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Inflation vs. Earnings

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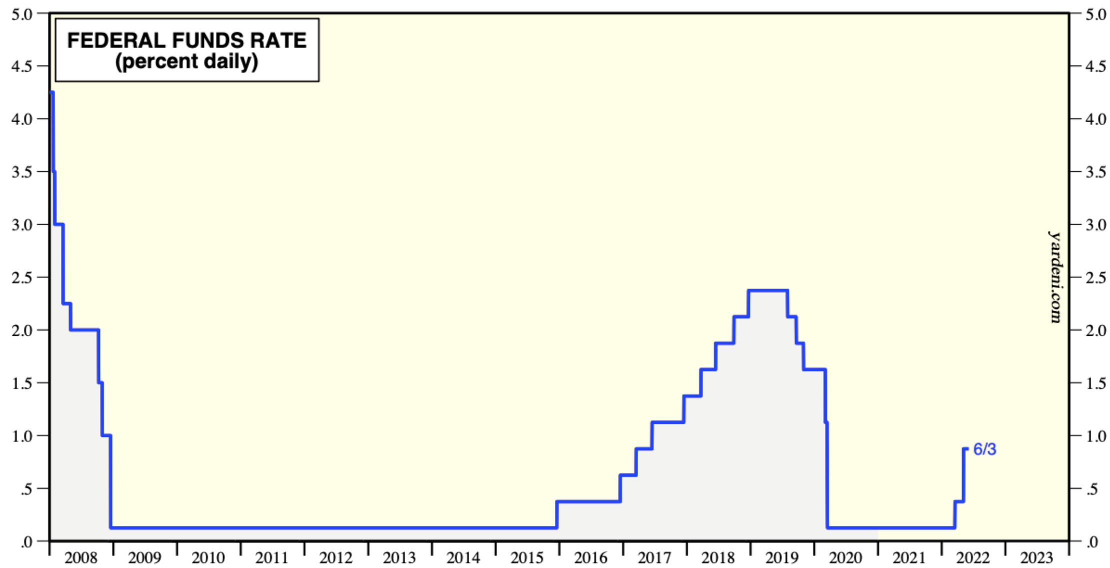
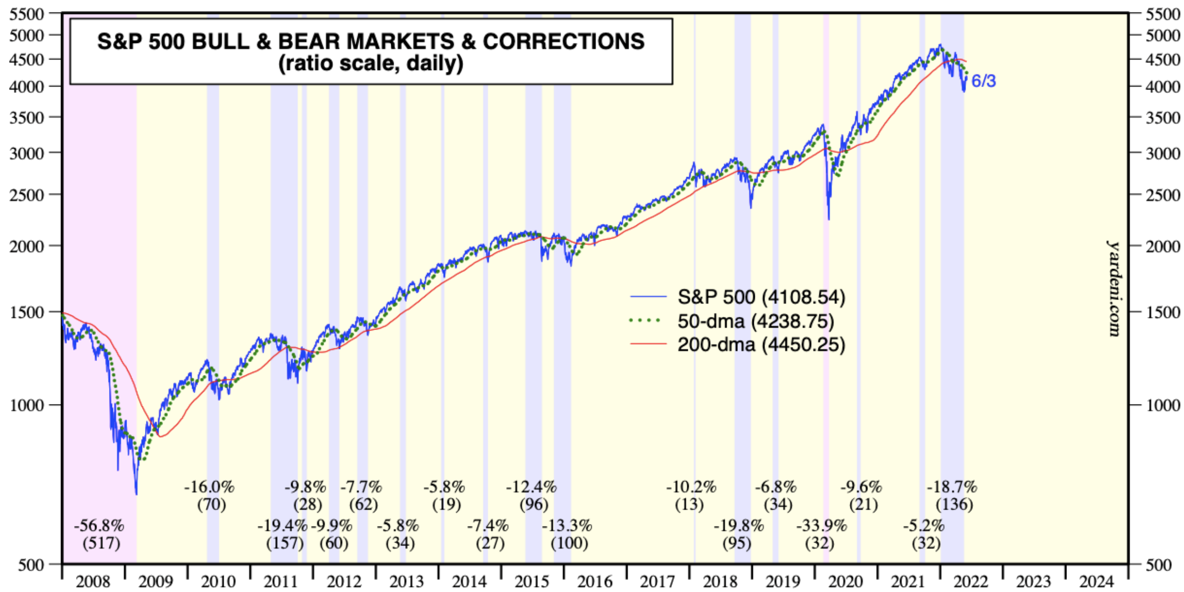
When market volatility is high, media pundits tend to focus their energy on explaining day-to-day price movements. This makes sense given this is what their investor/trader audience demands. Like all businesses, the media business strives to deliver on their customers' demands. There is a certain amount of sensationalism of the immediate that is required. The most recent data release will always be the most important. In direct contrast, overemphasizing the most recent data release or overly focusing on daily price movements is downright dangerous in the investment business.

After many years of getting walloped by the Bulls, the Bears have been beating up on the Bulls so far in 2022. Over the last week, Media Bears have been pointing to very troubling inflation data. Media Bulls continue pointing at positive earnings surprises. For our viewing pleasure, the on-screen debate rages about whether the recent bounce in stocks is a "dead cat" bounce or the start of a new bull market.

A few *Brevity Series* commentaries ago, we started our own dictionary. So far, we've redefined Bear Market, Correction, and Recession to name a few. The next word/expression we will redefine is Bull Market. Currently, a Bull Market is simply defined as "a period when stock prices are rising". By that definition, we have been in a Bull Market since June 16th. The S&P 500 fell 23.6% between January 3rd and its June 16th low. Stocks have since bounced 6% off of those lows and are now -17% YTD. We think a more accurate definition for *bull market* would be "a prolonged period when stock prices are rising due to an expanding economy, corporate earnings growth, and accommodative monetary policy". Implied is that accommodative monetary policy reflects a healthy economy with inflation in check. By this definition, the Bull Market that started in August of 2009 just ended on March 17th. That's the day the Fed acknowledged inflation was persistent, not transient. They recognized the need to start raising the Fed Funds Rate in order to slow inflation. Stocks promptly started to stumble.

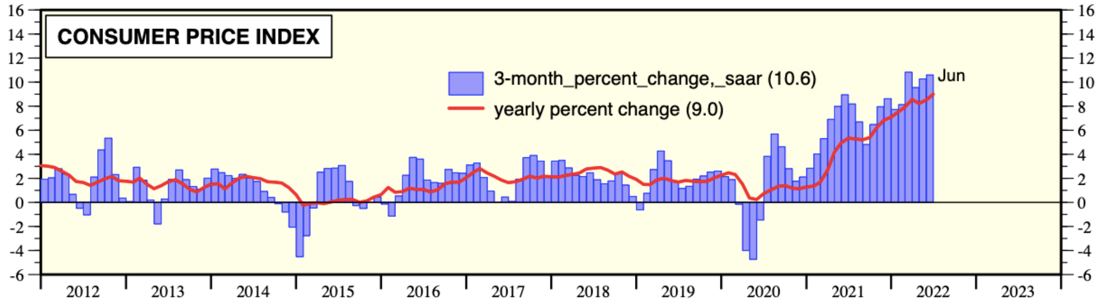


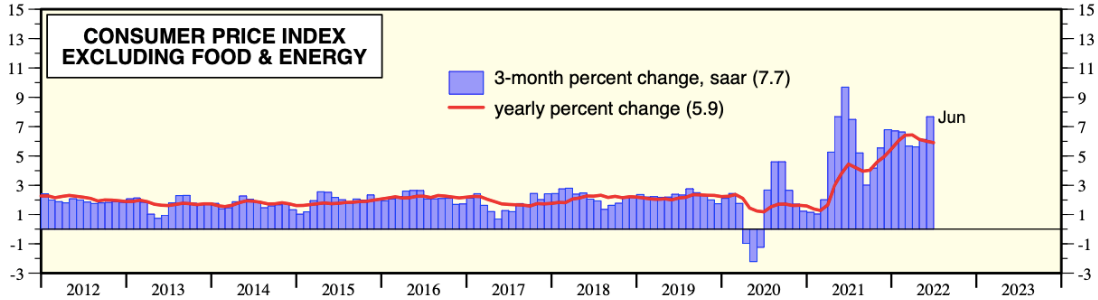
It's important to point out that an increasing Fed Funds Rate and an accommodative monetary policy can coexist. From 2015 until the start of the pandemic, the Fed consistently raised the FFR from near zero to 2.5%. They did so in methodical 25 basis point increments over a 4 yr. period, successfully slowing inflation without harming economic expansion. When the pandemic hit in early 2020, the Fed quickly returned to ZIRP (Zero Interest Rate Policy). We've mentioned previously, that although stocks plummeted 34% at the start of the pandemic, we don't consider this a Bear Market. Rather, a healthy economy was simply turned off. When it was turned back on, and then injected with monetary and fiscal steroids, the economy boomed and the Bull Market that started in 2009 resumed. Although there were many significant corrections along the way, from the depths of the Credit Crisis in 2009 until the Fed raised rates on March 17th of this year, the S&P 500 rose 476%.



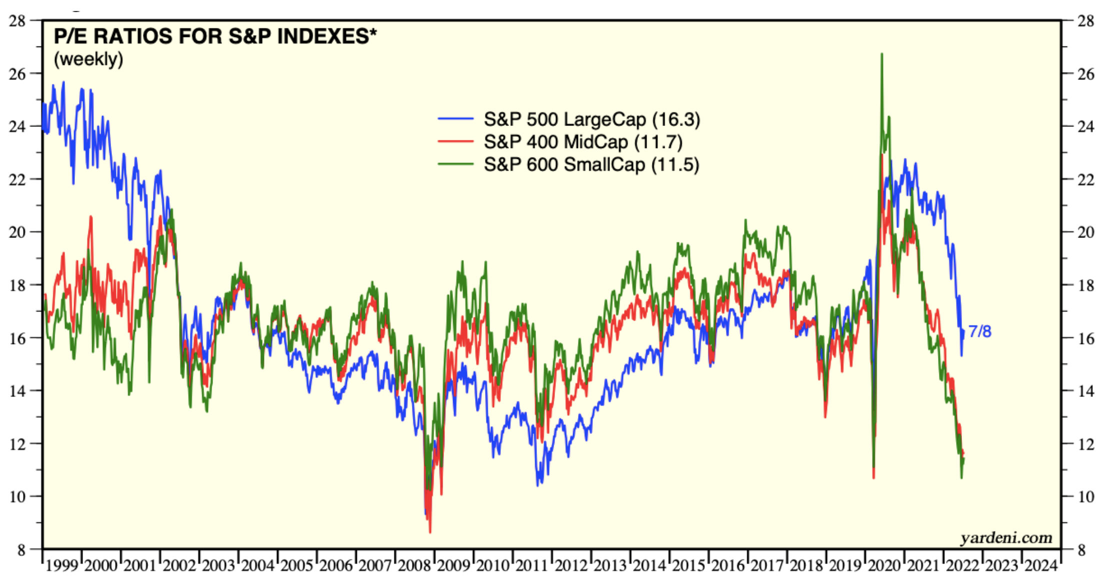
The blue shaded areas are the many corrections along the way, including the pandemic correction of 34%. The purple shaded area is what we consider to be the last real bear market. The economy contracted due to the systemic failure of credit markets. Firms such as Lehman Brothers and Bear Stearns had developed and sold financial derivates (Collateralized Mortgage Obligations) that greatly overleveraged the economy and caused credit markets to collapse. Major investment banks failed, the housing market crashed, and the S&P 500 fell by -57%. It was several years before the economy recovered.

This year's sell-off has elements of both a correction and a bear market but still resembles a correction more so than a bear market. The Fed has acknowledged that inflation is no longer transitory, rather it is persistent. They don't view inflation as systemic. This is also our view. Core inflation (ex food and energy) has already started to moderate. Our expectation is that headline inflation is currently peaking and will decline back towards 5% by year-end, and then decrease further from there. This will allow the Fed to stop aggressively raising interest rates by year-end. Stocks should do well in this scenario. If we are incorrect and inflation is systemic, the Fed will need to continue raising interest rates and a bonified bear market will likely be the result.



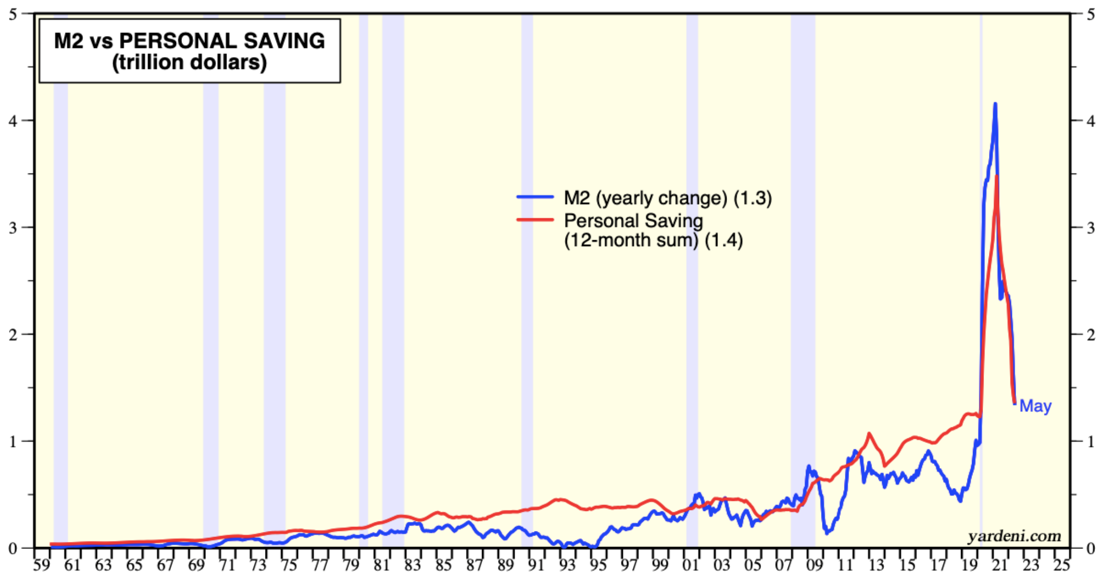


Although stocks have sold off more than 20% (the traditional definition of a bear market) and inflation has created the need for the Fed to temporarily slow the economy, corporate earnings continue to grow. The current correction in the stock market is entirely attributable to a valuation adjustment (lower P/E multiples). Large Cap Stocks have fallen from 22X earnings to 16.3X. Mid and Small Cap Stocks have fallen even more dramatically.



Hot inflation data has rightfully spooked investors. Investors fear that corporate earnings will fall because the Federal Reserve will need to crash the economy in order to get inflation under control. They have proactively sold stocks. Meanwhile, corporations are starting to release their Q2 earnings data, and it's looking pretty good. We've listened in on a few of the earnings calls and the Q2 theme has been remarkably similar to the Q1 theme. Inflation is inflating corporate revenues faster than it's inflating corporate costs. The net result is inflated earnings. CEOs then go on to warn they are concerned about the next quarter's earnings. Their fear is that inflation will erode discretionary spending.

There is validity in their concerns. High inflation erodes consumer discretionary spending. However, right now consumer savings and money supply (mostly from the pandemic relief), remain elevated. Simply put, consumers still have lots of money to spend. If there is one certainty about the American Consumer, they will spend money if they have it. That's why earnings continue to be strong.



For all the complexities and different arguments out there, it's all about inflation. If inflation becomes a systemic issue it will erode discretionary spending, the Fed will need to crush the economy, corporate earnings will get clobbered, and stocks will sell off further. If inflation is peaking and about to move lower, the American Consumer will be fine, the Fed will only need to raise rates once or twice more, corporate earnings will be healthy, and stocks will move higher and back in line with their average price-to-earnings multiples.

We will continue to update you as new data is released and the economic picture becomes clearer.
The MMFS Team

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