Wellington Shields

July 2022

Quarterly Market Strategy Report

Recession Proofing

Between March and June of this year, all three main market indices, the S&P 500 index, the Dow Jones Industrial Average, and the Nasdaq Composite index, recorded their worst 3-month declines since the first quarter of 2020. The S&P 500 suffered its worst first-half performance since 1970. But it is important to note that while these declines were steep, they had something else in common -- they took place during an economic recession. This is both the good news and the bad news for today's investors.

Keep in mind that the Bureau of Economic Analysis (BEA) recently confirmed that the US economy, or GDP growth, declined 1.6% in the first quarter. And since the National Bureau of Economic Analysis defines an economic recession as two consecutive quarters of negative GDP growth, it is possible that the US economy is already in a recession. In line with this possibility is the fact that, aside from employment statistics, many economic data series have been in a decline all year.

On July 28, the BEA will release its initial estimate for second quarter GDP and with this release, economists will have a much clearer sense of the strength or weakness of the economy. But even if second quarter GDP growth is positive, the fact that the Federal Reserve plans to slow the economy by raising interest rates at each of this year's upcoming FOMC meetings, means economic growth will remain at risk for most of 2022.

PLAYING DEFENSE

Therefore, we should assume that the risk of recession will be high over the next twelve months. If so, it is important for investors to be defensive and insulate their portfolios against such weakness. This means emphasizing areas of the stock market that should have the most predictable consumer demand and reliable earnings. In short, we would focus on household necessities such as staples, utilities, and energy. Aerospace and defense are expected to see demand and earnings growth in the wake of Russia's invasion of Ukraine. Ironically, these are the same areas of the stock market that we have been emphasizing in order to offset the impact of inflation. In short, these industries are both inflation and recession resistant.

Summary

We assume the risk of recession will be high over the next twelve months, and it is important for investors to be defensive. This means emphasizing areas of the stock market that should have the most predictable demand and reliable earnings. In short, focus on household necessities such as staples, utilities, and energy. Aerospace and defense should also see demand and earnings growth in the wake of Russian's invasion of Ukraine.

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We have been warning about the negative impact of inflation for over twelve months. High inflation is a destructive trend that acts like a massive tax increase on households, results in substantially higher interest rates, it pressures corporate margins, and it lowers the price-earnings multiples for stocks. Because of these factors, stock market leadership has made a massive shift from growth (including technology stocks where price-earnings multiples tend to be highest) to value (where price-earnings multiples tend to be low and dividend payouts high). We expect value stocks will continue to outperform growth stocks until inflation is under control, which may take a while.

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RECESSION RISK

There are a number of areas that suggest the economy is slowing, but the most important may be housing. The housing market represents 16% to 18% of GDP and it is showing signs of a weakness. The National Association of Realtors (NAR) publishes an affordability composite index and in April it fell to its lowest reading since the 2007 recession. The NAR housing market index has been falling all year, but in June the index measuring traffic of potential buyers fell to its lowest reading since June 2020. Unit sales of existing and new homes declined 8.6% YOY and 6% YOY, respectively. And new home sales are down 30% from its January 2021 peak. What is worrisome is that the median price of an existing home increased 15% YOY in May, but in the same period, personal income increased only 5.3% YOY. Moreover, disposable income rose 2.8% YOY and real disposable income fell 3.3% YOY. A combination of high prices, falling disposable income and soaring mortgage rates will have a negative impact on housing and the economy in coming months. The fact that on a year-over-year basis, real disposable income declined for twelve of the last thirteen months is not a good sign for the US economy which is 70% consumer-driven.

Consumer confidence levels are also giving warnings signs. Conference Board consumer confidence fell to 98.7 in June, its lowest level since February 2021 and expectations fell to its lowest point since October 2011. The University of Michigan consumer sentiment index fell to 50 in June, the lowest headline reading on record, and lower than any time during the recessions of 1980, 1982, 1990, 2001, 2008-2009, or 2020. Expectations fell to 47.5, the lowest reading since August 2011 (47.4) or May 1980 (45.3). In short, in both surveys, consumer confidence is at levels last seen during a recession.

THE GOOD NEWS

The good news is that while the stock market tends to be the best predictor of an economic recession, it usually bottoms halfway through a recession. This means that if second quarter GDP is negative, it suggests that the stock market would have been at, or close to, a bottom at its June 16th low in the S&P 500 index of 3666.77.

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In addition, a recent poll by the American Association of Individual Investors' showed only 18.2% of small investors are bullish and 59.3% are bearish. This was the fourth weekly poll with less than 20% bulls and more than 50% bears

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since end of April. The 8-week bearish reading of 50.9% on May 18 was the highest bearish percentage since the March 12, 2009 peak. According to the AAII, equity prices tend to be higher in the next six and/or twelve months following such extreme readings.

In sum, while the first half of the year has been a challenging period, it is clearly not the time to be bearish. In fact, several factors suggest that the slowdown the Fed has set as its goal may be materializing faster than expected. Ironically, this would be the good news. The one concern we have is that earnings forecasts are still too high in many cases, and this could make second quarter earnings season in late July a time of weakness. Volatility is likely to continue but investors should maintain a long-term view and adjust portfolios accordingly. The third quarter could produce opportunities to buy equities at attractive prices.

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