The Changes at Hand

February 7, 2022

The stock market is near $50 trillion in value, about $15 trillion greater than before COVID-19. Stock values rose far faster than bonds, market earnings forecasts are hitting new highs, and companies are finding it easy to borrow. Yet there are signs that this happy situation could be poised to change. This week, we look at some recent evidence to support this claim.

Inflation Boom

From the early days of the pandemic, Congress and the Federal Reserve (Fed) spared little to stimulate growth despite shutdowns. Federal borrowing expanded by 36%, or $8 trillion, to finance direct payments to private businesses and households. The Fed helped finance this spending by buying government and other bonds, increasing the money supply by 47% ($7 trillion).

Now, that expansion of money is contributing to a rise in inflation, in our view, and creating pressure to curtail further growth. Consumer prices are up 7% and producer prices up 12% from a year ago, both registering 40-year highs. Global energy and industrial metals prices are also up a staggering 50% and 60%, respectively. While supply chain issues exacerbate the issue, the leading cause is likely rooted in excess borrowing and money creation. History has proven a linkage between these factors time and again across multiple decades and economies.

As policymakers seek to put the inflation "genie" back in the bottle, the risks of a misstep rise. Will a bust follow this boom, or will policymakers achieve a "soft-landing?" Only time will tell how this plays out.

A Harder Climb

The transition to the next phase appears to be well underway. While earnings, credit spreads, and the Treasury yield curve point to growth, some conflicting signs emerge. For example, the ratio of advancing versus declining stocks on the New York Stock Exchange has rolled over. The ratio of high-risk stocks (high beta) to low-risk stocks (low beta) has been moving sideways after a sharp rise in 2021. Many meme stocks, cryptocurrencies, and "stay at home" themed stocks have retreated from highs. Lastly, the bond market is well along in repricing the path for interest rates, with forwards markets expecting higher short-term interest rates.

The transition also will shape the earnings outlook, the most significant factor driving stock returns. At present, S&P 500 earnings are up more than 25% in each of the past four quarters, according to FactSet. For the full year 2021, earnings are up 45% compared with very easy comparisons in 2020.

Looking Below the Surface

Despite good earnings, the market is looking forward. With more than half the companies have reported Q4 results already, the stock market performance has been mixed. While energy and financials are doing well given rising energy prices and interest rates, many other stocks are struggling. The table below shows various categories' average year-to-date stock performance through February 6, 2022.

As you can see, many stocks and sectors are faring worse than the market averages. Those stocks performing best are more defensive, dividend-paying, and larger in size. Financials and energy companies are benefitting from anticipated higher interest rates and rising commodity prices. Since higher interest and energy costs are a cost to most businesses and households, further increases in either or both things threaten to sap real income and savings.

A positive from all of this is that multiples have begun to adjust down, reducing valuation drag. The forward earnings multiple for the S&P 500 is now 19.7x (18% above the 10-year average) versus 21.3x on December 31 (28% above the 10-year average). A positive outcome could be that this recent shakeout sets the stage for a more durable pull into 2022-2023.

Year-to-Date Average U.S. Stock Returns

Based on Largest 3,000 U.S. Stocks by Market Capitalization

Category	Return % (YTD)
Small (Bottom Decile)	-18.1%
Non-Dividend Payer	-14.0%
All Stocks	-9.5%
Dividend Payer	-4.0%
Large (Top Decile)	-2.9%
* Based on Total Market Value (Equity + Debt)	

Sector	Return % (YTD)
Health Care	-17.8%
Technology	-12.6%
Consumer Discretionary	-11.3%
Industrials	-10.6%
Real Estate	-8.2%
Communication	-7.8%
Materials	-7.6%
Staples	-7.3%
Financials	-1.6%
Energy	+14.2%
S&P 500	-5.5%

Source: Bloomberg; WCA

Market Commentary

WASHINGTON CROSSING ADVISORS

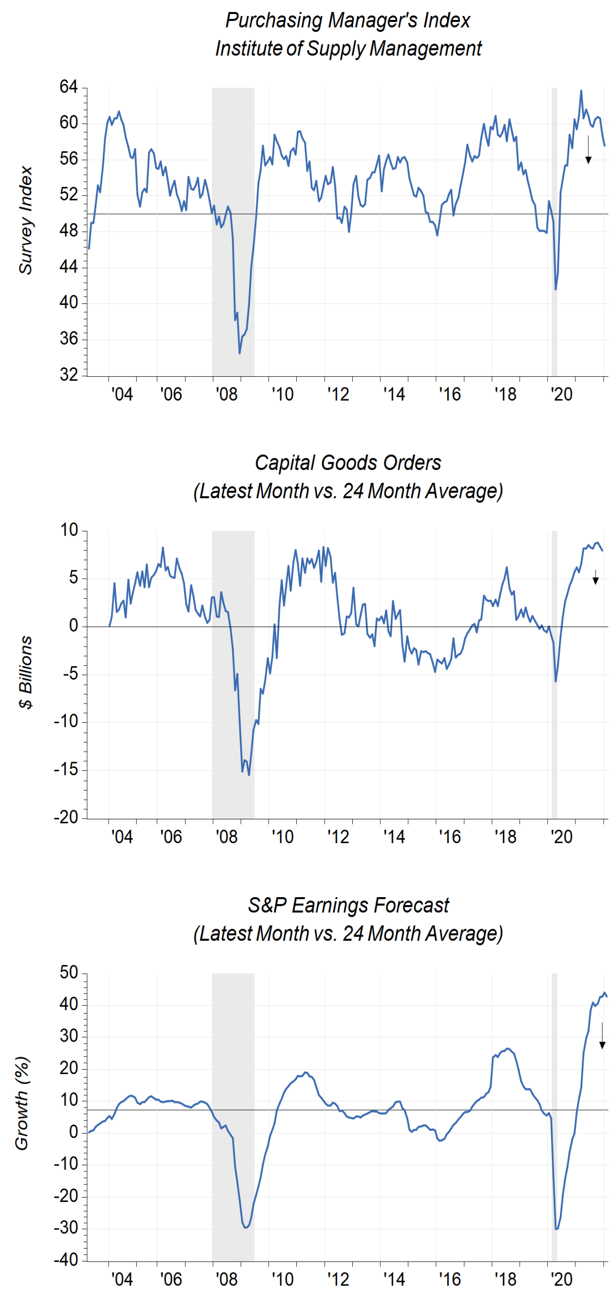
Earnings Pressure Ahead

We expect earnings growth to slow. The easy comparisons are behind us now, producer prices (+12%) are outstripping consumer prices (+7%), and hourly earnings are up 5.7%. Add higher energy and materials costs, continuing shortages, and higher forecast interest costs, and it becomes hard to see how rapid earnings growth continues.

It is also apparent that critical indicators of the cycle are poised to move lower. The charts below show the Institute of Supply Management's Purchasing Manager's Index (PMI), Core Capital Goods Orders (a proxy for business investment), and S&P 500 profit forecasts versus a two-year moving average. Each indicator is cyclical, and each is near peak levels. The PMI is rolling over, capital goods orders appear poised to follow, and profits tend to follow both.

Given these bottom-up and top-down observations, it is likely that the period of surging profits is now behind us. The easy money has been made, and pressure on the bottom line is expected to increase here.

Profit Cycle Indicators



Source: Bloomberg; WCA

WCA Barometer Update

Lastly, we want to update you on our WCA Barometer (Chart, below). This indicator summarizes many indicators we follow to assess market and economic trends. We now see a more mixed bag than several months ago. The near-term forecast for conditions is about average, having dropped from a more clearly expansionary bias last year. The stimulus and vaccine-induced up-swelling of activity post-shutdown is clearly fading. We are left with a less clear outlook and, as such, have returned equity exposure to "neutral" in tactically allocated portfolios.

Conclusion

This week's (rather long-winded) commentary leads us to conclude that we are likely at the close of an era. The factors that drove markets from the bottom in 2020 through 2021 are shifting. Accordingly, a more careful approach seems warranted.

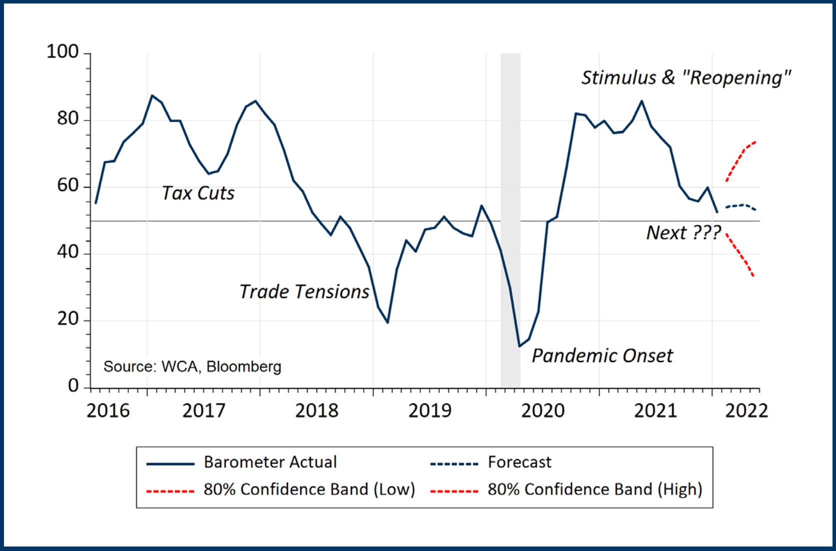
We recommend the following:

1) Focus on higher-quality companies with growing dividends.

2) Ladder bond exposure in light of a potentially higher and less certain rate environment ahead.

3) Approach investments with a more flexible and tactical approach.

WCA Barometer



◄ After a surge of stimulus and "reopening" energy propelled a bounce in 2021-2022, the path forward is less certain.

A return to 50 suggests tactically-oriented portfolios may wish to rebalance or return to a "neutral" exposure versus intended benchmarks.

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