Tillotson Kenefick

Private Wealth Management
of Wells Fargo Advisors

Half way where?

3rd Quarter 2022

The disappointing first half of the year was marked by a 22% loss in the S&P 500 and a 10% loss in the iShares Core US aggregate bond index (AGG). The market's decline and official bear status were caused by: fears of recession from Russia's invasion of Ukraine reducing oil and grain available to the world, China's response to the omicron variant with successive lockdowns around the country which exacerbated supply chain contributions to inflation, and the Federal Reserve's campaign to raise interest rates and remove stimulus conditions created during the pandemic…to name a few…

Recession indicators we follow include The Rule of 10 which says the price of a gallon of gas at $5 or greater and a 30 year mortgage with a 5% or greater yield added together exceeds 10, which temporarily occurred. Yield curve inversion, which is when short-term interest rates, like a 2-year bond pay more than a longer-term bond, like a 10-year, which has happened modestly and briefly. To name a few more...

If we are not in a recession now, we are close. Regardless of the timing of an official recession status, the economy is slowing. The market is a leading indicator for both the economy's health and earnings growth of publicly traded companies. Valuations for the S&P are based on the total earnings, their forward growth rate and a relative valuation. The range of earnings has been lowered to $220-$230 for 2022 and $240 for 2023. This implies a ~ 6.7% growth of earnings. Using a 15x recessionary multiple offers a directional low target of 3,375 – 3,625 on the S&P or an additional -9% downside risk.

During the first half of the year, the biggest decliners were bonds, crypto-currencies, small cap stocks and technology stocks. The biggest benefactors were energy, commodities, health care and consumer staples.

Some of the ongoing risks to the economy and the market include: Geo-political issues with China and Taiwan; as well as additional rolling lockdowns in China, Russia's war in Ukraine escalating, mid-term elections, an ineffective Federal Reserve, and inflation continuing to escalate.

Reasons to be optimistic include: the end of the pandemic, a pro-active Federal Reserve fighting inflation, indications inflation is abating in the labor, energy, housing and commodity markets

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and the fact that valuations on stocks are favorable for long-term investors, regardless of whether you are a harvester or accumulator.

We believe there is some constructive context for the second half of the year, even as we sit in a bear market. There are 3 main types of bear markets: structural ones caused by systemic failure like 2008 when the banking system failed, event-driven bear markets like the pandemic, and cyclical bear markets led by inflation and interest rate dynamics like the one we are in now.

These cyclical bear markets average ~290 days with ~35% declines. We are six months in and more than 2/3rds of the way there in magnitude. Conversely, bull markets last on average ~2.7 years with ~114% appreciation.

The potential recession is likely to be mild since we have full employment, strong corporate balance sheets and no asset bubbles, with the exception of crypto-currencies.

With this backdrop, we revise our year-end target to a directional ~4500 on the S&P. We are prepared for the potential of an additional 10% decline in the short run and for it to be short-lived. We consider that to be a potential entry point for new capital and a resumption of constructive markets in the fall and into 2023. Stocks are a leading indicator and will likely begin to appreciate before the economic data confirms the recovery.

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