Wellington Shields

October 2022

Quarterly Market Strategy Report

Staying Defensive

September has a long history of being a difficult time for the equity market and in 2022 this seasonal precedent held true once again. For the month, the S&P 500 fell 9.3%, notching its worst one-month decline since March 2020. The Nasdaq declined 10.5%, as soaring bond yields weighed heavily on high PE stocks and the Dow Jones Industrial Average tumbled 8.8%.

In terms of the third quarter, the S&P 500 fell 5.3%, the Nasdaq dropped 4.1%, and the Dow Jones Industrial Average lost 6.7%. Plus, for the first time since 2009 the S&P 500 and the Nasdaq suffered three consecutive quarterly losses. For the Dow Jones Industrial Average, it was the first time since 2015 that the index experienced three straight quarterly losses.

September's poor performance was not a total surprise. As we noted in our JULY 2022 QUARTERLY MARKET STRATEGY REPORT, by the end of June, the S&P 500 had suffered its worst first-half performance since 1970. But more importantly, these two declines had something in common -- they both took place during an economic recession. In general, it has been our view that economic activity was at risk for most, if not all of 2022, due primarily to the brunt of double-digit inflation and the negative impact this has on consumers' purchasing power, profit margins, PE multiples, and monetary policy. Our opinion has not changed.

EARNINGS RECESSION

Although the two quarters of negative GDP growth seen in the first half of this year have not officially been declared a recession by the National Bureau of Economic Reseach, there is little doubt that it has been a difficult time for both consumers and businesses. One example is corporate earnings. Despite the headlines in the financial press indicating that most S&P 500 companies beat earnings expectations in the second quarter of the year, the back story is that these earnings estimates were substantially reduced ahead of reports. In reality, the S&P Dow Jones consensus earnings estimate declined more than 8% from its April high. The full year estimate for year-over-year earnings growth has now collapsed to breakeven according to recent S&P data. More importantly,

Summary

We assume the risk of recession will be high over the next twelve months, and it is important for investors to remain 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 Russia's invasion of Ukraine.

The National Bureau of Economic Reseach is yet to declare the two quarters of negative GDP growth in 2022 a recession, but there is little doubt that it has been a difficult time for both consumers and businesses.

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full year earnings growth would be negative if earnings for the energy sector are excluded from the total.

In short, many companies are experiencing a deterioration in earnings in 2022, as is typical of a recession. We lowered our S&P 500 earnings forecast twice in the last eight weeks, but a further weakening of the economy could put even our reduced $209 per share estimate in jeopardy. It is this uncertainty surrounding earnings growth that has shaken investor confidence in recent weeks and taken stock prices lower.

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PIVOTAL SEPTEMBER

Plus, a number of global events helped trigger a negative shift in investor sentiment in September. Early in the month, the two-year advance in energy prices led to Finland announcing a 10-billion-euro credit package for the long-suffering Finnish power industry. The country also extended an additional 2.35-billion-euro package to its largest state-owned energy company which provides power to several countries in Europe. Some analysts estimate that the broader EU energy derivatives market may require as much as $1.2 trillion in government backing due to deteriorating debt in the sector.

Later in the month, the newly installed UK Prime Minister Liz Truss initiated a surprise tax cut intended to boost England's struggling economy. However, concern about the new government's fiscal responsibility and fear that this stimulus would inspire even more inflation led to turmoil in the financial markets. The British pound plummeted to an all-time low against the dollar, yields in 10-year British government gilts jumped above 4% for the first time in twelve years and the Bank of England hiked interest rates 50 basis points to its highest level in 14 years.

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In addition, the Bank of England was forced to buy bonds after British pension funds struggled to meet margin calls on debt instruments, some of which lost a third of their value in four days. This chaos in the global debt market is a big concern, and we worry that rising interest rates can continue to have unexpected consequences in the months ahead.

All in all, the fear of recession in Europe and the US increased at the end of September and the feedback loop between stock and bonds became blatantly apparent.

RECESSION PROOFING

In our opinion, the US is either in the midst of a recession or at risk of falling into a recession in coming months. Meanwhile, the Federal Reserve will continue to increase interest rates which will slow many sectors of the economy even more. Therefore, we continue to remain defensive and look to protect portfolios as much as possible for the likelihood of weak economic activity. This means emphasizing areas of the stock market that have predictable revenue growth and earnings

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streams. Many individual stocks can have these characteristics but in general, this suggests household necessities such as utilities, staples, and energy. The Russian invasion of Ukraine has stimulated demand for aerospace and defense, which is another recession-proof sector. In an environment of rising interest rates, we expect value stocks to continue to outperform growth stocks.

OCTOBER: THE TURNAROUND MONTH

The good news is that October has often been a time of reversing downtrends. In fact, twelve of the 48 declines of 10% or more seen since 1931 have taken place in October, which is why October has been called "the bear killer." And though many technical indicators broke down at the end of September, investor sentiment hit historic extremes.

The AAII sentiment readings recently showed a decline in bullishness to 17.7% and an increase in bearishness to 60.9%. This 17.7% bullishness reading is among the 20 lowest readings since the AAII survey began in 1987. Optimism was at a similar level in May. This is favorable since equity prices tend to be higher in the next six and/or twelve months following such extreme readings in sentiment.

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