Market commentary notes

Monthly call notes
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Wealth Management

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Summary: May—the pause that depresses

Are stock markets disconnected from the economy? U.S. and international stock markets appear to have taken a break in May with the S&P 500 up a mere 18 bp and small caps up 1.86%. International stock markets were up 72 bp. The bond market index rose 85 bp, while commodities, mainly oil and natural gas, rose a bit more than 5% once again. Much of this is probably motivated by reactions to the Fed and uncertainty about what the Fed will do with rates for the rest of this year. Fortunately, it appears that many of the more breathless voices from Wall Street, which predicted 75 bp raises and overnight rates of 3.5% by the end of the year, have quieted down. Nonetheless, in a period where the economic and market indicators are moderately to very strong, it is disconcerting to see the disconnect between the economy and the markets. It reinforces a suspicion that I've held for years that the bandwidth of the media/investors is very limited, and they seem to be able to focus on no more than two or three things at a time. Currently, that's the Fed and inflation, to the exclusion of all other relevant information.

Global stock indexes

Total Index	May %	YTD %	1 yr. %	2021 Est PE
S&P 500	0.18	-12.76	-0.30	24.56
S&P Mid Cap	0.75	-10.98	-6.52	20.93
S&P Small Cap	1.86	-11.37	-8.73	26.67
FTSE All REIT	-4.68	-13.00	4.11	
MSCI All Country xUS	0.72	-10.74	-12.41	
MSCI Emerg Mkt	0.44	-11.76	-19.83	

Source: Morningstar as of May 31, 2022. Estimated PEs are trailing 12-month values from S&P Dow Jones Indices, based on Operating Earnings, as of January 31, 2022. Figures are provided for comparisons over time.

Fixed income and alternatives

Total Return Index	April %	YTD %	1 yr. %
Bloom Agg Intermed	0.85	-6.30	-6.69
ICE BofA US Convertibles	-4.55	-16.04	-15.64
S&P GSCI	5.07	47.04	63.79
Bloom US Corp HY	0.25	-8.00	-5.27

Source: Morningstar as of May 31, 2022.

If the economy is doing well what might account for the dip in equities?

It's hard to say but one possibility is that it is linked to Bitcoin in an odd way. Since November, Bitcoin went from about $63,000 to just under $30,000. From March to the beginning of May, Bitcoin dropped about 35%. [https://www.barchart.com/crypto/quotes/%5EBTCUSD/performance, 5 June, 2022] Ethereum went from $4,800 in November to $1,700 recently—a 65% drop. The total market cap of Bitcoin and Ethereum went from $1.8 trillion in November to around $700 billion now. That is a loss of at least $1.1 trillion in market cap. This is a heavily levered marketplace so it is reasonable to presume that there would have been a flood of margin calls on this loss. That would require speculators to liquidate other assets to meet margin, which probably meant stock holdings for many. A friend who is an expert in cryptocurrencies estimates that the margin calls would have totaled at least $200 billion. It is possible, though I have no direct evidence, that this might have led to the drop in the U.S. stock market in April. I want to emphasize that this is a guess, but I think it is not out of the realm of possibility.

Sector performance

As of the end of May, the best performing sectors out of the S&P 500 for the month were energy (+15.8%), utilities (+4.3%) and financials (+2.7%). YTD it's energy, utilities and consumer staples, with the first two the only sectors with positive performance YTD. The worst performers last month were real estate, consumer discretionary and consumer staples. [www.spglobal.com/spdji/en/documents/performance-reports/dashboard-us.pdf, 4 June, 2022]

Commodity and food price changes, current month and YoY

Copper	3.3%	-1.3%
Lumber	-38.6%	-51.7%
Cotton	-12.6%	61.1%
Sugar	3.5%	8.9%
Coffee	5.9%	44.0%
Wheat	-3.4%	51.2%
Corn	-8.4%	6.5%
Oil	11.9%	71.3%
NatGas	1.4%	175.5%

Source: tradingeconomics.com/commodities, June 4, 2022

Four of these nine major commodities saw prices fall in May. Looking at the 12-month figures, only three—wheat, oil and natural gas—saw higher 12-month inflation at the end of May versus end of April. Looking more broadly at 20 different major agricultural commodities, only five—soybeans, oats, sugar, coffee and sunflower oil—saw prices increase in May. Likewise, looking at 25 categories of industrial metals, 18 saw price declines in May and seven saw increases. To me, this is pretty good evidence that the prices of supplies that underpin our goods are starting to moderate. With them, I'm expecting inflation rates to start to come down as well. I'd guess that by the end of this year, we'll see 12-month inflation in the low 7's and by next year, the low 6's or lower. A Washington, D.C., economist (who is a good friend of mine) pointed out to me a couple of weeks ago that while the U.S. goods' inflation rate is about 14% for services, it has been 5% in the last year. Again, I think that reflects the reality that much of what's driving our inflation is supply shortages. By the way, there are two major components to agricultural fertilizer manufacturing: natural gas and urea ammonium. Natural gas is up only 1.4% last month and urea ammonium prices are down 15% in May. Both are still up over 150% for 12 months, but this major component of agricultural costs does appear to be moderating.

Looking at the future of oil in particular, a number of factors will affect pricing. First, the EU appears to have agreed to ban much of Russia's imported oil. All else equal, you might imagine that this would increase oil prices, but not necessarily. First, the oil that Russia was sending to Europe will likely get redirected to India and China at a 30% discount (based on recent pricing). [RBC First Look, May 31, 2022] That will free up the oil that these countries were importing for Europe. Second, OPEC (ex-Russia) and, in particular, Saudi Arabia appear to have agreed to increase production by another 684K bbl/d now with more to come. That should help settle prices. The big issue is really natural gas, where substitution of sources is much harder due to an infrastructure that isn't very flexible. By the way, for what it's worth, crude oil futures for a year from now are at $95 and two years from now around $83. [S&P DJI Daily Dashboard, May 31, 2022]

U.S. economy

GDP advance estimate for 1Q 2022

We had an estimate of a small contraction in U.S. GDP in the first quarter, driven mostly by rising imports, shrinking exports (due mostly to dollar appreciation) and lower inventory growth and a temporary decline in defense outlays. My guess for the quarter we're now in is that we'll see around +2.5% growth. The Atlanta Fed published a frequently updated estimate called "GDPNow," which currently estimates this quarter's GDP growth rate at about 2%. [https://www.atlantafed.org/-/media/documents/cqer/researchcq/gdpnow/RealGDPTrackingSlides.pdf, June 4, 2022]

My guess is that as the year progresses the same forces that cause inflation to come down—relief from supply shortages and labor shortages—will cause GDP growth to improve. I'm expecting to see an acceleration in GDP growth over the next 12 months. That's in contrast to the many predictions of impending recession that I've seen.

New jobs

In April we had 436,000 new jobs and in May, an additional 390,000. That is better than I expected by a substantial 300,000. It is notable that the unemployment rate remained steady at 3.6%, indicating that the newly employed came from people who weren't previously looking for jobs. That means that higher wages and perhaps need are drawing more people into work. Average hourly earnings rose 0.3% in the month and 5.2% YoY to $31.95. The average work week for all employees was 34.6 hours, but in manufacturing it was 40.4 hours, indicating that manufacturing in this country is rather stretched. [https://www.bls.gov/news.release/empsit.nr0.htm]

Putting all these figures together, we can gain a sense for what has happened to the total income bill of the country in the last 12 months. The employed population has gone from 151.5 to 158.4 million in the last year—an increase of 4.6%. When we figure in changes in hours as well as wage increases, what we find is that the aggregate payroll dollars for the U.S. as a whole rose 9.6% in the last year. That implies a substantial increase in spending. [https://www.bls.gov/news.release/empsit.b.htm] By the way, 69% of establishments reported that they are increasing employment.

Inflation and the Federal Reserve

There's some evidence that inflation rates are starting to come down. I'd guess that by the end of the year inflation will be 7-something. The Fed has some impact on inflation although many of the sources, including supply problems and the war in Ukraine with its impacts on wheat prices, fertilizer and, of course, oil and natural gas, are largely beyond Fed control. Labor shortages here and to some extent abroad, also have an impact. I suspect that the major impact of Fed interest rate raises will be on real estate prices for two reasons. First, the direct impact of higher mortgage rates. The second, however, is the indirect impact that declining asset prices for stocks and bonds mean that the assets that some homebuyers were counting on for their down payments have diminished. That may slow the real estate market as well. [https://tradingeconomics.com/country-list/inflation-rate, 30 April, 2022]

In terms of what the Fed might do for the rest of the year, I took a look at what the Fed did or didn't do in election years since 1982. To my surprise in the 20 election years, the Fed has never changed rates after the beginning of September, until after the election. In fact, the Fed changed rates in September itself only once. While the past doesn't necessarily predict the future, the reality is that I think the Fed would prefer to avoid being a news story during an election campaign and therefore, I am guessing, is going to be inclined to do nothing from September until perhaps December. If that's true this year, that would likely mean that we are in store for no more than two raises before the election, totaling no more than 1%. I think that sort of increase (and perhaps more) is already priced into interest rates. In other words, from the standpoint of interest rate moves, the rest of the year until after the election may be pretty benign, which might also create some space of equities to improve.

U.S. PMI statistics

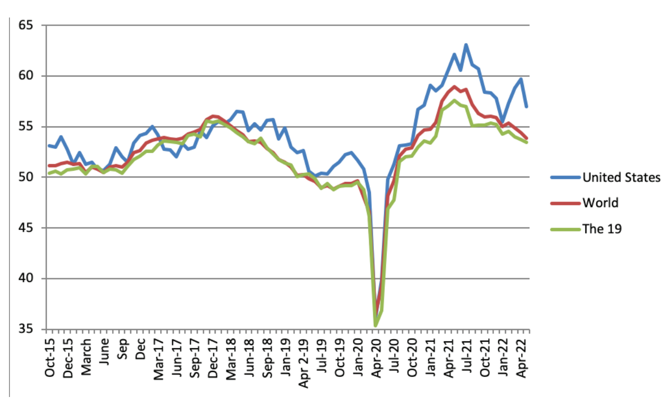
The U.S. Manufacturing PMI for mid-May came in at 57, down from last month's 59.7 and about where it was in February. [Trading Economics, PMI statistics 4 June, 2022] However, our Services PMI, covering some 80% of the economy, dropped to 53.4, still showing moderate growth but trending down in recent months. [Trading Economics, https://tradingeconomics.com/country-list/services-pmi 4 June, 2022]

International

Manufacturing PMI

Every month I look at global Purchasing Managers Index (PMI) statistics. Four of our 38 countries came in below 50 in May. That's better than the six reported in the last two months. However, the average has declined a bit to 53.8 from 54.4. China came up two points to 48, probably reflecting their gradual reopening from the last COVID-19 scare. The Euro area remains in moderate territory, around 54.8. Within Europe, Sweden posted a 68 and Switzerland a 60. The other countries were more moderate with Germany at 55 and UK at 51.8. Looking across the major Asian economies, most appear to be coasting along just slightly above 50, so growing, but slowly. [https://tradingeconomics.com/country-list/manufacturing-production] On the services side, the Euro area remains strong at 56.1. Australia is also growing well, although the other Asian economies, including Japan are just barely above 50. China's services came in at a devastating 36—for reasons we know. [https://tradingeconomics.com/country-list/services-pmi]

Here's our updated graph of Manufacturing PMIs:



Source: Author's calculations based on published PMI statistics, as of June 4, 2022.

Table summary

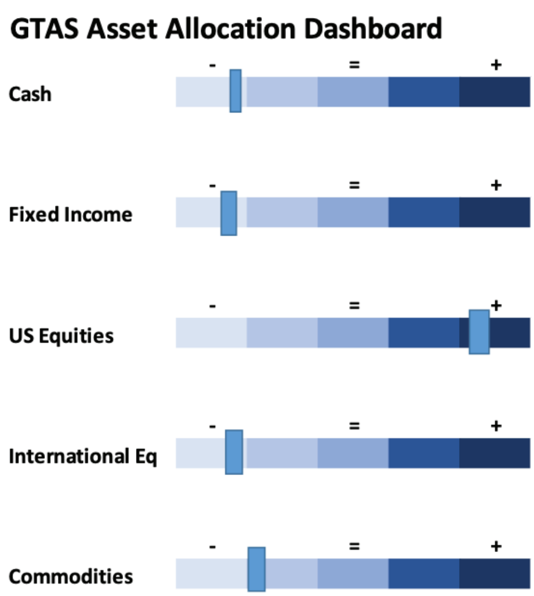
Region	Manu PMI	Last Month	12 Mo. Ago
US	57	59.7	62.1
19 majors	53.4	53.7	57.6
38 world	53.8	54.4	59.0
EU	54.6	55.3	63.1
China	48.1	46	52

Source: Author's calculations based on published PMI statistics, June 4, 2022.

Tactical positioning

The RBC recession dashboard indicates only a very small chance of recession in the near future. However, for a variety of reasons, the international equity environment might be a little weaker than U.S. equities from the perspective of a U.S. dollar investor. Consequently, we have been and will continue to focus on U.S. equities. On the bond side, we added to TIPs and especially short-term TIPS where we could. Our commodities exposure has been somewhat underweight, unfortunately, but with prices showing signs of tempering that may be okay longer term. The key to us is that the stock market has come down substantially while earnings continue to grow. That suggests that stocks may be due to rise before too much longer.

GTAS allocation tilts



(+/=/-) represents our group's views over a 6- to 18-month time horizon concerning tilts relative to our strategic positions.

+ implies an overweight in that asset class.

= implies a weighting similar to our strategic weight.

- implies an underweight. Index definitions

Index definitions

Past performance is no guarantee of future results. You cannot invest directly in an index.

Bar Agg Intermed — Bloomberg Barclays U.S. Aggregate Intermediate Total Return index is composed of the BarCap Government/Credit Index, the Mortgage-Backed Securities Index, and the Asset-Backed Securities Index. The returns for the index are total returns, which includes the daily reinvestment of dividends.

Bar U.S. Corp HY — Bloomberg Barclays U.S. Corporate High Yield Total Return index includes all fixed income securities having a maximum quality rating from Moody's Investor Service of Ba1, a minimum amount outstanding of $100 million, and at least one year to maturity.

FTSE All REIT — FTSE Nareit All Equity REITs Total Return index is an index of publicly traded Real Estate Investment Trusts (REITs) that own commercial property. All tax-qualified REITs with common shares traded on the NYSE, AMSE or NASDAQ National Market List are eligible. Additionally, each company must be valued at more than US$100 million at the date of the annual review.

ICE BofA US Convertibles — ICE BofA U.S. Convertible Bonds Total Return index tracks the returns of U.S.-traded convertible debt issued by companies with a significant presence in the United States. The index is composed of various combinations of convertible structure and credit quality, e.g. it includes investment-grade, speculative-grade, and non-rated issues. The returns for the index are total returns, which include reinvestment of dividends.

MSCI All Country xUS — MSCI All Country World Index Ex USA NR is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global developed and emerging markets. The index consists of 48 developed and emerging market country indices. The returns for the index are total returns, which include reinvestment of dividends.

MSCI Emerg Mkt — MSCI Emerging Markets NR index consists of 26 developing economies including Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey and the United Arab Emirates.

S&P 500 — S&P 500 Total Return index is a market capitalization-weighted index composed of the 500 most widely held stocks whose assets and/or revenues are based in the U.S.; it's often used as a proxy for the U.S. stock market. Total Return (TR) indexes include daily reinvestment of dividends.

S&P GSCI — S&P GSCI Total Return index is a composite index of the commodity futures. It represents unleveraged, long only investments in commodity futures that are broadly diversified.

S&P Mid Cap — S&P MidCap 400 Total Return index is comprised of stocks in the middle-capitalization range, and includes approximately 10% of the capitalization of U.S. equity securities. Total Return (TR) indexes include daily reinvestment of dividends.

S&P Small Cap — S&P SmallCap 600 Total Return index consists of 600 domestic stocks chosen for market size, liquidity, and industry group representation. Total Return (TR) indexes include daily reinvestment of dividends.

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