Smith Group
ASSET MANAGEMENT
A BUSINESS OF CANTOR FITZGERALD INVESTMENT ADVISORS

MARKET PERSPECTIVES

JUNE 30, 2022

Market Summary

U.S. Equity Markets (%)	2Q'22	1 Year	3 Years	5 Years	10 Years
S&P 500	-16.1	-10.6	10.6	11.3	13.0
Russell 1000 Growth	-20.9	-18.8	12.6	14.3	14.8
Russell 1000 Value	-12.2	-6.8	6.9	7.2	10.5
Russell 2000	-17.2	-25.2	4.2	5.2	9.4
Russell 2000 Growth	-19.3	-33.4	1.4	4.8	9.3
Russell 2000 Value	-15.3	-16.3	6.2	4.9	9.1

Top/Bottom Sectors (%)	2Q'22	1 Year
Cons. Staples	-4.6	6.7
Energy	-5.1	40.1
Utilities	-5.1	14.2
Cons. Discretionary	-26.2	-24.3
Info. Technology	-20.2	-13.6
Comm. Services	-20.2	-28.5

Price Comparison (in USD)	Jun. 30, 2022	Jun. 30, 2021
Oil (WTI spot)	$105.76	$73.47
Natural Gas	$5.39	$3.65
Gold	$1,807	$1,772
Fed Funds Rate (effective)	1.58%	0.08%
10-Yr Treasury	3.01%	1.47%
VIX	28.71	15.83

Non-US Equity Markets (in USD)	2Q'22	1 Year	3 Years	5 Years	10 Years
MSCI AC World Ex U.S.	-13.7	-19.4	1.4	2.5	4.8
MSCI EAFE (Developed)	-14.5	-17.8	1.1	2.2	5.4
MSCI Emerging Markets	-11.5	-25.3	0.6	2.2	3.1

Non-US Regions (in USD)	2Q'22	1 Year
Developed Americas	-15.6	-7.0
Developed Asia	-14.4	-17.8
Developed Europe	-14.0	-16.9

Non-US Regions (in USD)	2Q'22	1 Year
Emerging Americas	-21.8	-15.7
Emerging Asia	-8.9	-25.3
Emerging EMEA	-16.9	-26.7

Source: MSCI, S&P Global, FTSE Russell; Refinitiv, St. Louis Federal Reserve Bank; Periods greater than one-year have been annualized

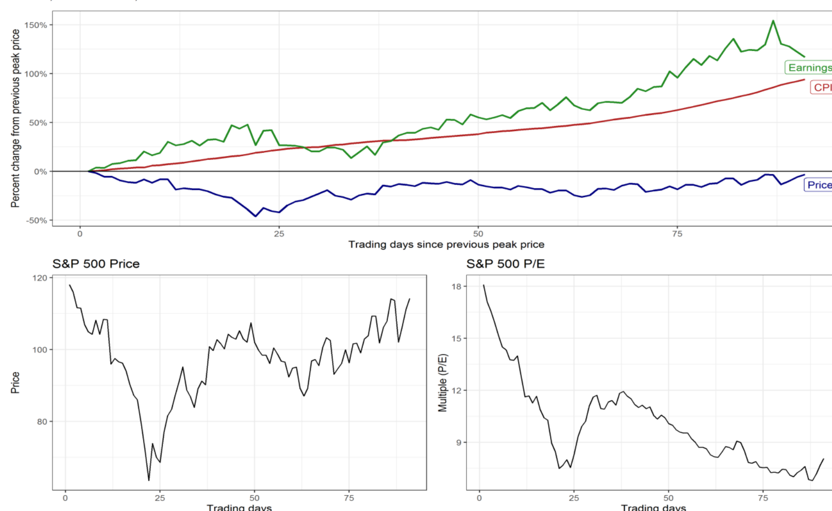
Market Review:

The market sell-off continued through the second quarter with the S&P 500 Index falling almost 25% from its early January peak before recovering to finish the quarter down 16.1% and 21.4% below its peak. Small caps continue to underperform large caps as the Russell 2000 fell 17.2% and is now trading 30.5% below its peak of early November 2021. Non-US equity markets performed largely in-line with the U.S. as the MSCI All-Country World ex-U.S. Index fell 13.7% for the quarter. Commodity prices, as measured by the Bloomberg Commodity Index, extended their rally for the first two months of the quarter before peaking in early June and selling off almost 15% into quarter end. Crude Oil, as measured by West Texas Intermediate Spot Prices, fell 5.6% for the quarter and finished 19% below their peak of early March 2022.

Are we headed for a 1970's redux?

Current year-over-year inflation readings in the U.S., as measured by the Consumer Price Index, are running north of 8% which are levels not felt since the early 1980's. In our March 2022 letter we discussed that while many of the current inflationary pressures could prove transitory, namely commodity cost pressures and some supply chain constraints, many pressures such as a tight labor force and housing costs are likely to keep prices stubbornly high for an extended period. Even if wage and supply chain constraints begin to ease and inflation slows **to half** of its current rate [the typical behavior of the prior inflationary peaks of the post WWII era], inflation would still average north of 6% over the next 12-months, a rate not seen since 1982.

Exhibit 1 *(Source: S&P Global, Refinitiv, St. Louis Federal Reserve Bank)*



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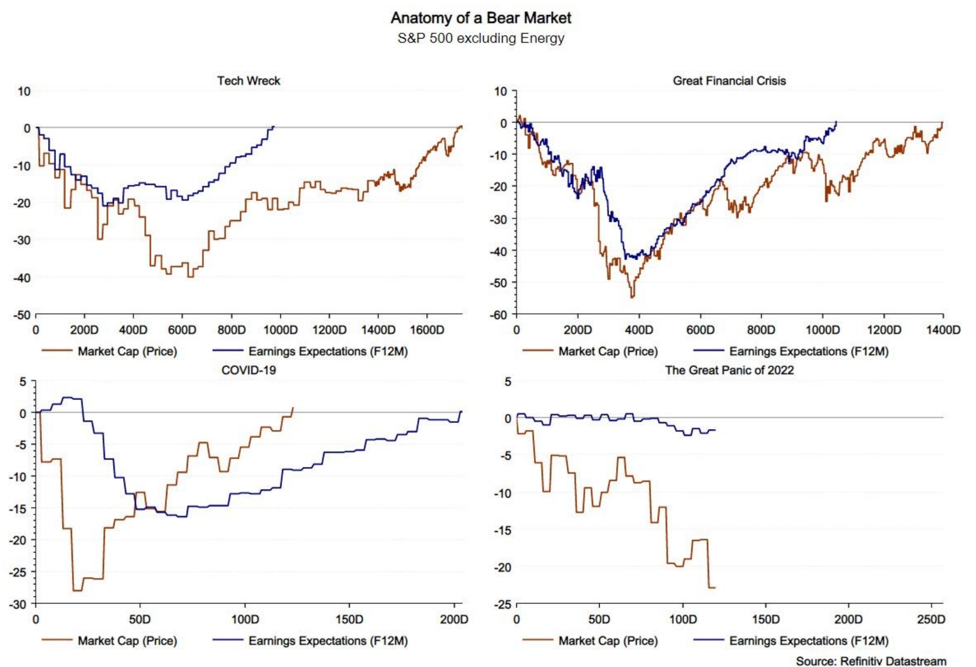
Given that inflation is going to be a challenge, it is worth looking at how earnings and market multiples responded to the last period of extended high inflation readings. Fortunately for consumers, there is still only one good reference period for extended high inflation post-WWII era and that is the 1970's. Exhibit 1 shows the market downturn that began in late 1972 and did not reach full recovery until mid-1980, a stretch of over 7.5 years. Of note from the 1970's market downturn is that earnings held up reasonably well and the downturn was largely attributable to price-earnings multiple contraction as interest rates and inflation spiked. Over this time the CPI rose 94% and 10-year Treasury yields rose from 6.5% to 10.5% before eventually peaking at almost 16% in the second half of 1981. As interest rates and inflation rose, price-earnings multiples contracted from 18x in late 1972 to as low as 7x in late 1979. Of course the question for today is are we are headed for a repeat of the multiple contraction that occurred in the 1970's? We find that scenario to be unlikely. Despite the Federal Reserve being behind the curve in fighting inflation, they are catching up far more quickly than the Fed's nearly interminable delay in the 1970's. Therefore, more near-term pain may be in store for the markets but a period of seven plus years of multiple contraction seems highly unlikely.

Are earnings estimates the catalyst for more pain in the equity markets?

Equity markets are 21% off their highs of early 2022, U.S. real GDP contracted at annual rate of 1.5% in the first quarter and the Atlanta Federal Reserve GDPNow estimate is for only 0.3% growth in the second quarter. Despite the market sell-off and slowing economy, **estimates for corporate earnings have barely budged.** Exhibit 2 displays the S&P 500 Index returns and earnings estimates, excluding the energy sector, during the last four bear markets (including the current period labeled as "The Great Panic of 2022"). Of note is that earnings estimates for the S&P 500 have historically fallen by at least half as much as the market decline during previous bear markets. However, current estimates for 2022 S&P 500 earnings, ex-energy, have only recently shown a slight dip down. Over the past 12 months earnings expectations for the S&P 500 have risen by about 10%, and energy accounts for all of the rise. For 2022 energy is expected to contribute almost 20% of total earnings in the S&P 500 yet accounts for less than 5% of the market capitalization of the index.

Exhibit 2 *(Source: S&P Global, Refinitiv)*



The upcoming earnings reporting season will be crucial in anchoring the outlook for earnings over the next 12-months. This past quarter saw retailers such as Amazon, Wal-Mart and Target announce significant earnings headwinds, but across the full index aggregate reported earnings and revenues were 7.0% and 2.6% above expectations, respectively. Should that level of upside surprise be repeated in the upcoming reporting season, the market would have a significant buffer against further declines attributable to re-rating of valuations based on a lower outlook for earnings.

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Conclusions

Bear markets brought on by a forecast of an impending recession can be a self-fulfilling prophecy, just as higher inflation brought on by rising inflation expectations can also become self-fulfilling. It does appear the U.S. economy is headed toward at least a mild recession, if it is not already in one. But equity markets are a forward-looking discounting mechanism and the pain felt year-to-date could very well be fully discounting a mild recession and the rise in interest rates that the Federal Reserve has painstakingly forecast. It does appear that estimates for 2022 earnings remain too high. But given that earnings multiples for the S&P 500 are down by more than 25% year-to-date, further compression is not a foregone conclusion. The labor market remains very strong and anything beyond a mild recession seems unlikely given the number of help wanted signs still hanging outside the doors of Corporate America.

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