Market commentary notes

Monthly call notes
Monday, July 11, 2022

Wealth Management

Eric A. Stubbs
Senior Vice President – Financial Advisor
Senior Portfolio Manager – Portfolio Focus

1211 Avenue of the Americas
Suite 3300
New York, NY 10036

(212) 703-6165
eric.stubbs@rbc.com

Summary: May—June—bad across the board

On a YTD basis all of the major stock indexes are down between 17.6 and 20%. That is an uncannily tight spread and suggests that the dip has more to do with investors exiting stocks indiscriminately rather than specific concerns about the market and the economy—although there are those as well. The S&P 500 was down 8.25% for June, and mid-cap, small-cap, international and emerging markets all experienced similar dips. The bond index was also down, 1.27%. Even commodities dipped—and that's the good news! I'll talk about what this might mean for the rest of the year in a few moments.

Global stock indexes

Total Index	June %	YTD %	1 yr. %	2021 Est PE
S&P 500	-8.25	-19.96	-10.62	24.56
S&P Mid Cap	-9.62	-19.54	-14.64	20.93
S&P Small Cap	-8.55	-18.94	-16.81	26.67
FTSE All REIT	-7.10	-19.17	-5.89	
MSCI All Country xUS	-8.60	-18.42	-19.42	
MSCI Emerg Mkt	-6.65	-17.63	-25.28	

Source: Morningstar as of June 30, 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	June %	YTD %	1 yr. %
Bloom Agg Intermed	-1.27	-7.48	-7.91
ICE BofA US Convertibles	-6.18	-21.23	-23.38
S&P GSCI	-7.64	35.80	45.05
Bloom US Corp HY	-6.73	-14.19	-12.81

Source: Morningstar as of June 30, 2022.

A few facts about the historical record for market performance when recession risk rises.

Looking at the last 11 recessions, according to an RBC analysis, the S&P was up from beginning to end in five of them and down in six of them. In other words, the S&P dropped start to finish in recessions only 55% of the time.

Another historical statistic that I found interesting was that the average drop during or in anticipation of a recession was 32%, and the range was 13% to about 50%. In other words, we're toward the low end, but by no means out of the ordinary in terms of drops.

In terms of frequency of dips, a recent study reported that since 1980 there were seven drops of at least 20% and 15 drops of between 10 and 20% for the S&P 500 (22 drops of 10% or more). [Yardeni Research, Inc., S&P 500 Bull and Bear Markets and Corrections, July 8, 2022]. Since there were 11 recessions, you can do the math: recessions don't necessarily lead to big dips and only about half of the dips were associated with recessions—so the dips aren't good predictors of recession either.

By the way, during the Dot-com era from 1997 to 2000, before we reached the 2000–2002 Dot-bomb, there were four corrections ranging from -9.6% to -19.3%. After the Great Recession and in the 2010 to 2015 recovery period, there were 10 dips ranging from 5.8% to 19.4%. So, these dips aren't uncommon and they don't necessarily predict recessions.

In terms of guessing the likelihood of a recession, RBC uses a panel of seven indicators measuring things like trends in unemployment, yield curve movements, corporate free cash flow, business new orders and inventory. Three months ago, all seven were flashing green meaning a low likelihood of recession. Now one is red (new orders), two are yellow, including the yield curve and four are still green. So, I would conclude that the chances of a recession, however shallow, have increased but that we are far from saying that one is on the way.

Sector performance

So, here's an interesting pair of questions: Which S&P sector has the lowest PE ratio? Which one has the highest? The lowest currently is financials at 9.7. The highest, real estate at 30.5 and utilities at 28.2. [S&P Dashboard, 30 June, 2022, www.spglobal.com/spdji/en/documents/performance-reports/dashboard-us-sector.pdf]. Tech cos are in the middle at 23.2. The other major sectors, such as consumer staples, consumer discretionary, health care and industrials are also all in the 22 to 24 range. Energy is at about 14 and materials around 15.5.

My point is that most of these are pretty moderate and you have a really significant premium on slow income growers like utilities and real estate right now, while other sectors appear to be at discounts compared to historical norms. In terms of June performance, the best performing sectors were utilities, health care and consumer staples—all negative though. The worst were energy, materials and financials. [www.spglobal.com/spdji/en/documents/performance-reports/dashboard-us.pdf, 4 July, 2022] So we should understand from this that the sectors with low PEs generally landed there due to price declines and not income changes. That's an important distinction as we look for opportunities going forward.

Commodity and food price changes, current month and YoY

Copper	-19.4%	-18.9%
Lumber	16%	-6.2%
Cotton	-30%	16.6%
Sugar	-1.4%	10.2%
Coffee	-6.1%	47.4%
Wheat	-18%	44.4%
Corn	0.7%	23.6%
Oil	-12%	40.5%
NatGas	-32.8%	64.2%

Source: tradingeconomics.com/commodities, July 9, 2022.

Four of these nine major commodities saw prices fall in May. In June, seven saw price declines. Looking more broadly at commodities, when we look at 22 categories of agricultural commodities, 18 of them saw price increases over the last 12 months, but only four of 22 saw increases in June. For 14 categories of energy commodities, 13 saw 12-month price increases but only three increased in June. For 35 categories of metals and industrial commodities, 18, roughly half, were up from a year ago but only five out of 35 saw price increases in June. That's about half as many as saw increased prices in May. So, to me, it looks like the prices of a whole range of commodities other than natural gas are starting to moderate.

We're now seeing similar effects in the price of shipping containers from China to the U.S. West Coast. In January 2020 the cost was around $1,500. By September 2021 it was $20K. In January 2022 it had dropped to $15K and by the end of June was $7-8K. Still dramatically higher than it was 30 months ago but down 65% from its peak less than a year ago. [www.globaltimes.cn/page/202207/1270086. shtml]

What all this might mean is that the underpinnings to our inflation—input costs and transportation costs—are coming down significantly. It takes a while for that to filter through the goods system so with the exception of oil, I wouldn't expect to see immediate inflation relief; but, I'd guess that by the end of this year, 12-month inflation will be in the sevens and a year from now, probably somewhere in the sixes. By the way, that probably means that mortgage and borrowing rates in the fives will remain a pretty good deal for a couple of years, and then refinance down. As an interesting aside, the Russian oil index, called Urals Oil, ended the month at $85 while Brent

was $104—meaning that China and India are still getting a major discount for being willing to buy Russian oil.

U.S. economy

GDP advance estimate for 2Q 2022

We won't have a 2Q Advance estimate for another two weeks, but the Atlanta Fed's GDPNow estimator gives us a peek at what might be in store. This estimator uses updates on various economic statistics to forecast the upcoming official number. A month ago, GDPNow estimated 2Q GDP at about +2%. Its central estimate is now -1% with a range covering 2/3 of the probability from -2.4% to +0.2%. So overall, a small negative number. I'm slightly more optimistic and am guessing it'll come in around +1-1.5%, but we'll see soon enough. [www.atlantafed.org/-/media/documents/cqer/researchcq/gdpnow/RealGDPTrackingSlides.pdf, June 4, 2022]

By the way, contrary to what many seem to believe, the official definition of a recession isn't two consecutive negative GDP quarters. However, if we have two in a row, people (and the headlines) will likely treat it as if it means we are in a recession. Either way, for investors, the key question is really, how much of a recession is already priced in? On the bond side, which has seen 10-year rates rise more than 2%, the answer is probably not much—meaning a recession could bring interest rates down some. On the stock side, it is harder to tell. In previous recessions the stock market drop has ranged from 13% to 57%—a very wide range. There's also no correlation between the depth of the stock market drop and the depth or duration of the recession. In all but one recession since 1937, the stock market troughed before the recession ended.

New jobs

One of the reasons that I'm a little more optimistic on GDP growth is that our new jobs statistics continue to come in strongly. For June, we saw 372,000 new jobs, after 384K in May and 468K in April. That is an astonishingly good run. That put the unemployment rate and unemployment numbers back to where they were pre-COVID. Private sector employment is actually 140K higher than pre-COVID levels, while government employment is 644K lower. Average hourly earnings increased again, to $32.08. That's up 5.1% from a year ago. Total pay is up 9.4% from a year ago. That's one reason that I am less concerned about a recession right now—incomes in the aggregate are rising faster than inflation. [www.bls.gov/news.release/empsit.b.htm] By the way, once again, 69% of establishments reported that they are increasing employment—a very strong figure.

U.S. PMI statistics

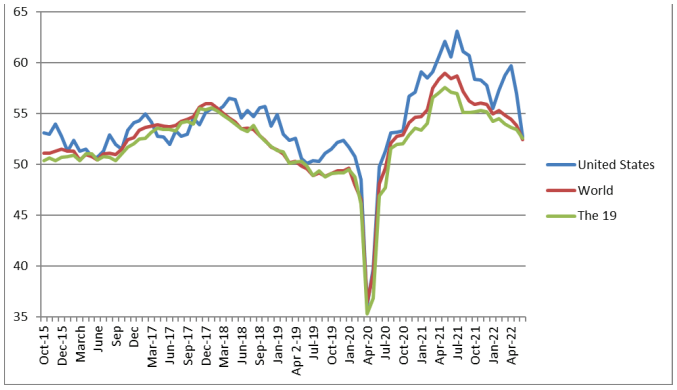
The U.S. Manufacturing PMI for mid-May came in at 52.7, down substantially from 57 last month and 59.7 the month before. That suggests a clear cooling in manufacturing activity. [Trading Economics, PMI statistics 9 July, 2022.]. However, our Services PMI, covering some 80% of the economy, dropped a little more to 52.7 from 53.4, still showing moderate growth but trending down in recent months. [Trading Economics, tradingeconomics.com/country-list/services-pmi 9 July, 2022]. Together these suggest a cooling of the economy despite the strong new payroll numbers.

International

Manufacturing PMI

Every month I look at global Purchasing Managers Index (PMI) statistics. Five of our 38 countries came in below 50 in June. That's similar to the last two months, but the average, 52.5, is down from 53.8. China returned to the positive column at 51.7 up from 48, probably reflecting their gradual reopening from the last COVID-19 scare. The Euro area remains in slow/moderate territory, around 52.1, down from 54.8. UK at 52.8. [tradingeconomics.com/country-list/manufacturing-production] On the services side, the Euro area moderated to a 53 from the previous 56.1. China's services PMI resurged to 54.5 after shrinking dramatically in their COVID-19 lock-down. [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 July 9, 2022.

Table summary

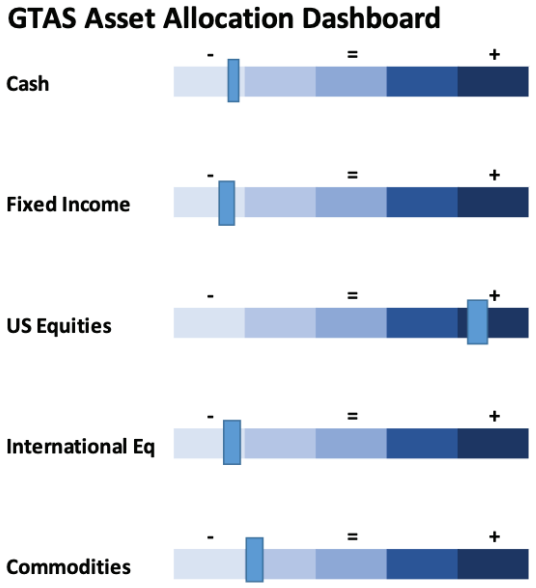
Region	Manu PMI	Last Month	12 Mo. Ago
US	52.7	57	60.6
19 majors	52.6	53.4	57.1
38 world	52.5	53.8	58.4
EU	52.1	54.6	63.4
China	51.7	48.1	51.3

Source: Author's calculations based on published PMI statistics, July 9, 2022

Tactical positioning

Dollar appreciation weighs against international investing. It looks like commodities prices in general may be moderating. With the Fed appearing poised to raise rates at least one more time and possibly twice, conventional fixed income may be better priced in a few weeks or a month. From the domestic stock side, PEs have moderated and indeed there look to be bargains in a few sectors. If oil prices do come down, the oil and energy sector stocks may moderate as well.

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 $100MM USD 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.

Wealth Management

22-NF-01776 (07/22)