Inverness
Counsel

2Q 2022 Commentary

A Bear Market Begins

Over the last few years, equity investors have experienced positive returns, but with extremely high levels of volatility. In March 2020, the global pandemic struck and the S&P 500 experienced the quickest meltdown in history, with a loss of 33.9%. The Federal Reserve and Congress acted rapidly by slashing interest rates to zero and implementing enormous stimulus plans that helped to drive the V-shaped economic recovery and one of the biggest rallies in the S&P 500 in decades. With the U.S. economy, as measured by gross domestic product (GDP), surpassing its 2019 peak at the end of 2021, the Federal Reserve had accomplished the full employment part of its mandate, but the second part, aimed at keeping inflation around 2%, was at risk. Given this, the Fed entered 2022 looking to gradually end the emergency measures they had put in place. A lot has changed since then.

Back in the second half of 2021, the Fed initially looked to raise short-term interest rates in late 2022 or 2023. This was based on its view that many of the inflation issues were "transitory" as strong consumer spending collided with a global supply chain that was too fragile to keep up with demand. Since Covid cases seemed to be one of the leading causes for shipping bottlenecks and shortages in labor, we agreed with the Fed that supply chains should eventually catch up with demand as cases declined, albeit with uncertain timing. Unfortunately, in late November, the term "transitory" was dropped as the Fed acknowledged inflation was present, but still not a concern.

During the first quarter of 2022, inflation figures came in higher than expected forcing a sharp pivot in Fed policy. In March, interest rates were raised by 0.25% for the first time since 2018. Projections at that time called for six more 0.25% rate hikes in 2022, with the possibility of one or two of these rate hikes at 0.50%, to put year end rates between 1.5%-2%. The Russian invasion of Ukraine further complicated the inflation outlook both in the U.S. and globally, as the price of oil and natural gas skyrocketed. Additionally, Russia and Ukraine account for more than one-fourth of the world's wheat exports and are important sources of many other kinds of commodities.

During the second quarter, the outlook became even worse. The crisis in Ukraine continued and China's zero-Covid policy, which shut down major parts of that country, further complicated supply chains and business outlooks. The Fed raised rates for the second time in May by 0.50% — the biggest move in over 20 years — and announced the kickoff date for unwinding its $9 trillion balance sheet. Many investors were hoping inflation figures had peaked and that the Fed would be less aggressive, but the consumer price index released in June came in higher than expected, hitting its fastest pace since 1981. The Fed was forced to react yet again and raised interest rates by 0.75% in June, instituting the largest rate hike since 1994. The S&P 500 entered official bear market territory — defined as a decline of 20% or more from recent highs — as investors became increasingly disappointed with the Fed's grasp on inflation.

As we noted last quarter, the Federal Reserve is stuck in a difficult position. On one hand, it is attempting to rein in inflation by raising interest rates to slow consumer spending, and on the other, it is trying to avoid triggering an economic recession. Investors now see the U.S. benchmark rate topping out at 3.5% at the end of 2022 (up from 1.5%-2% just 90 days ago — see Figure 1) followed by interest rate cuts in 2023, which mark a dramatic change from just six months ago. We believe this combination of market uncertainties will keep volatility elevated and have adjusted portfolios accordingly.

Inside

Inverness Counsel, LLC
845 Third Avenue
New York, NY 10022
www.invernesscounsel.com
212-207-2122
info@invernesscounsel.com

Figure 1

Fed Funds Rate Expectations for Year-End 2022

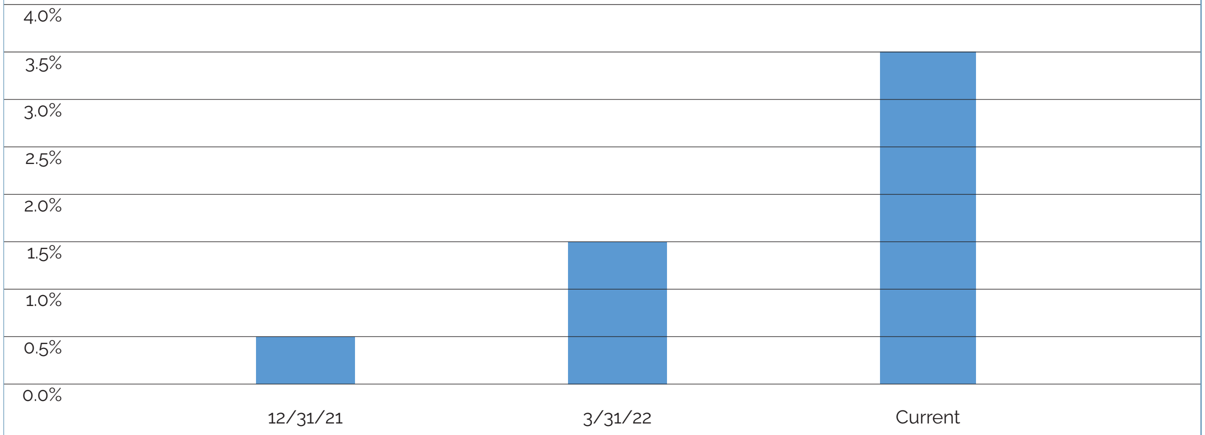

Figure 1 Source: Bloomberg. Data as of June 30, 2022.

As of the end of June, the S&P 500 Index was down 20% for the year (Figure 2), officially entering a bear market. During the quarter, growth areas of the market: Consumer Discretionary, Communication Services, and Technology, continued to be the detractors. The Energy sector remains the outlier, with year to date performance up almost 32%. The S&P 500 Index was down 16% for the quarter. Defensive areas of the market: Consumer Staples, Utilities and Healthcare, were relative outperformers both in the quarter and year to date.

Figure 2

2022 Performance by Sector

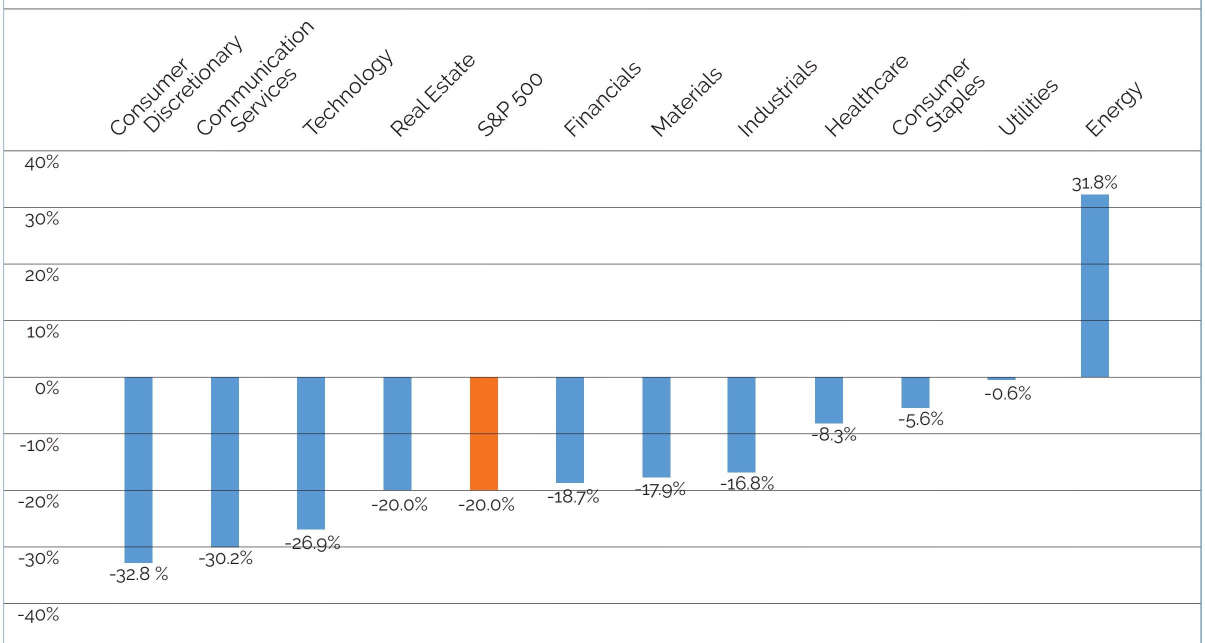

Figure 2 Source: Bloomberg. All performance based on total returns. Data as of June 30, 2022.

The first half of the year was not only a struggle for global equities but fixed income as well. The asset class is off to its worst start in history, as seen by both of Barclay's fixed income indices that are down double digits (Figure 3).

Figure 3

2022 Performance by Category

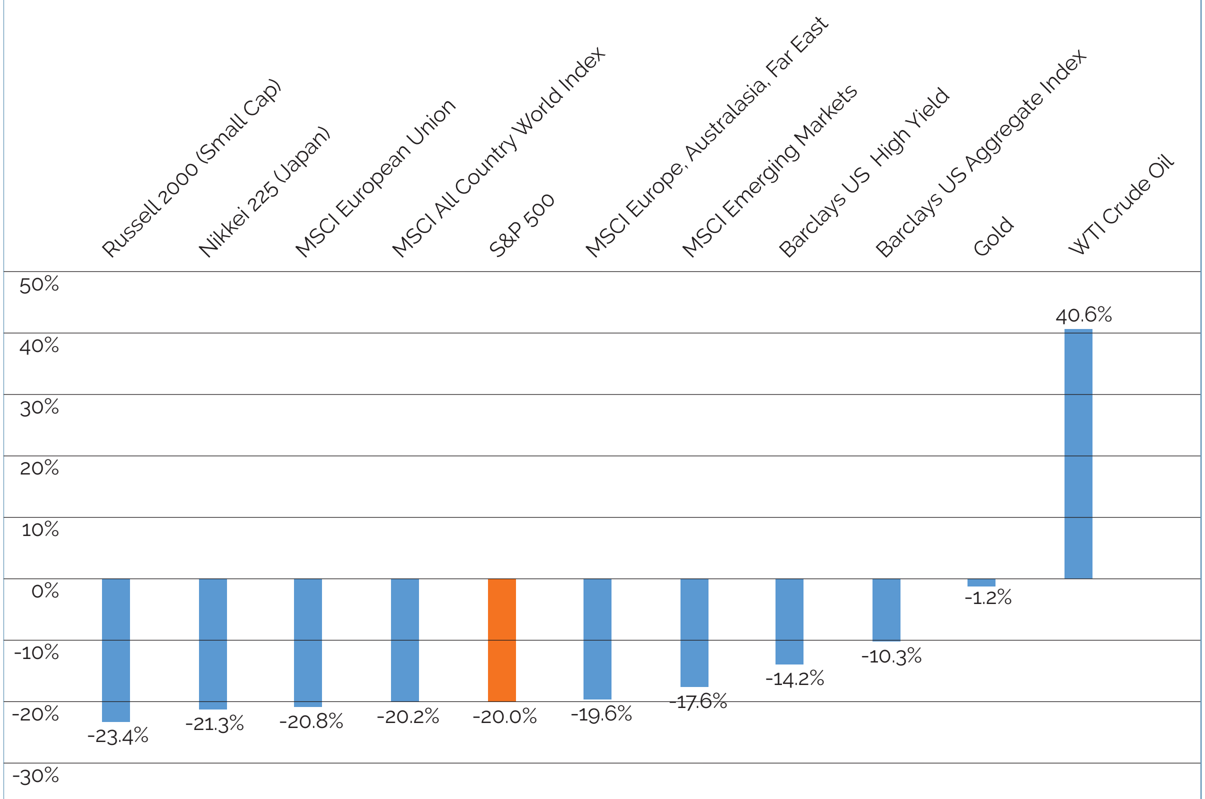

Figure 3 Source: Bloomberg. All performance based on total returns. Data as of June 30, 2022.

The Consumer Is Under Pressure

Consumer spending, which makes up 70% of our economy, was robust in 2021 with many participants engaging in "revenge spending" to make up for lost time during the height of the pandemic. Strength was expected to continue into 2022: many consumers still have access to elevated savings accounts; they are employed and getting raises; and for many, their largest asset, their home, has appreciated considerably over the last two years.

However, recent sentiment indicators suggest the average consumer is not feeling optimistic about the future. Inflation is eating into household budgets (rent, food, and energy), and interest rates have soared making general debt and mortgages more expensive.

We noted last quarter the divergence between the two closely watched consumer sentiment indices. The Conference Board Consumer Confidence survey puts a greater emphasis on employment and labor market conditions, while the University of Michigan Consumer Sentiment assessment emphasizes individual household finances. At the end of first quarter, the Conference Board Consumer Confidence improved slightly, while the University of Michigan survey ended at a decade low. With initial jobless claims falling to their lowest level since March 1968, people felt confident in their employment, but less confident in the ability of their finances to keep up with inflation.

Both indices have now converged to signal that overall, the consumer is feeling uncertain, at best. The Conference Board fell to its lowest point in a decade. The University of Michigan Consumer Sentiment Index, the one more influenced by inflation, hit a low of 50 in the June survey. This marked the lowest level on record in data for the series, which spans back to the mid-1970s (Figure 4).

Figure 4

University of Michigan

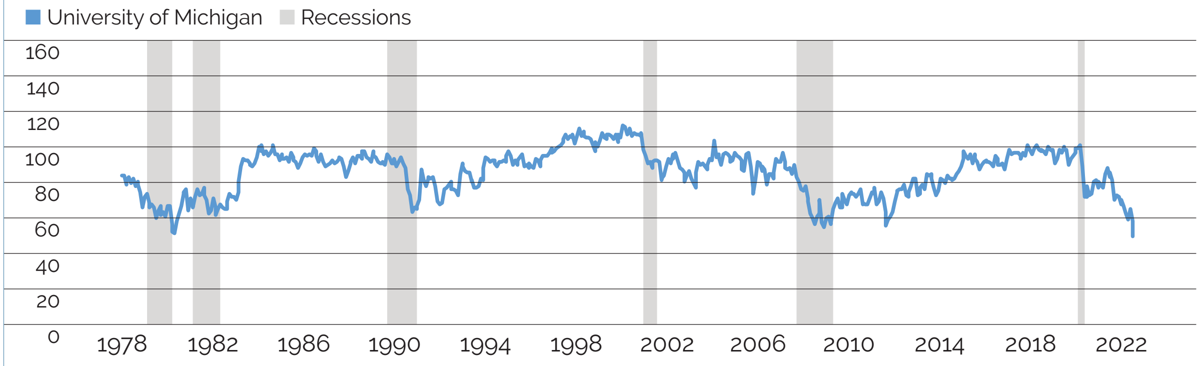

Figure 4 Source: Bloomberg. Data as of June 30, 2022.

The consumer benefitted from the strong housing market during the last two years. Home prices just set a new year-over-year record, in part due to record-low inventory of existing homes, but also due to low rates on mortgages and home equity loans. The 30-year mortgage bottomed in late 2020, at a record low of 2.7%, and stayed around this level for most of 2021. The increase in rates by the Fed has had an impact on mortgages with the 30-year mortgage rate jumping to 6% during the second quarter. In the short-term, this is a rapid increase, but when compared to history, rates remain low (see Figure 5). Nonetheless, the combination of record high home prices, coupled with mortgage rates that are now more expensive, make housing an important area to watch.

Figure 5

30-Year Mortgage Fixed Rate

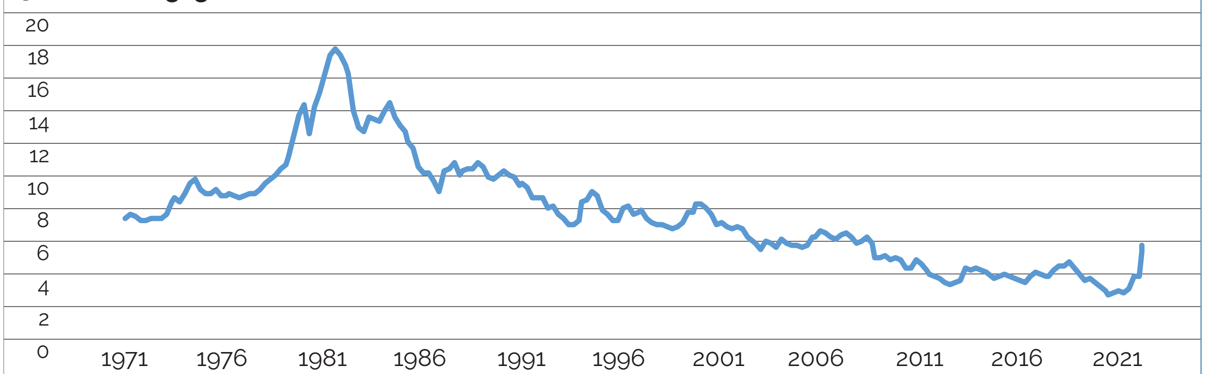

Figure 5 Source: Bloomberg. Data as of June 30, 2022.

Risk of a Recession is Increasing

As previously mentioned, the Fed is looking to raise interest rates enough to slow the economy and tame inflation (orchestrating what is referred to as a "soft" landing) without causing a significant increase in unemployment and an economic recession (which is known as a "hard" landing). After falling behind the inflation curve, the Fed has now been forced to aggressively raise interest rates, increasing the chance of a hard landing. Fed Chairman Powell acknowledged this in late June and commented that achieving its soft landing for the U.S. economy would be "very challenging." He reinforced that the Fed is fully committed to getting inflation back down to the 2% target.

In light of these dynamics, we continue to monitor a variety of indicators to evaluate the economic outlook (Figure 6). Fears of an economic downturn are growing among leading Fortune 500 CEOs, with some convinced the economy has already rolled over. The Conference Board released a survey in June reporting that "more than 60% of CEOs expect a recession in their primary area of operations in the next 12 to 18 months".

The U.S. economy has experienced 12 recessions since World War II, and each one included two features: economic output contracted for at least two quarters and unemployment rose. With the Bureau of Economic Analysis reporting that the U.S. economy shrank in the first quarter of 2022 and the Atlanta Fed's GDPNow gauge projecting a decline in the second quarter, there may be evidence that economic output has contracted. Regardless, the job market remains healthy with unemployment at 3.6%, which is down from 4% at the beginning of the year. If we do enter a technical recession, the low levels of unemployment would make this much different when compared to previous recessionary periods.

Figure 6

Tailwinds That Support a Soft Landing	Headwinds Against a Soft Landing
U.S. household finances are generally healthy. Internal data at Bank of America suggest balances in checking and savings accounts remain well above pre-pandemic levels. Unemployment remains at low levels with initial jobless claims close to five-decade lows.	Consumer confidence is plunging with current levels comparable to previous economic recessions. Declining net worth coupled with low confidence and strong consumer spending during the pandemic may make year-over-year comparisons difficult.
Inflation is showing some signs of easing — following recent weaknesses in copper, fertilizer, wheat, oil and other commodities (see Figure 7). Additionally, excess inventories at retailers may result in discounting.	Oil prices and commodity shocks have a propensity to cause recessions. Over the past 50 years, in the six instances where crude oil prices increased 50% or more, a recession occurred every time.
Companies remain in good shape with robust balance sheets, perhaps making many less dependent on credit growth as interest rates rise.	A downward sloping/inverted yield curve, in which long-term interest rates in U.S. Treasury bonds have fallen below short-term rates, suggests that bond investors are expecting an economic slowdown.
The banking system is generally in good shape. Stress test results released in June show that the banking system is well-positioned and has adequate capital to withstand a recession.	The Federal Reserve may be less likely to pause raising rates, despite global economic weakness or volatile stock markets.

Figure 7

Recent Weakness in Commodity Prices

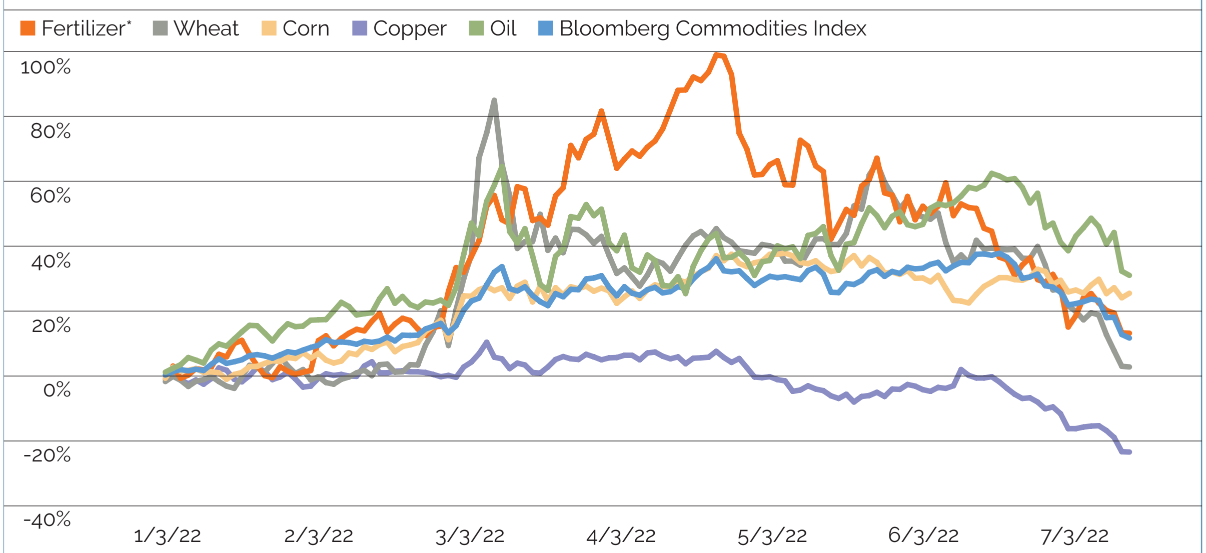

Figure 7 Source: Bloomberg. Data as of June 30, 2022. *Stock price of Mosaic (ticker: MOS), proxy for fertilizer prices.

Course of Action

Although our commentaries typically include many observations on the macro environment, we always rely on our "bottom-up" process to drive portfolio decisions.

Our approach is to invest in a core group of companies that we believe will create long-term value for shareholders. We look to invest in high quality companies with superior management teams and durable business models that we can own for many years. Our investment team focuses on the long-term and uses both 12-18 month and three-year target prices when evaluating the potential upside in an investment, but we also incorporate downside scenarios to help us manage risk and be ready to spot opportunities in a downturn.

To this end, we reduced our exposure in the Industrials sector during the quarter. We continue to have significant exposure to the Healthcare sector, with many companies benefiting from secular tailwinds. Through our bottom-up research process, our team will continue to look for opportunities in the growth focused Consumer Discretionary and Technology sectors, but some caution on the fundamentals is warranted.

Moreover, given the rapidly changing environment we have experienced this year, most of the team's focus has been on managing risk. When thinking about possible downsides, we use a typical market correction framework (over the last 30 years stocks have corrected by an average of 14% annually) and a more severe recession downside scenario (this is a much longer duration event, typically 22 months, with an average decline in the S&P 500 reaching -39%). Fundamental analysis focused on possible earnings contraction, inventory levels, debt burdens, and cash flow strength are even more critical during times of economic stress. For now, earnings for many companies are still forecasted to be strong, but valuations have contracted as skepticism builds. With current market valuations closer to long-term averages, some risk of a recession has been priced in. However, we still anticipate risk to earnings projections if a recession unfolds and believe this process may take some time.

Important Disclosure Information