidedly defensive. Leadership has rotated between Defensive and Value oriented stocks this year, while higher multiple growth names have remained under pressure. We have not seen a traditional capitulation bottom yet though, so some further weakness is likely.

While we may not have seen the worst levels for the market yet, our sense is that much of the damage has been realized. Sentiment is negative enough that a significant recovery rally is likely in the second half, as the table on page 1 suggests. We need to see some of the classic bottoming indicators and signs of capitulation, like elevated Volatility Index Levels, and increased put/call activity. With this being a midterm election year, this bottom may not occur until later in the summer. Mid-term election years tend to bottom in August or September so we might have to work through what could prove to be a long hot summer. In the meanwhile, we are focused on our longer-term themes in our portfolios, and they are continuing to play out. We also see the rotation to value stocks remains in place and would urge investors to position to benefit from that. We believe that should aid our strategies as it continues.

## Factors during Q2

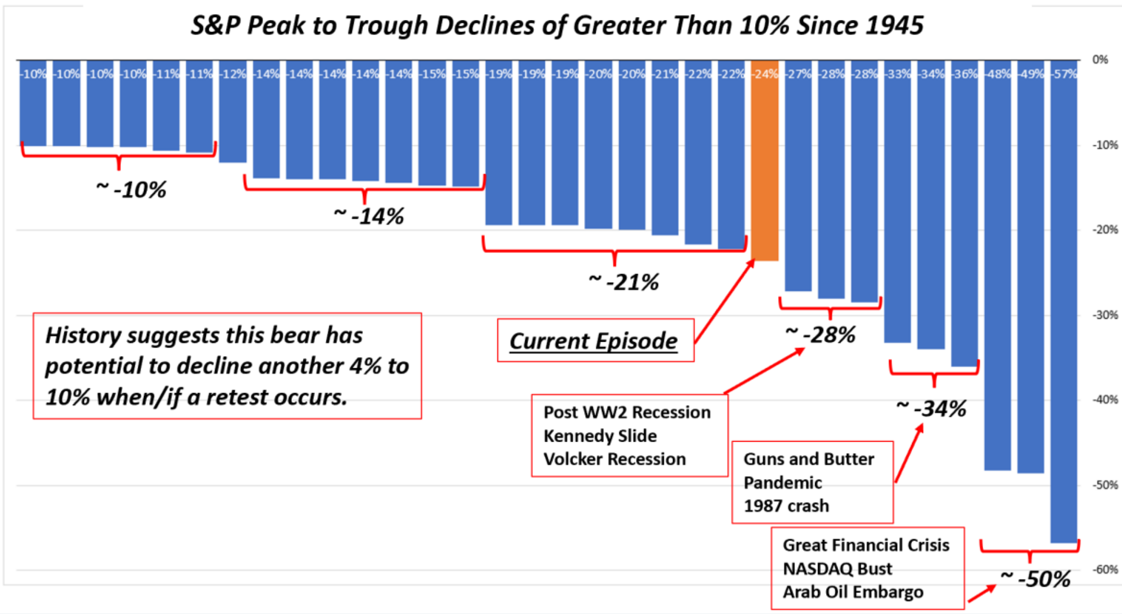



Source: Bloomberg, William O'Neill + Co. and Todd Asset Management

Our customary factor attribution for Q2 2022 is presented above. This chart measures the performance of the best 100 stocks versus the least attractive 100 stocks within the S&P 500 stock index, ranked by factor over the past quarter. The market decline prompted a flight to low beta, yield, quality, and performance visibility during the quarter. Dividend yield was especially good to see near the top of the list, as it had suffered during the large cap growth boom we saw in recent years. Seeing low beta (volatility) as the best contributor made us realize how dramatically beta has shifted in the market. About a year ago the lowest beta names in the index tended to be the Large Capitalization Growth stocks. They have gotten decimated with higher rates this year. Growth factors were at the bottom of the rankings this quarter, and it appears that a value cycle is underway.

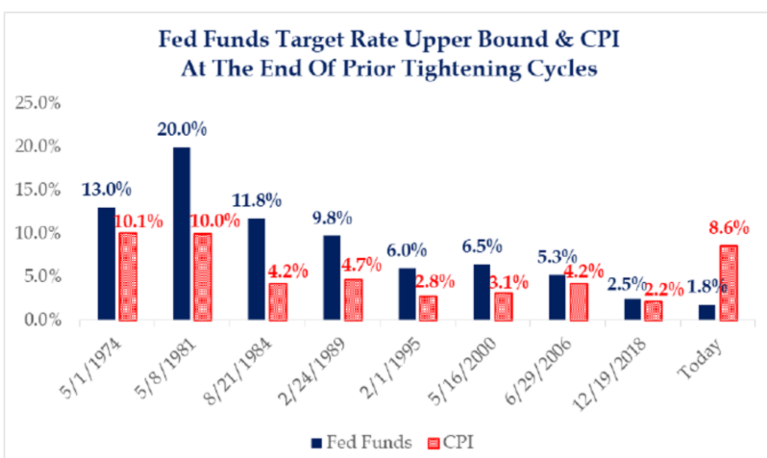
*Charts We Are Showing Our Clients:*

## Sizing up Bears- Current Episode Already Ranks Among Worst




Source: Todd Asset Management and Bloomberg as of 7-7-22

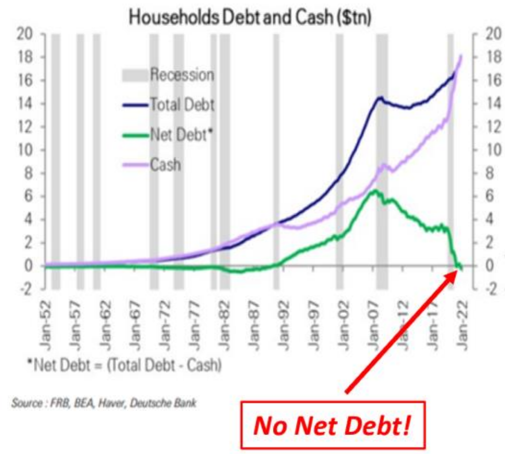
## The Problem: Past Tightening Cycles Ended With Fed Funds Above CPI




Market indicators suggest the Fed may finish their rate hiking cycle in 2023 at 3.5%.
Prior cycles have not ended until short term rates are above CPI.

Source: Strategas

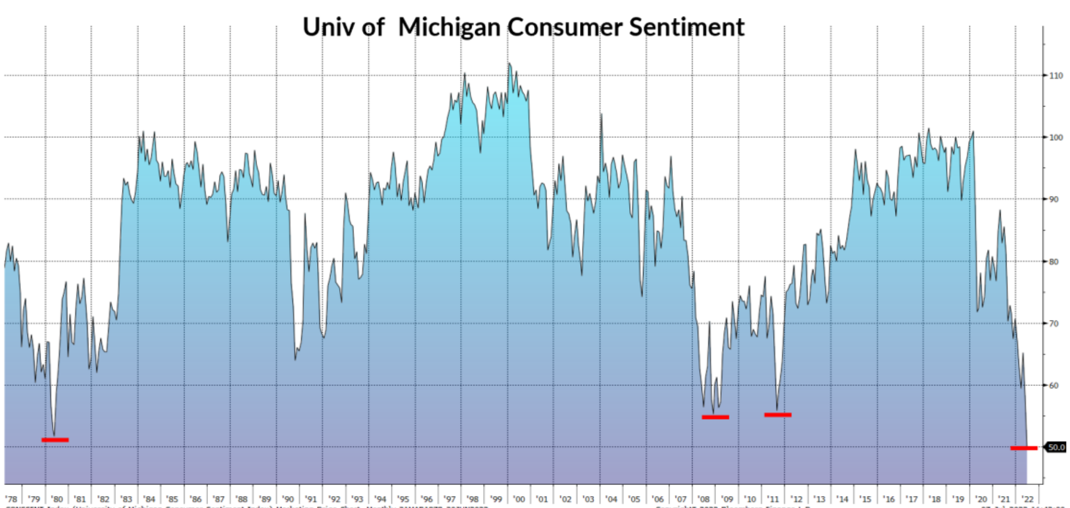
## The Problem: Consumers Stressed Despite Having No Debt


These two charts contradict each other. Consumer stress indexes are higher due to higher rates and inflation, but they have no net debt according to the chart on the right. If inflation eases, could stress decline?

Source: Strategas and Deutsche Bank

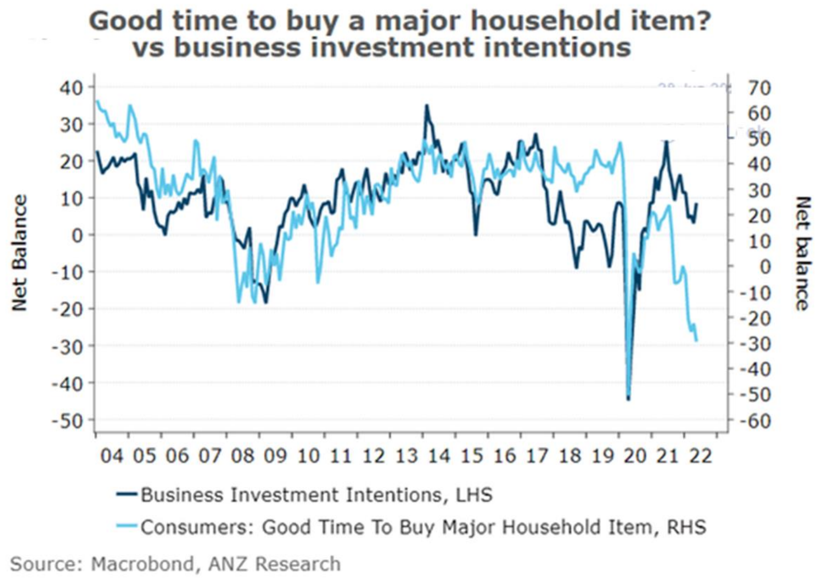
## Opportunity or Problem? Sentiment at Historic Lows




Sentiment is below lows reached in 1980, 2008 and 2011. **The year following those lows, the S&P gained 25.2%, 17.9% and 25.3% respectively**. Stay tuned.

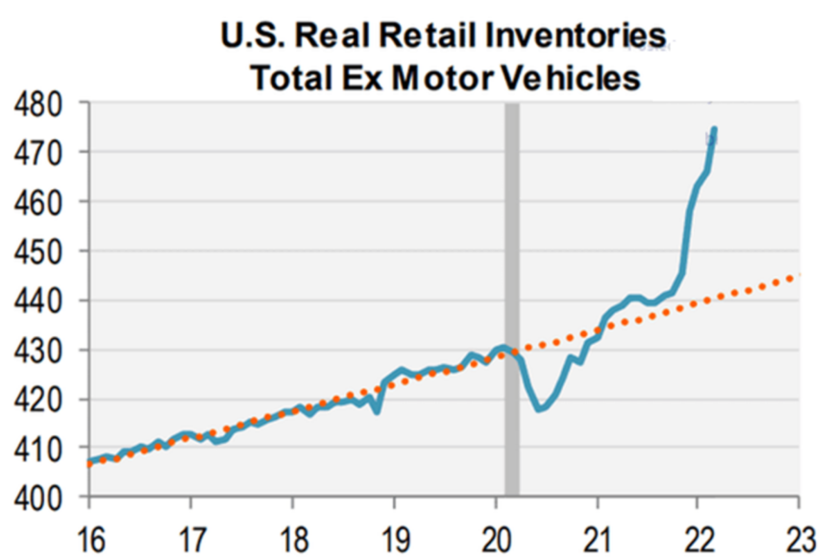
Source: Bloomberg as of 6/31/2022

## Business Spending Is Holding Up vs. Consumer




Source: Daily Shot

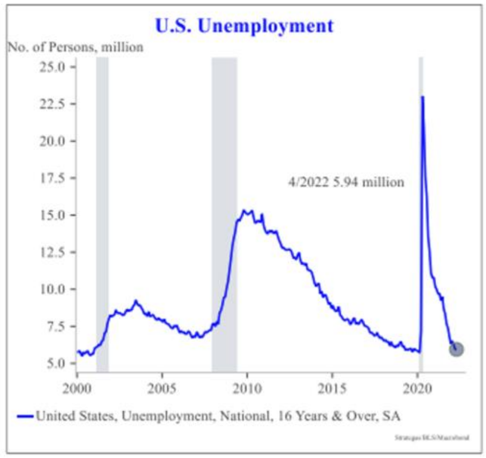
## Inflation Easing? Inventory Overhang Should Prompt Lower Prices




Major retailers like Target and Walmart warned of too much inventory and announced promotions to eliminate the overhang.

Source: Piper Sandler as of 5-30-22

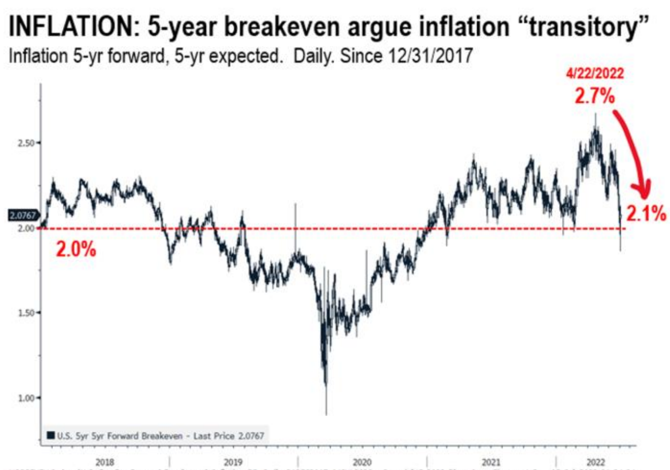
## Labor Market is Still Very Strong


We have never heard of a recession starting when employment is strong.

Source: Strategas as of 6/2/2022

## Opportunity: Inflation Expectations Begin to Decline




Source: Fundstrat, Bloomberg

Markets are pricing expected inflation 5 years from now for the following 5 years at 2.1%. Markets expect the Fed to be successful in containing inflation. Could this slow the pace of tightening?

Source: Fundstrat

## Theme: Rates Remains in an Uptrend

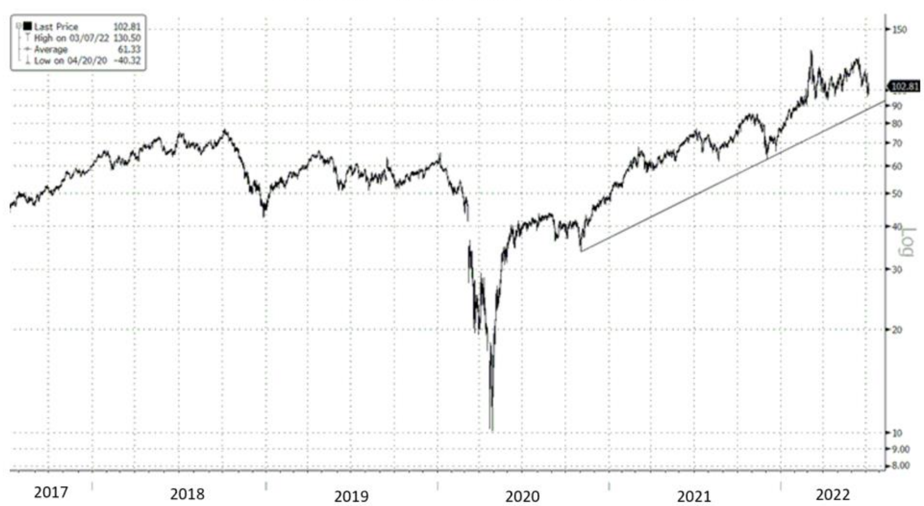
US Government 10-year Yield


Despite being off the recent highs, rates remain in an uptrend. We favor financials in a higher rate environment.

Source: Bloomberg and TAM 7-6-22

## Theme: Oil Remains in an Uptrend

Crude Oil- West Texas Intermediate

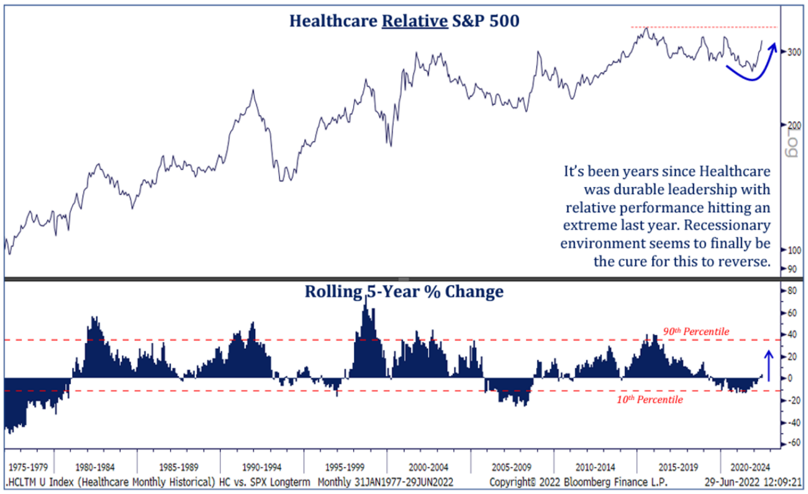



Despite being off the recent highs, oil remains supply constrained, and the price is in an uptrend. We still like the sector on this pullback.

Source: Bloomberg and TAM 7-6-22

## Theme: Healthcare is Acting Better After Tough times

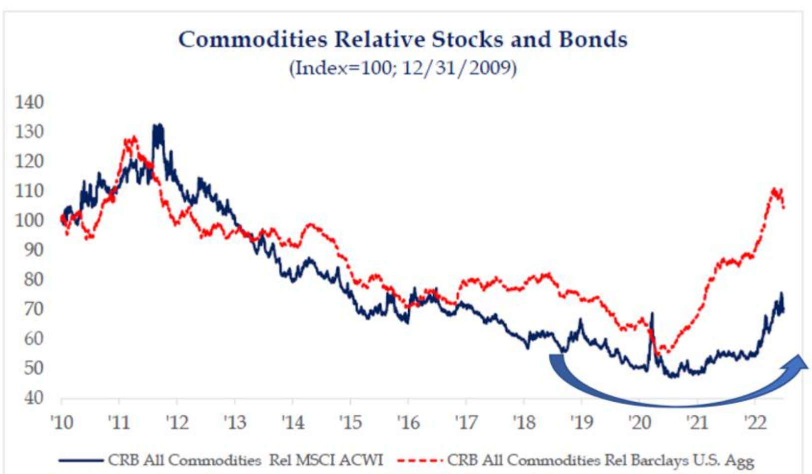
HEALTHCARE RELATIVE PROFILE ACCELERATING…




Concerns over price regulation have kept Healthcare under pressure since 2015. We are more interested recently as new product innovation and predictability have stirred up interest in the group.

Source: Strategas 6-30-22

## Theme: Commodities Cycle Appears to Have Begun




We favor commodities. They have begun to structurally outperform as years of underinvestment are meeting with reopening demand and supply curtailments.

Source: Strategas

***Summary***

Bear markets are difficult in ordinary times, like when economies need to work off an excess that is clearly visible. This bear market is more difficult than most as investors are anticipating a stagflation environment where a recession is accompanied by significantly tighter policies. Inflation is running hot, which has most Developed Market central banks on edge and seeking to normalize rates. We believe inflation may be peaking and could decline in the second half, which would lessen the urgency of those rate moves and could lead to some better sentiment for the markets. For now, investors seem to be waiting to see if a recession develops or inflation remains high. Bond markets have already done a lot of the heavy lifting for the central banks though and if off-ramps develop for the war-related inflation, Central Bank anxiety, or zero-Covid shutdowns, markets could be in for a better second half. Until then, the pressure remains on stocks to prove they can work through the current issues. We believe investors should make sure they are positioned in the new market leadership, which is the value stocks. Macro trends favor rates remaining higher post Covid, which has pressured the more expensive growth stocks and caused a cycle change. When markets eventually recover, we believe the Value style should be the leadership for the next several years.


As always, if you need any additional information, please feel free to contact us.

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07/15/22
S&P 500 – 3790, Russell 1000 Value – 1407 (*priced at market close 7-14-22)*
***Refer to the following page for more information on the commentary presented. This is pertinent to this letter and should not be reproduced or duplicated without this disclosure.***

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**Russell 1000 Value Index** is a widely recognized index of market activity based on the aggregate performance of common stocks from the Russell 1000 Index, with lower price-to-book ratios and lower forecasted growth values. The performance data was supplied by Frank Russell Trust Company.

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