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Wealth Advisory Market Update

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Market Update

Europe dominated the economic headlines last week, and the news wasn't pleasant. Gas supply issues, Italian political turmoil (PM Mario Draghi stepped down), and the European Central Bank (ECB) raised rates for the first time in ten years in anticipation of a growing economic downturn. We can't fail to mention Europe's prevailing inflationary headwinds (Stagflation).

Fast forward to this week and it is all about the USA. There are some key Federal Open Market Committee (FOMC) events taking place this week that will begin to shape our market thesis for the next few months. The FOMC meets on Tuesday and Wednesday with an announcement at 2 p.m. Wednesday where we will hear policy decisions on rate increases and continued pace of Quantitative Tightening (QT). Earnings will also be in focus this week. Along with the FOMC announcement, 50% of the S&P 500's market cap will report earnings this week. Guidance is our main focus on earnings calls. For example, Walmart has already lowered guidance this week. At this point, second quarter earnings are stale; we want to position for the future.

On the macro side, I expect the US GDP print on Thursday to show us in a technical recession. Inflation will be in focus as well, with the Federal Reserve's favorite inflation indicator (Core PCE). So far, July has been smooth sailing because of the lack of data but we expect volatility to begin to pick up once again.

This is the Federal Reserve's biggest meeting of the year. Let's be clear though, no matter whether they hike by 75bps or 100bps, *guidance* going forward is key. We will be looking ahead to Federal Reserve Chairman Jerome Powell's press conference after the release of the FOMC decision. If the Federal Reserve keeps a hawkish tone, the market will have to reset expectations. Currently, most market participants expect a pause after this meeting to reassess economic data before tightening further. In our opinion, this won't happen. The FOMC has been behind the curve from the beginning, and the last thing we want to see is persistently higher inflation. The question is, does the current voting board of governors have the stomach to do what it might take to tame inflation, and will policy makers force the hand of the "*independent"* FED? If the Fed follows its mandates, and gets real rates back to even, we should expect a hawkish tone. We want the Fed to try to get ahead of the curve but we don't expect the Fed Funds rate to reach 6+% which is the level the textbook tells us it needs to be.

My thought on this is simple, I believe inflation will begin to moderate over the next few months. Recent economic data shows consumer spending has weakened, and revolving credit has exploded as savings dwindle. Employee resignation rates have begun to slow, job openings have come down, and layoffs have begun. All of these factors point to slower growth and lower inflation going forward (recession). We believe the neutral rate lies somewhere in the 3-4% range.

Also, company earnings and guidance will be dictating market direction over the next few months. This is actually the most important factor over the long term, but much less so in the short run. This week, 50% of the S&P 500's market cap will be reporting. The companies reporting have major market share in their respective industries and are a great gauge of overall economic health. Their second quarter earnings are important, but more important is their guidance going forward. So far, earnings have been relatively strong but guidance hasn't been great. This is causing earnings estimates from analysts to be brought down significantly. Most CEO's report that margins have suffered, which is due to rising costs and a slowing consumer.

Some companies have reverted back to giving no guidance due to the uncertainty of the economic backdrop. This lack of guidance gives rise to more uncertainty and drives volatility. This is why we structure our portfolio's the way we do. In my opinion, the type of companies we buy, and that we currently own, are well positioned with pricing power and dominant market share. Even in a more severe recession occurs, our stocks will go down but they will still produce a stream of cash flows (dividends and buybacks). These companies will also be the first to bounce back when the recovery takes place. We don't invest on a quarter-to-quarter basis. As investor's we are looking out over 5-10 years at different growth scenarios to see if each company will be worth more in the future than it is now. We feel our portfolios reflect this approach well.

On the back burner, but still important, are the macro data points coming out this week. We believe they will show the US is in a technical recession, which is two consecutive quarters of negative GDP prints. We also expect PCE inflation data to come in high once again. Because of the timing of the data releases, Thursday and Friday, it will not play a role in the Fed decision. It may however, begin to shape the narrative for the future Fed meeting in September. A hot inflation number this month and next, will guarantee a continued hawkish stance by the Fed in September. This would get us to the 3-4% range on the Fed funds rate, which is where we think the current neutral rate lies.

As we mentioned, we expect inflation to moderate later in the year giving the Fed some breathing room. We will be following this closely. Even though over the longer term it doesn't affect our thinking about the stock market, it has everything to do with our positioning in fixed income and other more tactical decisions.

This is a snapshot of the current trends, although they could change in the future. Economic data coming out in the near future could alter our outlook. If this occurs, we will be quick to assess and make adjustments to our portfolios. As always, we continue to navigate this difficult environment to the very best of our ability. We at AMB thank you for your support and for allowing us to partner with you in reaching your financial goals.

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