KINGSVIEW
INVESTMENT MANAGEMENT

Nolte Notes

By Paul Nolte, CFA

July 11, 2022

If everything is coming up roses, why do investors feel so bad? The employment report on Friday was a surprise in the number of jobs that got “recreated”. Another month or so, and the job market will have regained all the jobs lost since the beginning of the pandemic shutdown. It has been a long way back, but jobs have been the bright spot in the recovery. Durable goods orders were also above expectations and the various mangers surveys from businesses indicated things are still good. HOWEVER, the Atlanta Fed’s model for economic growth is showing a negative reading for the second quarter, on top of a first quarter decline, which has been the short-hand definition of a recession. Inflation figures out this week are likely to still be on the “hot” side and well above the Fed’s 2% target. The combination of strong jobs and higher inflation should mean the Fed will hike rates by 0.75% at the end of July. The push/pull between rates rising, solid job reports and inflation running strong is making it hard for the stock market to muster up a few positive days in a row. Is there another shoe to drop this summer? Will the earnings season be a positive surprise? Can stocks withstand higher interest rates? The answers will be unfolding over the next three weeks.

The stock market has been taking one step forward and almost one step back for the past month. Since the start of the year, stocks have been stair-stepping lower: a few weeks of gains followed by a month or two of losses. Only briefly have they traded above their short-term average price, which is now roughly 100 SP500 points higher than Friday’s close. Friday’s trading was one of the slowest all year, so maybe Wall Street has adjourned and is heading for the Hampton’s for the summer. Without much in the way of volume, any move will be a bit suspect due to lack of conviction. This week kicks off the quarterly earnings season, with banks now being the “lead” companies reporting. The next three weeks will be loaded with nearly every SP500 company reporting. What is said on the earning calls, from margin impact of higher prices, wage growth, revenue and “supply chain” impacts will be weighed carefully by investors. It is expected that earnings will be roughly equal to last quarter. How Wall Street reacts to earnings may be instructive to the overall direction of the economy into the third quarter and whether the Fed sticks to their rate increasing ways.

After one week in “buy” territory, the bond market turned tail and rates rose on the week. The strong employment report will like give “cover” for the Fed to hike rates 0.75% at the end of the month. Yields on the 2-year treasury are now above those on a 10-year, implying that a recession is either at hand or coming soon. That said, the yields on junk bonds declined in relationship to the 10-year, indicating investors are willing to take on more risk. Yes, the bond market is nearly as confusing as the stock market these days! If the bond market replays prior recessionary periods, the high yield spread should widen further and interest rates on the treasury bonds should fall as investors seek the safety of the very liquid government bonds.

Is there hope in the stock market? Maybe, if investors look once again at the growth sectors, which have been performing very well over the past few weeks. This comes on the heels of a 30+% decline during the first half of the year. That said, many of the stocks within the technology sector remain well down from their highs. The recent rally has not really been much more than a blip on the long-term chart. It is not a surprise to see the worst sector this year experience a decent rally off the lows. Whether the rally can be built upon is an open question and earnings season could be enlightening for many of these companies. Answering questions about their business model in a “non-covid” world and whether they can generate enough money to be self-sustaining will go a long way in determining whether the recent bounce can last or is temporary. If the economy is indeed heading toward a recession, the large cap stocks that can generate profits, no matter the economic environment, should continue to do well through the rest of the year.

The strong employment report is likely to cement in the 0.75% rate increase by the Fed at the end of July. The CPI report due later this week should show some easing, but the year over year figure will still be well above the Fe Fed’s target. Expect more rate increases from the Fed until it becomes clear the economy is struggling, then we could see the Fed begin to ease off the brakes.

The opinions expressed in the Investment Newsletter are those of the author and are based upon information that is believed to be accurate and reliable but are opinions and do not constitute a guarantee of present or future financial market conditions.