Marketline August 2022

Stocks:

Last month we wrote: "Don't be too disappointed if July's good results melt away." Sure enough, that is exactly what happened. September is shaping up to be challenging as well. But one thing at a time. During August, all three U.S. equity indices fell by 4% to 5%, not quite obliterating July's gains, but coming close. The primary reason for the switchback was a resurgence of worries over inflation. July was a story of investors convincing themselves that inflation would abate shortly, and August was a story that it wouldn't. As we also mentioned last month, stock market bottoms are a process, not a moment. We are in that process.

Overseas, the energy crisis has taken hold with vigor. Some of you have probably noticed that the U.S. dollar is very strong – nearly at par with the Euro, and just a hair below par versus the British pound. That is not helpful to overseas economies. Still, European stocks managed better returns in August than the U.S. posted – the FT-SE fell by 1.9%. Europe's decent numbers are thanks to a heavy representation of mining and energy commodities in the index. Canada's Toronto exchange was off just 1.8%. We could expect stout performance from Canada, which is an energy exporter. In Mexico, which we discussed at length last month, returns were poor at -6.7%.

Stock movements in the near future will continue to be volatile. You will see below that the yield curve has decidedly inverted – a sign of impending recession. But this is the time to remember that stocks are always ahead of the economy, sensing trouble before it is apparent, and likewise, sensing recovery ahead of reality. Stocks will rise when you think they have absolutely no reason to.

Now that we have raised above-normal levels of cash in most portfolios, our strategy is to …. wait. You will see us buying in tiny amounts after negative returns, and perhaps paring stocks after upturns like July. (For example, we sold holdings of Mueller Water from all portfolios that held it. This stock hasn't gained traction despite factors in its favor over the years we've held it, and for now, we prefer to hold cash.) But we are not ready to significantly draw down cash holdings unless we are re-allocating to bonds. A prime example of why we want to wait resides on our "Watch" list – four housing stocks. These stocks have declined and are historically cheap. They even pay small dividends. However, we are not ready to migrate this economically sensitive sector to our "Buy" list because the last shoe has not yet fallen: while contract cancellations are rising, the companies have thus far been able to find other buyers for those homes. At some point, they won't. Then earnings will decline. We are hoping that once we see an actual earnings shortfall, these stock prices will fall even more. So, we wait.

Bonds:

Interest rates especially in shorter maturities rose markedly last month as the "lower inflation" narrative subsided. From one year all the way out to ten years, the increase in yields was around 60 basis points or 0.60 percentage points. For instance, the one year rose from 2.89% to 3.49%. The long Treasury rose less, about 0.3 percentage points to 3.29%. The curve has quit being flat, so you don't have to read that litany from me any longer! However, we have a new shape to complain about, and that is "inversion", meaning short-term rates are now higher than long-term rates. Every single time the interest rate curve inverts, a recession follows. Pundits will try to shove this phenomenon under the rug with arguments that "the employment market is strong", "consumers are in good shape", or other such. But the reality is that government measurements of these statistics are notoriously lagged and subject to revision. Most job numbers reported over the last year have been revised downward. We will see a recession, but likely only when we look back upon it, and after many revisions to data that has been reported in the last few months.

In terms of buying bonds now, that job remains tricky. Yields are in a price-finding process, just like stocks. Most purchases last month are underwater this month. Sales look smart. But those observations are of limited use in a practical sense because we need to stay invested. We need to meet client budgets or provide a risk mitigator to portfolios that are heavily allocated to stocks. We don't have the option to pull the plug on bond portfolios to "wait it out" – or more specifically, that option brings costs that we don't want clients to bear. So we remain opportunistic about investing in this asset class. We are currently shifting preferences from par-ish paper (selling around 100) to premium bonds. If we accept premium dollar prices (over 100), we can buy interest rates of 4.5% and 5% on municipal bonds, for instance, translating to mostly tax-free yields of over 4%. That's generous even by today's standards.