



Market Update Second Quarter 2022

Dieting is hard

After a poor start to 2022, US stocks declined again in the second quarter. The S&P 500 fell more than 16% over the period, and has dropped nearly 20% year-to-date. While the issues of inflation, quantitative tightening, and Ukraine are all well documented, the decline accelerated in the quarter. So, what happened for US stocks to turn more negative and what is our outlook?

The main driver of equity market weakness in 2022 centers around whether the Federal Reserve's interest rate tightening cycle will simply cool the US economy or cause a full-blown recession as it seeks to suppress inflation. Certainly, inflationary pressures have proven more persistent than "transitory". The Federal Reserve has finally conceded this. After a 25-basis point hike in March and a 50-point increase in May, the Fed raised short-term interest rates by another 75-basis points in June. It had been 28 years since the market had seen a rate increase that large.

Rising prices are not just a United States problem but rampant globally. The Russian invasion of Ukraine added a monkey wrench into the equation, by affecting grain and global energy prices. The war's effect on European energy costs is likely to push many of the continent's economies into recession, adding pressure to a global slowdown. The Fed may now seem serious about curtailing inflation, but its ability to influence global commodity prices is limited. Attempts to cool the economy without successfully restraining prices risks producing stagflation (a recession with inflation). This risk weighed on equities in the quarter.

Additionally, investors are grappling with the reality of a new monetary backdrop. Not only are rising rates a more restrictive element affecting valuations, but the demise of Quantitative Easing (QE) is underway. The monetary experiment of QE, where the Fed regularly purchased bonds to inject liquidity into the market and to artificially suppress interest rates, buoyed markets through the dot-com/Y2K bubble, sub-prime crash, and most recently the Covid pandemic. Now that QE's long-feared most dangerous consequence, inflation, has actually occurred (even if coincidentally), the QE experiment may be indeterminately abandoned and unwound through Quantitative Tightening (QT).

One market concern that is more ambiguous is the perception that the Fed, which had been accommodative to the stock market for the past 40 years, could now prefer Main Street over Wall Street. In prior economic cycles, deflation was prevalent and the Fed's approach to moderating the business cycle provided some inadvertent support for stocks. The term "Fed Put" arose to define the prospect that too much market weakness will prompt the Fed to act to support businesses as employers and equity prices default. While not without flaws, these mechanisms worked pretty well.

Today's dynamic is different. With robust employment, the Fed must address the other aspect of its charter, "...to promote stable prices...". Efforts to tackle inflation are essentially less stock market friendly. The market feasted on friendly monetary practices for 20+ years, but now faces a restrictive diet. Too much stimulus, combined with supply chain issues and pent-up consumer demand, have all contributed to inflation. As the Fed confronts the second part of its mandate, it is less likely to fret equity weakness as long as the labor market is strong. With the Bureau of Labor Statistic's May unemployment rate at 3.6%, it remains near record lows.

All these factors hampered US equities year-to-date and raised uncertainty. However, investing out of fear or on backward-looking data is usually a mistake. We continue to believe inflationary pressures, while pronounced in news headlines, are likely to soften due to restrictive monetary conditions and the Fed's actions to slow economic activity. Consumers are more constrained and the post-pandemic consumption binge has stalled. The velocity of money is under heavy braking. Nevertheless, headline CPI has yet to reflect a drop in inflation and remains above 8% on a year-over-year basis.

So what does it all mean?

Oak's process has always favored quality and sustainability, but that does not mean we are immune to the changes in valuation mathematics. Growth stocks, which have previously enjoyed a premium during slowdowns as their rare earnings abilities are considered valuable, may not be rewarded in light of tighter monetary conditions and persistent inflation. Due to the market's year-to-date correction, valuations have contracted sharply and provide better support today than 6 months ago. We continue to monitor the shifting economic backdrop and, as always, will make adjustments to portfolios as opportunities arise.

It is worth mentioning that upside to US equities exists should inflation abate, we avoid a recession, or if President Putin declares victory and abandons Ukraine. Only time will tell whether the Fed is late to the game or simply pushing on a string as it addresses inflation. Since an uptick in unemployment usually corresponds with a recession, we continue to monitor the labor market closely. Regardless of whether the economy fall into recession or a soft landing, we can ensure our portfolios have high-quality companies and shift exposure based on the upcoming investment environment. Stocks have anticipated both an interest rate tightening cycle and the unwinding of quantitative easing. Outsized movements may occur as equities absorb information but the market's biggest concerns are well understood.

Finally, decades of abundant liquidity have inadvertently benefited lower quality, high-beta, and riskier investments. With cheap funding and a tolerance for long paths to profitability, the overall quality of US equities has deteriorated. The decline is reflected in both the number of unprofitable companies on US exchanges and the percentage of “zombie companies” (businesses that do not earn enough to cover their interest expense and yet have endured despite the viability risk.) We believe these segments should be avoided. Fortunately, another aspect of Oak’s investment process includes a focus on companies which demonstrate a respect for shareholders and positive capital reinvestment. The combination of quality and profitability are likely important characteristics in the foreseeable market environment.

Thank you for reading. Please call with any questions.

Kindest Regards,

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