Investment Solutions

HIGHTOWER MARKET NOTE

with Stephanie Link

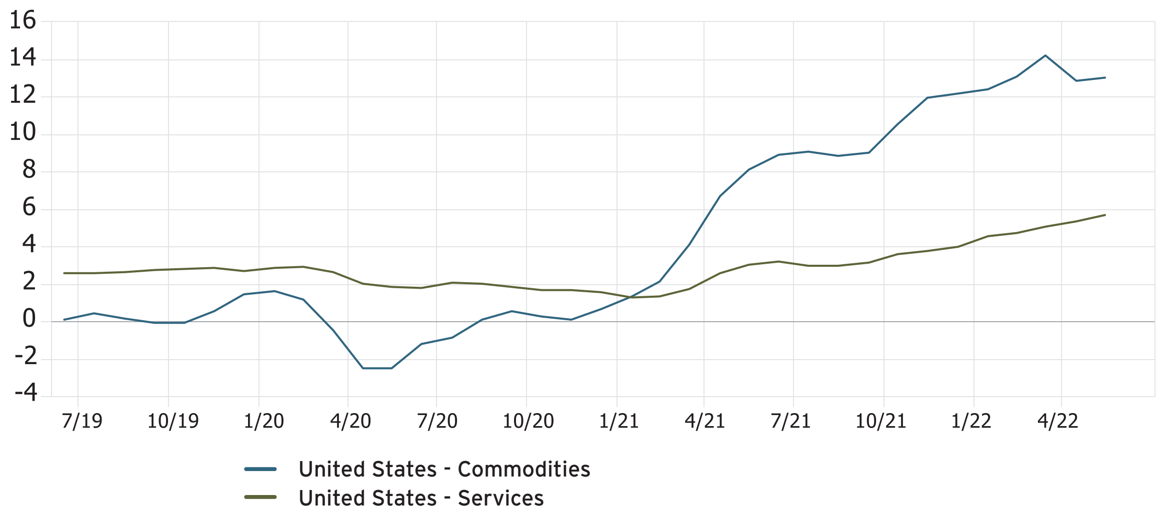
Be Opportunistic When Others Are Fearful

Week of June 21, 2022

1. __Aggressive Fed Taming Demand.__ The Fed is acting on their mandate to create price stability by slowing demand, as they announced raising interest rates by 75 bps last week – the largest such rate hike since 1994. The fed funds rate's current range is 1.50-1.75% and projected to be 3.4% by year end – indicating roughly another 175 bps of rate hikes before 2023.

   We applaud this action by the Fed to move "expeditiously" and finally get ahead of the curve given the resilient inflation and so far robust consumer demand. Inflation is the biggest risk to the consumer (and the economy, since the consumer represents 70% of the economy), underscoring the need for the Fed's aggressive action fighting inflation. Consumer momentum remains driven by healthy balance sheets, job availability and rising wages – aggregate employee earnings are up 9.6% y/y and up 16.1% on a three-year stack (pre-pandemic). While consumer demand has certainly shifted – notably, from goods to services – overall demand remains strong. We're beginning to see pockets of the economy slow, like technology sector hiring and housing demand, while many areas continue to highlight strong momentum, like travel and hospitality, and beauty and luxury retail.

Chart 1: Commodities CPI Peaked, Services CPI Steadily Rising[1]



[1] Source: FactSet (chart)

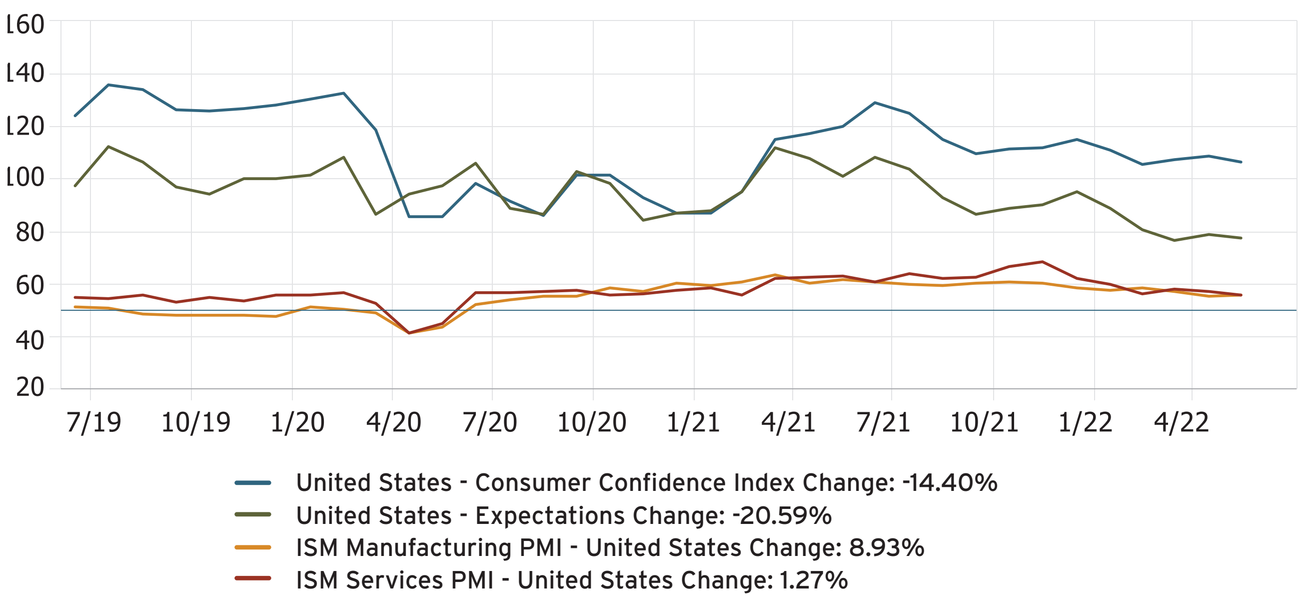
Higher rates are meant to slow inflation, making it more expensive to borrow and taming the pace of rising prices. Slowing demand is only half the equation; the supply-side also needs to recover from post-pandemic shortages and bottlenecks in order for the Fed to execute a soft landing (a rate hiking cycle that does not result in a recession). Fed commentary last week on their aggressive tightening increases likelihood of recession, though our base case remains "no recession in 2022" and "uncertainty in 2023" – we will continue to be data-dependent.

2. <u>Additional Commentary from the Fed and Reaction from Bond Market.</u> Fed Chair Jerome Powell said that additional 75 bp hikes are now on the table at upcoming meetings as they are "acutely focused on returning inflation to their 2% target," and furthermore took unemployment language out of meeting notes. Prior to the announcement on Wednesday, the 2 and 10-year Treasury yields reached their highest levels since 2007 and 2011, respectively; they rallied to finish the week at 3.14% and 3.20%. Municipals sold off early in the week as yields rose 25 bps across the curve, then stabilized and were unchanged in the latter half. Corporate spreads widened during the week, investment grade by 2 bps and high yield by 23 bps.

3. <u>Market Selloff, Market Opportunities.</u> Aggregate next-twelve-months (NTM) price-to-earnings (P/E) of the S&P 500 has fallen from 21.5x to start the year to 15.5x at the end of last week. This selloff (the S&P 500 is down 22.33% year-to-date) presents substantial opportunities to buy at attractive valuations. As mentioned earlier, while certain pockets of the economy are slowing, other areas remain robust.

   Consumer confidence – particularly consumer expectations – has trended downward since mid-2021, when peak-growth was the headline narrative. Meanwhile, ISM surveys, providing guidance on manufacturing and services industries, have remained in expansionary territory for 24 consecutive months. ISM is a diffusionary index where levels above 50 indicate expansion.

Chart 2: Consumer Confidence Below, While ISM Above Pre-Pandemic Levels[2]



While markets have been volatile, we have not experienced a spike in the volatility index (VIX) that would accompany a total market panic scenario as we saw in 2020. We're advocating for investors to avoid timing the market, being selective in their portfolios, and adding to high conviction names at attractive prices.

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[2] Source: FactSet (chart)

4. <u>Upside Narrative: Attractive Valuations, Less Uncertainty.</u> A significant market selloff from record-high valuations, reduced confidence in the Fed, rising inflation and the Russia/Ukraine conflict have all created a strongly negative narrative. Year-to-date, markets have followed that narrative. Markets were priced at very extended valuations prior to this year's selloff – valuations driven by the easy monetary policies of the past decade. 2020-2021 was the highest S&P 500 aggregate NTM P/E since the dot-com bubble in 2000-2002. Today, the S&P 500 is priced below its historical average NTM P/E.

   After the Fed's 75 bps rate hike, remaining uncertainty into how aggressive the Fed will be has been removed from the equation. Bank of America's latest Bull & Bear Indicator fell to zero, which the firm said has historically led to a strong three-month return. CNN's Fear and Greed index is at "Extreme Fear." Meanwhile, U.S. equities saw a sixth-straight week of inflows and JPMorgan noted that hedge funds have kept leverage low and overall positions muted, which could provide future support. Also, China demand appears to have bottomed, with expectations for improving global demand in the months ahead following strict COVID lockdown protocols.

   Despite recession fears, the market's forward-looking valuation shows an improving risk/reward scenario for investors. We will continue watch economic data, with heavy scrutiny on whether consumer demand and supply shortages begin to balance.

5. <u>The Week Ahead.</u>
   Earnings – Tuesday: LEN. Thursday: ACN, DRI, FDX.

Stephanie Link: CNBC TV Schedule

DATE	SHOW	TIME
Tuesday, June 21	Half Time	12:00 PM ET
Wednesday, June 22	Squawk Box	6:00 AM ET (time to be determined)
Thursday, June 23	Closing Bell	3:00 PM ET

Return for Selected Indices[3]

		% CHANGE		
Index Name	End of Week	Week	Month	YTD
S&P 500 INDEX	3,675	-5.75%	-6.19%	-22.34%
NASDAQ COMPOSITE	10,798	-4.76%	-5.36%	-30.71%
DOW JONES INDUS. AVG	29,889	-4.73%	-4.83%	-16.91%
RUSSELL 1000 INDEX	2,017	-5.86%	-6.20%	-23.22%
RUSSELL 2000 INDEX	1,666	-7.43%	-6.01%	-25.39%
FTSE 100 INDEX	7,016	-4.07%	-5.25%	-3.17%
HANG SENG INDEX	21,075	-3.28%	3.13%	-8.65%
NIKKEI 225	27,824	0.23%	6.14%	-2.41%

				% CHANGE		
Index Name	YTW	Spread	Duration	Week	Month	YTD
U.S. TREASURY	3.32%		6.46	-0.52%	-1.89%	-10.34%
U.S. AGGREGATE	3.93%	+61 bps	6.65	-0.92%	-1.99%	-11.48%
U.S. CORPORATE INV. GRADE	4.79%	+147 bps	7.80	-1.19%	-1.64%	-14.89%
U.S. CORPORATE HIGH YIELD	8.51%	+519 bps	4.79	-2.90%	-2.30%	-13.10%
U.S. MUNICIPAL BOND INDEX	3.38%		6.14	-2.00%	0.59%	-10.06%

[3] Source: Bloomberg

Disclosure

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