Wellington Shields

BOTTOMING PROCESS

The S&P 500 declined 21% in the first half of 2022, the worst showing since 1970. More persistent inflation than the Federal Reserve had forecast is forcing it to tighten monetary policy into a slowing economy. Russia's invasion of Ukraine has been an additive to inflationary pressures, especially in energy and agricultural commodities. COVID lockdowns and fiscal responses in the past two years distorted supply chains and consumption patterns throughout the global economy. The repercussions are profound. Workers left the energy and many services sectors. Durable goods consumption was pulled forward at a time factories remained supply constrained. These distortions lead to a lagged inventory build now present at precisely the wrong time as consumers are tightening belts in response to food, rent and energy inflation. With the Fed fighting to catch up to inflation, these stresses make it likely the US will experience a recession in the coming months, and indeed may already be in one. The actual timing and severity will only be known with hindsight.

Inflation is pressuring corporate margins and forcing consumers to curtail discretionary spending, reducing aggregate demand. This, in turn, will flow through to negatively impact corporate earnings. So far analysts' estimates of forward earnings have remained resilient, and the market's decline to date has been largely a compression of the multiple investors are willing to pay for those earnings. The final market lows will likely be accompanied by a reduction in earnings estimates.

Regardless of whether a recession occurs or not, the stock market is unwinding a liquidity-driven run-up from the extraordinary monetary policies enacted during the COVID crisis. Market bottoms are emotional and take time. While the tell-tale characteristics of a final market capitulation are not evident yet, we are well into the process of forming a bottom.

Investors should not lose hope, as there are some silver linings. Strong earnings and shareholder returns—in the form of dividends and buy-backs—have propelled the market in the past two and a half years. The S&P 500 finished the first half of 2022 17% higher than the end of 2019, before COVID, however second quarter trailing twelve-month S&P earnings are estimated to be 43% above pre-COVID levels. While the pace of growth should decelerate from current expectations—and may pause—growth will resume again. A variety of secular growth areas from batteries and electric vehicles, to hydrogen and solar, to genetics and big data (to name just a few) will continue to provide ample growth opportunities for companies in many industries.

Historically, markets bottom in the midst of recession, not at the end. The market is a discounting mechanism and the decline in the market to date has discounted a lot of the dour news cited above. This year marked the sixth time in history that the S&P 500 declined over 15% in the first half. On each of those occasions the market rallied in the second half. It is too early to say the low is altogether in, but we are significantly on the way.

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