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MARKET COMMENTARY - May 17, 2022



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By Rob Edel, Chief Investment Officer

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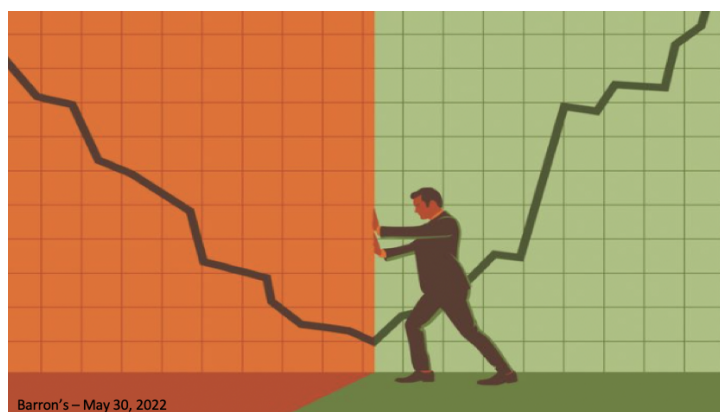
Highlights this Month

- The S&P 500 is key when calling a bear market.
- 2022 has presented the fourth-worst start to the year for stocks in 90 years.
- It's tempting to buy the dip after stocks have fallen. Who doesn't like buying things on sale?
- Why is all this important?
- How much the Fed will need to tighten money supply will largely be determined by inflation.
- Can inflation be tamed without a recession? Here is our verdict.

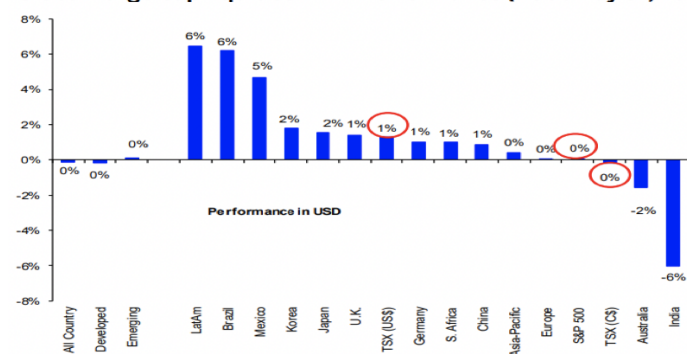
May in Review

Until the last week of the month, May was shaping up to be a continuation of the drawdown seen in markets in 2022, with the S&P 500 coming ever so close to falling into bear market territory. On May 19, by the end of day, the S&P 500 was down 5.4% in US dollar terms and a further 18.4% from its January 3, 2022, high: the brink of a bear market. On May 20, the S&P 500 slipped below the 20% threshold intra-day but finished the trading day above the 20% level. The following week, however, markets pushed back, with a rally that left the S&P 500 up 0.2% (basically flat) for the month and down 12.8% year to date.

Strategas shows that the S&P 500 rallied 9% over five days, which, while impressive, is less so when compared to other bear market rallies since 1950. Their research also indicates that the average bear market rally has lasted more than 34 days and increased by over 15%. Notice Strategas is inferring that the S&P 500 is in a bear market. The tech-heavy NASDAQ has been in a bear market since March, down 8.6% in May and 27.8% year-to-date (negative 29.5% from November 19, 2021) before rallying to end the month down a mere 1.9%. Still, down 22.5% year to date shows there is no question that the NASDAQ experienced a bear market rally last month. The S&P/TSX, on the other hand, got nowhere near bear market territory, falling as much as 5.0% mid-month before rallying to end the month flat and down a mere 1.3% year to date. On May 12, the S&P/TSX was 10.5% off its March 29th high in official correction territory, but that's as low as it got. For those counting, that's one bear rally, one near bear rally, and one non-bear rally (so far, anyway).

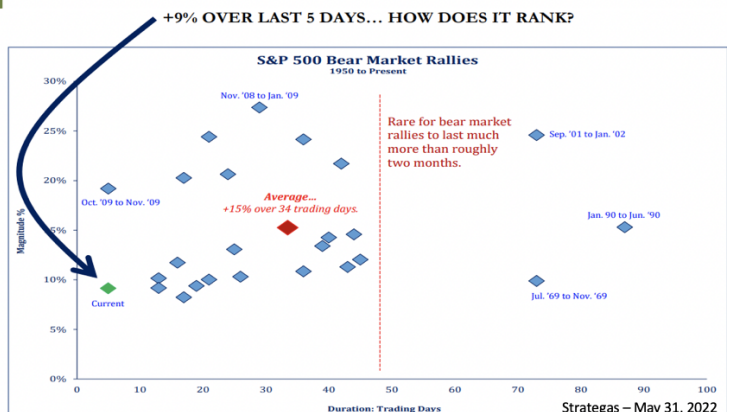
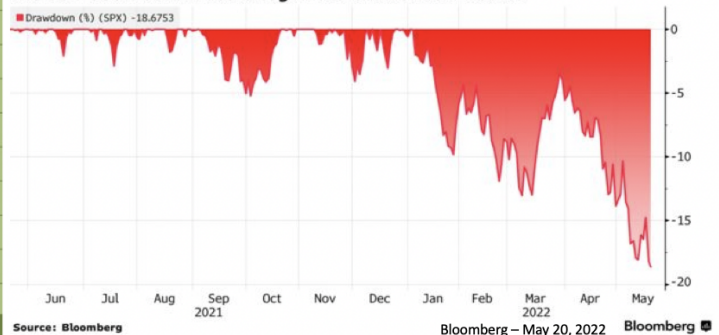


Global Large Cap Equities: MTD Performance (As at May 31, 2022)



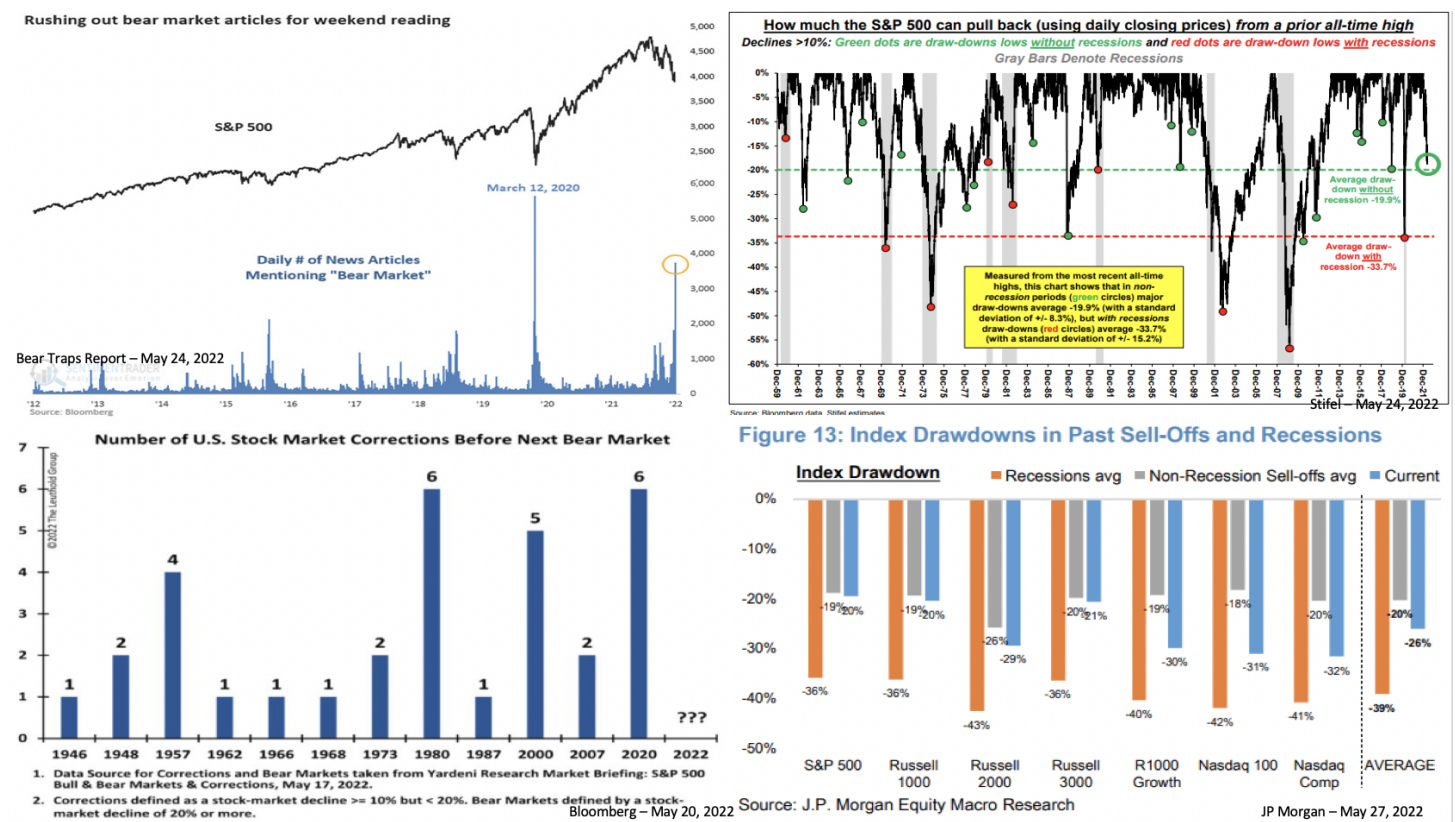
Based on MSCI indices unless otherwise indicated Scotiabank – June 1, 2022

Still on Bear-Market Watch
The S&P 500's decline has brought it to brink of bear market



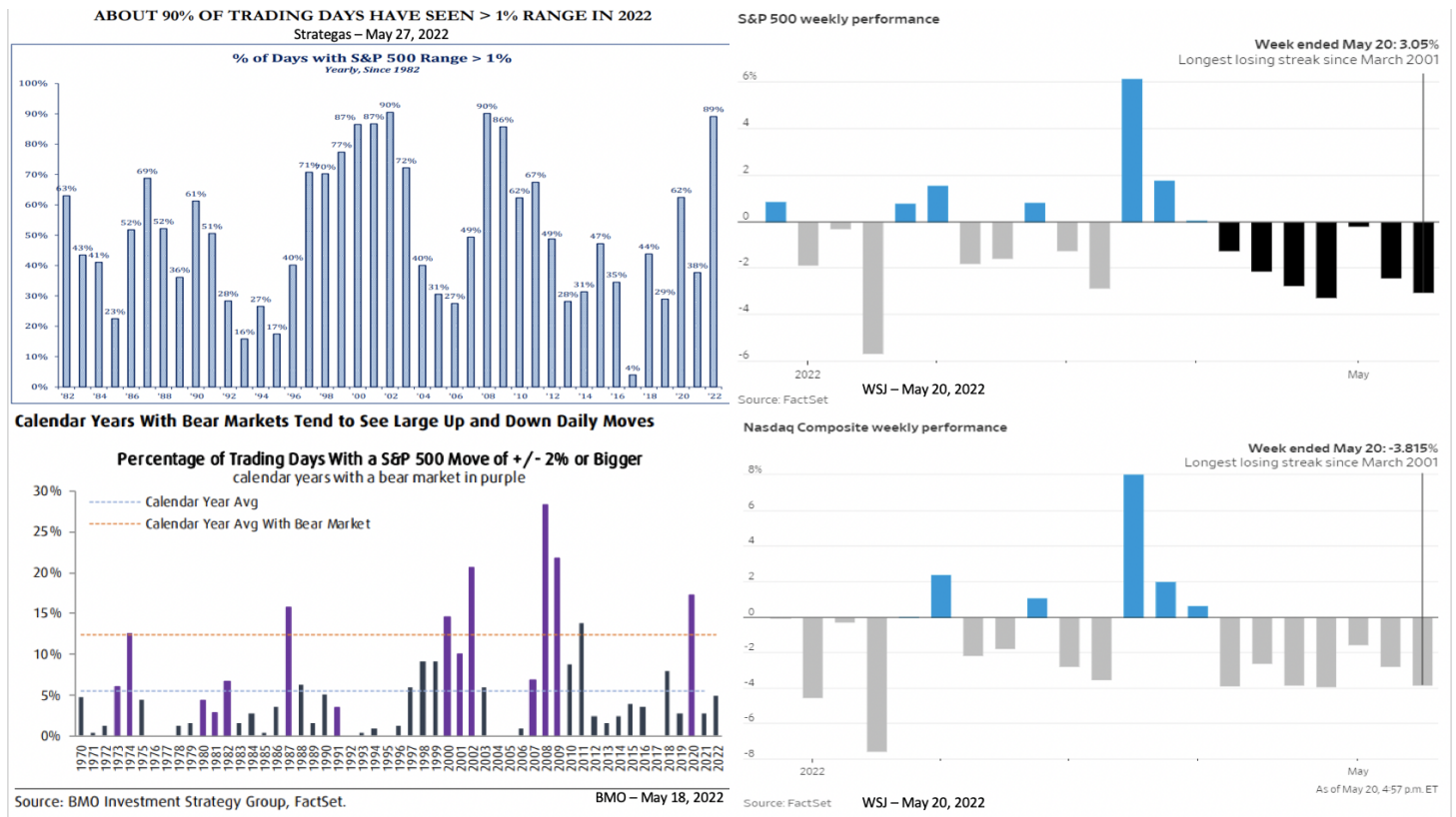
The S&P 500 is key when calling a bear market.

Its close call last month has led to an influx of bear market articles as it seems inevitable that the US large-cap stock index will enter a bear territory shortly. Not willing to concede the point, a recent Bloomberg article pointed out that bear markets have historically been preceded by at least one market correction (a price decline of more than 10% but less than 20%). If the current swoon is a bear market, it would be the first in the post-WWII era without a 10% plus drop in prices before markets experienced a more considerable 20% plus decline. Jim Paulsen, Chief Investment Strategist from Leuthold Group, points out that there has not been a 10% plus drawdown in the S&P 500 since the March 2020 low, so if we are indeed in a bear market, it will be a postwar record. As we discussed last month, the market's fate likely depends on the economy's ability to avoid a recession. According to the American Investment Bank Stifel, the average non-recession drawdown for the S&P 500 has averaged negative 19.9% versus negative 33.7% during a recession. JP Morgan reports similar statistics, a 36% drop for the S&P 500 if there is a recession and a 19% drop during non-recession sell-offs. Following these historical guidelines, if the economy avoids recession, we may have seen the worst for this stock market drawdown and may even avoid an S&P 500 bear market. However, if we have a recession, we are likely only halfway through the current drawdown, and a bear market is a given.



The verdict? BMO's Investment Strategy Group states that bear markets have historically tended to see a more significant number of up and down days, which Strategas points out has been common in 2022. As of late May, about 90% of trading days have seen stocks trade in more than a 1% range. Also influencing

the jury towards proclaiming a bear market verdict, before its epic 9% rally at the end of May, the S&P 500 and the NASDAQ were on a seven-week losing streak, the most prolonged consecutive weekly decline since 2001. The Dow notched eight down months in a row to break a record dating back to 1932.



2022 has presented the fourth-worst start to the year for stocks in 90 years.

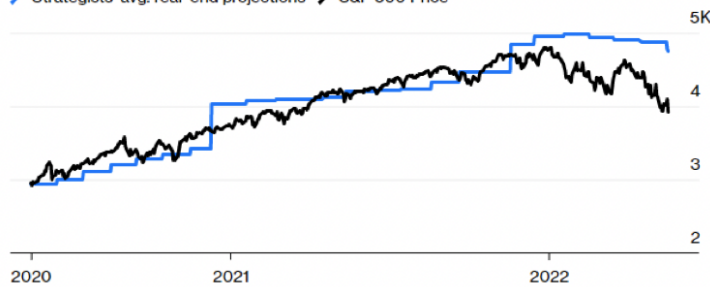
Research presented by JP Morgan shows that only the Great Depression (1932), World War II (1940), and the Vietnam War (1970) have seen the S&P 500 fall more than 2022's negative 17.3% year-to-date return. What this means for the rest of the year is unclear, but 1932, 1940 and 1970 did see the S&P 500 post solid returns for the rest of the year. Tallying up the S&P 500's worst five-month starts to the year, Strategas finds that performance for the rest of the year is somewhat of a coin flip. Average returns are negative 0.5%, with positive and negative years evenly split. In some years, like May 2008, when the S&P 500 fell 4.6% and dropped an additional 35.5% by the end of the year, investors felt like they were catching a falling anvil. However, in 1982 the S&P 500 fell 8.7% in the first five months of the year, then went on to rally 25.7%. According to a recent Bank of America Fund Manager Survey, investors are focused on hawkish central banks and global recession, viewing them as the most significant risks to the market. These concerns seem reasonable to us. Central Banks need to get inflation under control, but in doing so, they risk driving the economy into recession and stocks into a bear market. Figure out what central banks will do, and investors can probably determine whether we are in a recession and a bear market. Of course, it is easier said than done, but we attempt to present our case below.

From Wall Street's perspective, they hate to forecast bear markets. Wall Street is in the business of selling stocks (and bonds), and bear markets are bad for business. According to Bloomberg, while strategists have been cutting their target levels as the S&P 500 has fallen, they still see upside left in their 2022 forecasts. Year-end targets are wider than usual, however, showing more discord than expected as a few "honest brokers" break ranks. Morgan Stanley, for example, is one of the more bearish on the street, but even they assign a healthy range to their forecasts. As of mid-May, their bullish forecast sees the S&P 500 11% higher by year-end, while in their bearish scenario, they see the S&P 500 falling another 17% to the 3,350 level. The drop would leave the S&P 500 with a 30% drawdown from its January 3, 2022, high. In early June, Morgan Stanley updated their base case, forecasting a fall of 17% in the S&P 500 to 3,400 by August. According to Strategas, the average bear market in the post-WWII era has lasted 15 months and fallen 33.8%. A 33.8% fall would take the S&P 500 down to 3,174, lower than even bearish Morgan Stanley's bear scenario target. So, we can make the case that it can go even lower. Can, not will, mind you, no guilty verdict quite yet.

Looking Up

Strategists are cutting their S&P 500 projections but still see upside

Strategists' avg. year-end projections S&P 500 Price

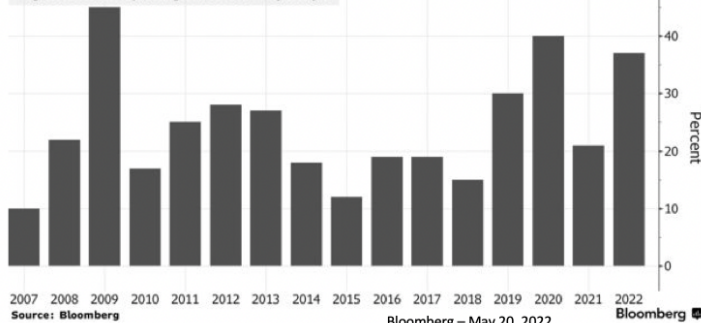


Source: Bloomberg data Bloomberg – May 18, 2022

Split Views

Strategists' year-end targets for S&P 500 show a wider range than usual

Highest versus lowest price target for S&P 500 in May each year



Source: Bloomberg

Bloomberg – May 20, 2022

Exhibit 4: Our S&P 500 Bull/Base/Bear Case Targets

S&P 500: Morgan Stanley Fwd. 12-Month Price Targets



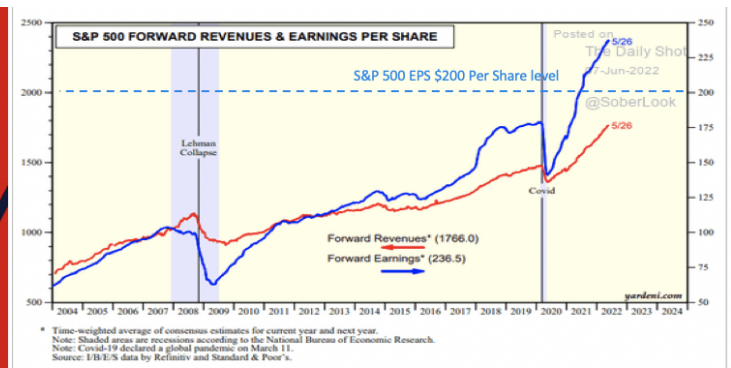
Source: FactSet, Bloomberg, Morgan Stanley Research estimates. Morgan Stanley – May 16, 2022

S&P 500 Bear Markets

Start Date	Start Price	End Date	End Price	Duration (Months)	Percent Change	Implied S&P 500 Level from 2022 Closing High
5/29/1946	19.3	6/13/1949	13.6	37	-29.6%	3376
8/2/1956	49.7	10/22/1957	39.0	15	-21.6%	3759
12/12/1961	72.6	6/26/1962	52.3	6	-28.0%	3455
2/9/1966	94.1	10/7/1966	73.2	8	-22.2%	3733
11/29/1968	108.4	5/26/1970	69.3	18	-36.1%	3067
1/11/1973	120.2	10/3/1974	62.3	21	-48.2%	2484
11/28/1980	140.5	8/12/1982	102.4	20	-27.1%	3496
8/25/1987	336.8	12/4/1987	223.9	3	-33.5%	3189
7/16/1990	369.0	10/11/1990	295.5	3	-19.9%	3841
3/24/2000	1527.5	10/9/2002	776.8	31	-49.1%	2439
10/9/2007	1565.2	3/9/2009	676.5	17	-56.8%	2073
2/19/2020	3386.2	3/23/2020	2237.4	1	-33.9%	3169
Strategas – May 13, 2022		Average:		15	-33.8%	3174

Drawing back the curtain on S&P 500 price targets, through a combination of lower valuations (P/E multiple) and lower earnings, a case can be made for a target index level of 3,000. Current P/E levels are around the 10-year average at around 17 times earnings, but according to Strategas' models, current conditions justify a 15 times valuation. On the earnings front, 2022 and 2023 earnings forecasts still show a rising trend, but given the expected tighter financial conditions, high inflation, and a strong dollar, \$200 per share does not look unreasonable. Historically high-profit margins look to be rolling over and are threatening to take earnings down with them. Strategas also claims that current economic trends

suggest a decline in profit margins of 4.4%, which when applied against First Call's 2021 S&P 500 EPS level of 209.38 would imply earnings for 2022 of roughly \$200 per share. Put a 15 times multiple on \$200 and you get a 3,000 target for the S&P 500, or down 37% from the January highs, and very close to the average recession bear market. Strategas believes S&P 500 earnings can fall to 70% of peak pre-recession earnings, which are \$229 and would result in earnings falling closer to \$160. Slap a 15 multiple on \$160, and you get 2,400, which would leave the S&P 500 down a discouraging 50%. While this may seem a lot, keep in mind stocks have seen a remarkable rally off the March 2020 pandemic lows. If one were to look through the pandemic and project a 7% return from the end of 2019 forward, the current level of the S&P 500 would appear on track to a year-end target of 4,000, which is 132 points lower than where we closed at the end of May. A 37% drawdown would only take us back to 2019 levels, hardly a dramatic setback given the challenges over the past couple of years—score one for the prosecution and a guilty (or bear market) verdict for the market.



Source: [Yardeni Research](#) The Daily Shot – June 7, 2022

		S&P Operating		Implied	
	Probability	Earnings	Multiple	Index Level	Contribution
Recession*	40%	\$158	16	2,528	1,011
Soft Landing	50%	\$233	16	3,728	1,864
Stick-the-Landing	10%	\$250	18	4,500	450
		\$200	15	Expected Value:	3,325
* Recession earnings are estimated at roughly 70% of peak pre-recession earnings of \$229.					3,000
* Multiples may stabilize as long rates fall.					
Strategas – May 20, 2022					

It's tempting to buy the dip after stocks have fallen. Who doesn't like buying things on sale?

A little perspective is needed because while stocks are cheaper than they were at the start of the year, this is solely due to the fact that they gained so much last year. Retail investors are particularly vulnerable to missing this point. While systematic funds, hedge funds and mutual funds, the so-called "smart money," have been selling stocks, retail flow continues to move into stocks, with individual investors pumping a record \$28.2 billion into US stock ETFs in March as they continue to buy the dip. Of

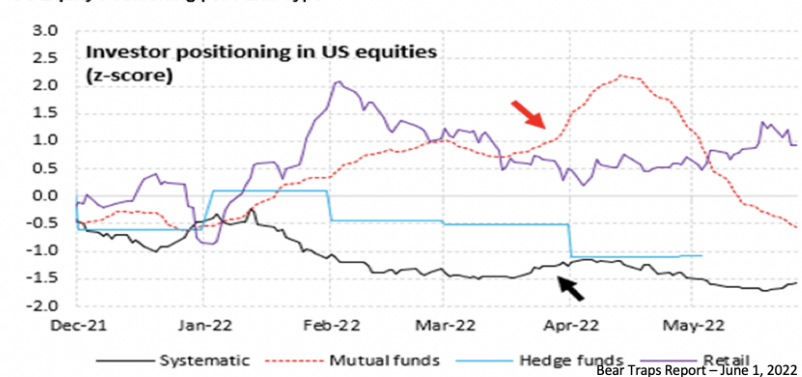
course, if we have seen the lows, this might turn out to be a good call, though it would be unusual for leadership in a new bull market to remain the same as that in the last bull market, a point that retail investors also appear to be missing. According to Strategas, flows into the ARK Innovation ETF were a positive \$1.8 billion year to date, despite losing nearly 54% so far this year. Likewise, the triple-long NASDAQ ETF (TQQQ) took in \$7.7 billion, even though it is down 62% for the year. On the other hand, energy continues to get no respect. The energy sector ETF took in a non-material \$23 million, even though it has gained nearly 46% this year in a down market. Retail investors are a weak witness for the defense in the bear market trial and buckle under cross-examination—one more for the prosecution.



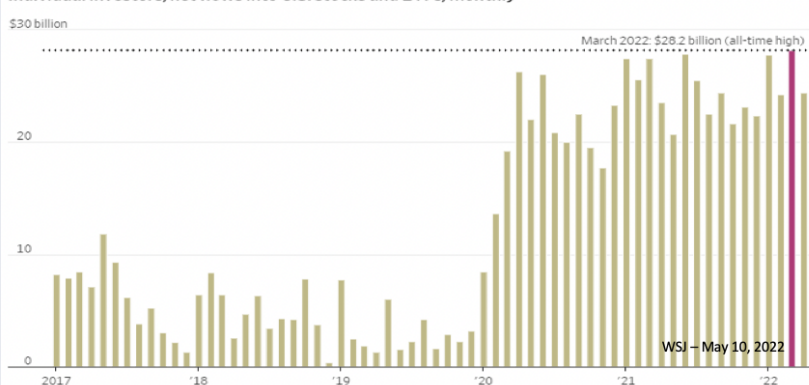
ETF	YTD Performance	YTD Flows (\$MM)
3x Long QQQ (TQQQ)	-62.0%	\$7,668
Long Duration Treasuries (TLT)	-21.3%	\$3,811
ARK Innovation (ARKK)	-53.9%	\$1,794
Energy Sector (XLE)	45.5%	-\$23

Strategas – May 24, 2022

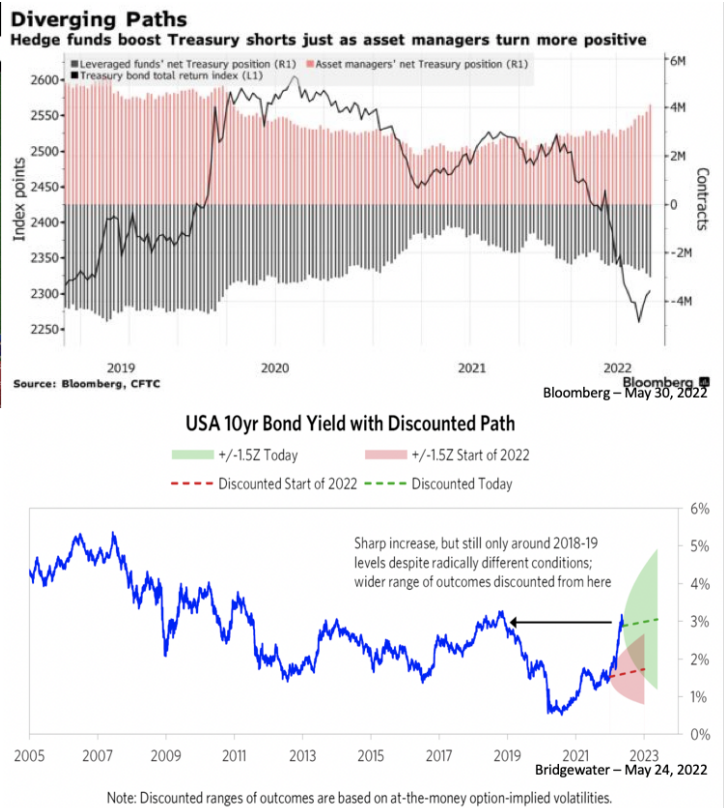
US Equity Positioning per Fund Type



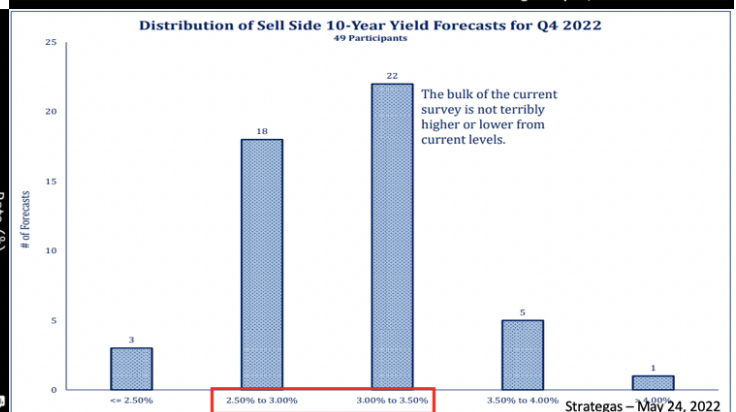
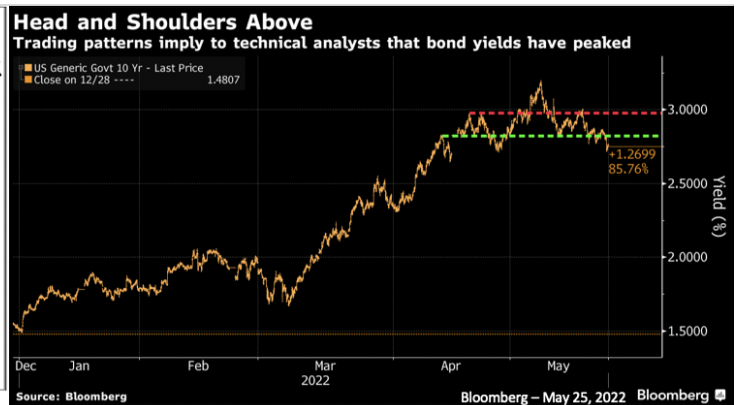
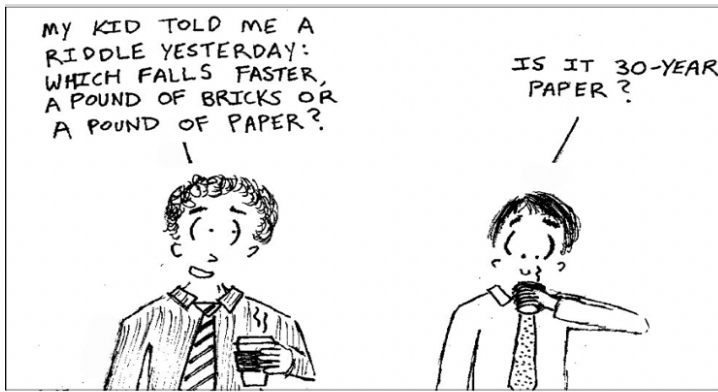
Individual investors, net flows into U.S. stocks and ETFs, monthly



Not only are stock investors continuing to buy the dip, but bond investors are also buying the dip, with the shares of the iShares 20+ Year Treasury Bond ETF soaring this year. Also adding to their bond holdings have been asset managers, who have seen their net Treasury position increase, despite the decline in bond returns this year. Of course, for each buyer there must be a seller, and for bonds that have been hedge funds, which have increased their short positions in betting against Treasury bonds in the belief that bond yields have further to rise. According to Bridgewater, the difference in opinion is understandable given they believe a wider range of yield outcomes is currently being discounted in the market.



The bond market's testimony could be key in determining whether the move in stocks last month was a bear market rally (a rally within a longer-term bear market) or the start of a new bull market. After peaking at 3.13% in early May, US 10-year Treasury yields appeared unable to stay above the 3% level, drifting lower to close the month at 2.85%. From a technical perspective, 10-year yields have formed a head and shoulders pattern, implying yields may have peaked. According to a survey by Strategas, most respondents don't see 10-year yields moving much higher or lower from here. As a recent Bloomberg article pointed out, 3% is becoming the magic number for the bond market, with both Fed Funds and 10-year yields converging at this level. If yields have peaked and 10-year rates stay below 3%, maybe a bear market can be avoided. A break back above 3% would likely blow the defendant's case apart and signal a bear market is in progress. Based on the decline in yields at the end of May, score one for the defense.

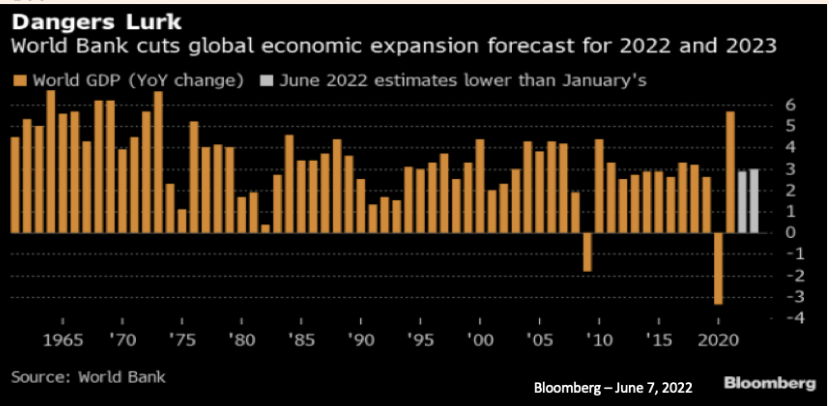
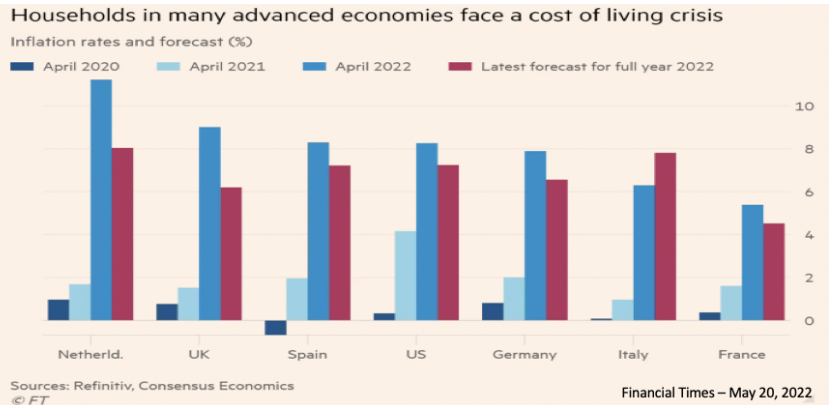
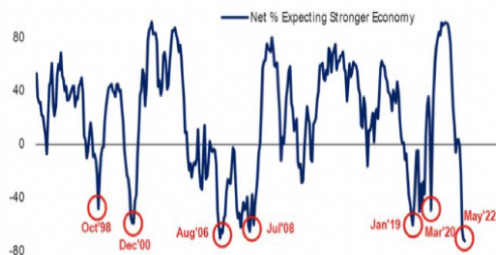


The bond markets take their cue from the economy, and with global growth facing an uphill battle, it becomes harder to make the case that yields should move higher. According to a Bank of America Fund Manager survey in May, investors are the most pessimistic about global growth in the survey's history, which dates back to 1994. Economic growth in Europe and the US slowed in May as purchasing manager indices turned lower, and as pointed out in a recent Financial Times article, households in advanced economies are facing a cost-of-living crisis due to soaring inflation rates. In early June, the World Bank cut its estimate for global growth in 2022 to 2.9% from January's 4.1% forecast and April's 3.2% prediction, down significantly from 2021's 5.7% global economic expansion. The World Bank believes that many countries will find a recession challenging to avoid. A credible witness: The World Bank.

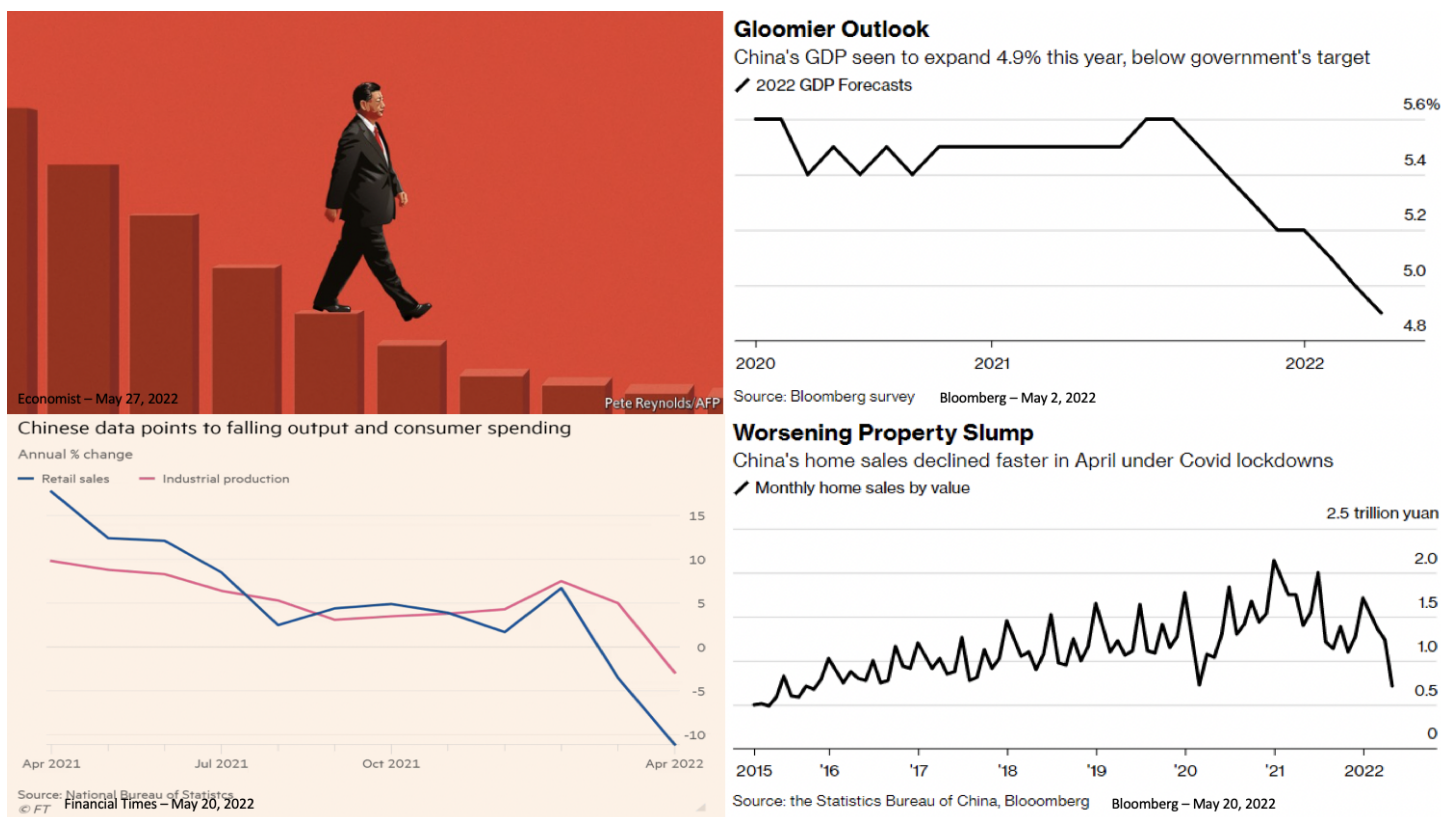


Chart 5: Global growth optimism at new record lows

FMS net % expecting stronger economy

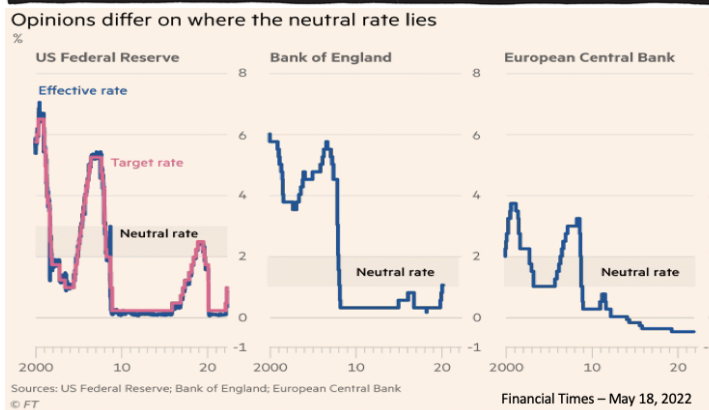


And don't expect China to bail out global growth as it did during the Financial Crisis. On the contrary, President Xi's covid lockdown strategy is helping walk China's growth rate lower as consumer spending plummets and housing sales grind to a halt.



Why is all this important?

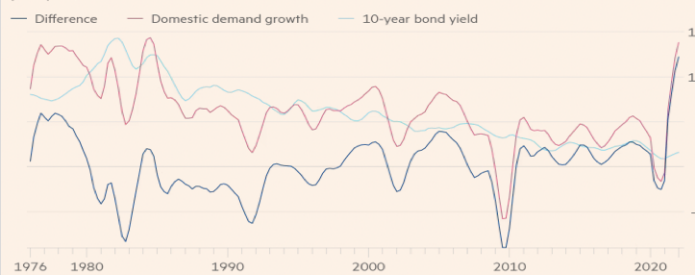
Investors' two most significant risks are hawkish central banks and global recession. A tightening central bank is bad for the economy and the market, but if the economy slows too much, markets will start to anticipate an end to the tightening cycle. It's a case of bad being good and is one of the reasons the market rallied the last week of May. Ideally, the Fed would like to slow the economy just enough to slow inflation, but not so much that they create a recession. It's a narrow landing strip, with plenty of opportunities for them to skid off the runway. To slow inflation, they need to move interest rates above the so-called neutral rate, which is more art than science, as there are many different opinions on where the neutral rate lies. In April, markets were worried the Fed would prove too aggressive and make a policy error by tightening too much, thus choking the economy into submission. In May, rate hike expectations backed off a bit, with Fed Funds futures indicating rates early next year would stay below 3%. Two-year Treasury yields, a good proxy for where Fed funds are expected to peak in the current tightening cycle, also stabilized or even drifted lower.



While some worry about a policy mistake with an aggressive Fed raising rates too much, others believe the error would be a pre-mature pivot that fails to control inflation and results in an unanchoring of inflationary expectations. Once inflation becomes unanchored, it takes even tighter financial conditions and a more severe recession to rein in price increases. In other words, stagflation. In May, Martin Wolf of the Financial Times alluded to the danger of stagflation if central banks don't throttle inflation now, even if it means risking some economic pain. With the gap between the growth of nominal spending and interest rates in uncharted territory, high inflation is at risk of becoming the new normal. So far, the Fed appears to be heeding Mr. Wolf's warning, risking slower economic growth and higher unemployment to tame inflation. While the Fed has only raised rates 75 basis points as of early June, financial conditions have already tightened to levels seen in 2018, even though it took twice the number of rate increases in 2018 to achieve the same level of monetary tightening. As pointed out by Bridgewater, by the time equities had fallen 15% in 2018, 2-year yields had already fallen 50 basis points as the market began to anticipate the Fed pivoting into an easing cycle, which they did. In 2022, despite a similar 15% drawdown in stocks, the Fed is still hawkish, and 2-year yields are holding steady. The strength in stocks and decline in bond yields at the end of May were a sign the markets aren't convinced that the Fed will do the job if the economy comes under pressure, and they may be right.

The gap between growth of nominal spending and interest rates is unmatched in almost 50 years

Growth in US nominal domestic demand compared with 10-year bond yield (% average over past year)



Sources: US BEA, FT
Financial Times – May 24, 2022

Back to the Future Financial conditions have tightened to levels seen in 2018 hiking cycle



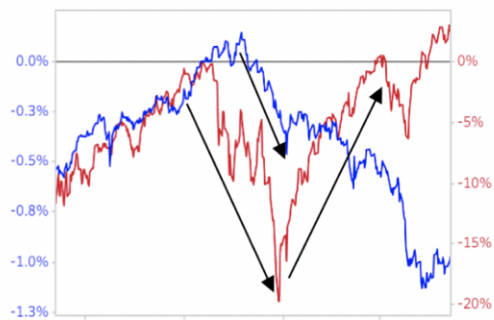
Source: Bloomberg

Bloomberg – May 17, 2022

2018 Drawdown (Indexed to Stock Peak)

— US 2yr Yield — US Stock Prices

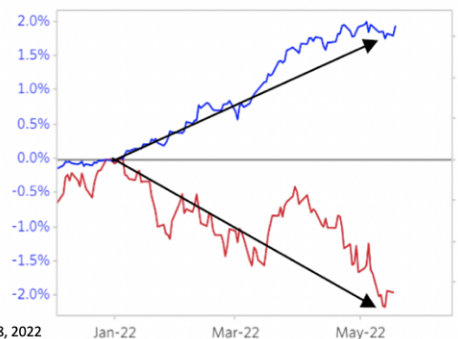
In 2018, by the time equities had fallen 15%, 2-year yields had already fallen by 50bps as the market expected the Fed to pivot back to easing; equities quickly rebounded once this thesis was confirmed



Bridgewater – May 18, 2022

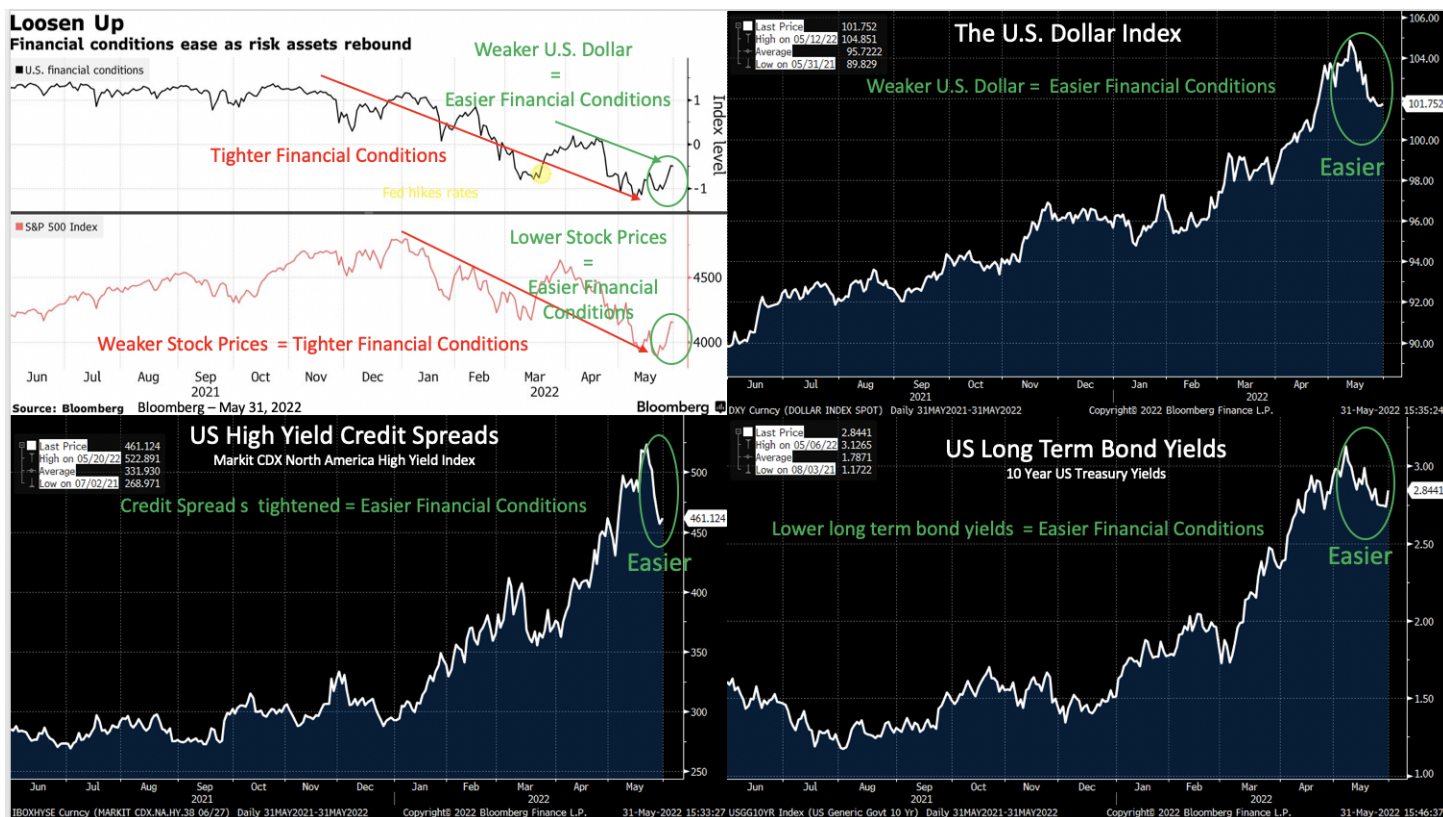
2022 Drawdown (Indexed to Stock Peak)

— US 2yr Yield — US Stock Prices



Today, the Fed put is nowhere in sight; despite a similar 15% sell-off in equities, 2-year yields continue to push higher as high levels of inflation force policy makers to adopt a tighter stance

The Fed has just started its tightening cycle, but they have been aided by the market's anticipation of higher rates, resulting in a material tightening in financial conditions. However, the rally in the last week of May reversed some of this tightening, making it more likely the Fed will need to maintain its hawkish stance. Not only did stock prices rally, which plays a role in easing financial conditions, but credit spreads tightened, 10-year yields fell, and the US dollar weakened. All helped ease financial conditions, which is the opposite of what the Fed is trying to accomplish.



How much the Fed will need to tighten money supply will largely be determined by inflation.

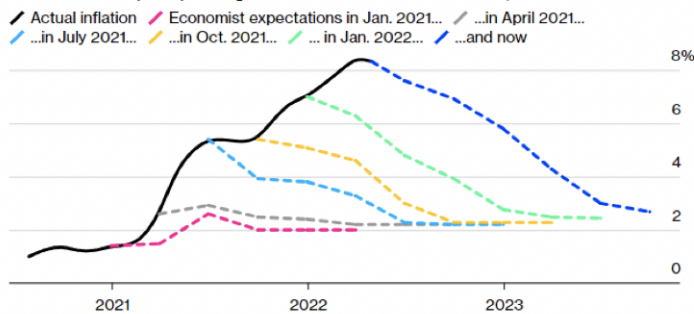
It's the proverbial "smoking gun" in this trial. Many believe the Fed is behind the curve in taming inflation and will need to aggressively raise rates and tighten financial conditions even more to get inflation back near its 2% target range. Others still believe inflation is transitory and a slowing economy and structural longer-term disinflationary forces will bring prices under control, and the Fed's action will only result in unnecessary harm to the economy. So far, those in the inflation camp have had the upper hand until the last week in May. Then, an increase in initial jobless claims and news from the National Federation of Independent Business that small business owners are finding it easier to fill jobs and are planning to raise wages less gave rise to the idea that tightness in the job market might have peaked.

A turn lower in financial market inflationary expectations reinforced the notion that perhaps inflation had also peaked. A recent Strategas survey of institutional investors found that 74% believe we have seen the highs for inflation for the next three years. Word of caution, however, economists have been forecasting inflation to subside since January 2021, and so far, they have been wrong. Regardless, if inflation has indeed peaked, it is more likely the Fed could use it as an excuse to pivot and end its tightening cycle earlier than expected. Markets would likely react favourably, and a bear market may be avoided, but if inflation remains high and longer-term inflationary expectations move higher, a bear market is inevitable.



Not Fade Away

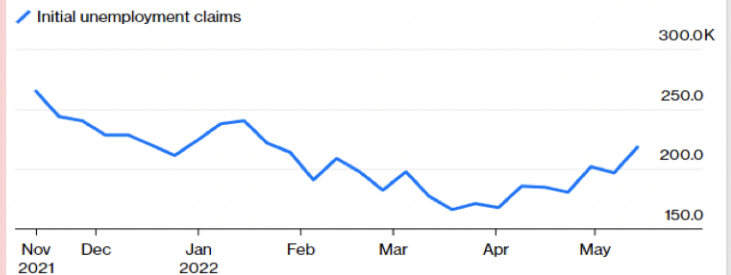
Economists kept expecting US inflation to subside. So far, it hasn't



Bloomberg – May 13, 2022

Layoff Wave

The labor market is beginning to see more churn as some workers lose their jobs



Bloomberg – May 24, 2022

A Breaking Inflation Wave

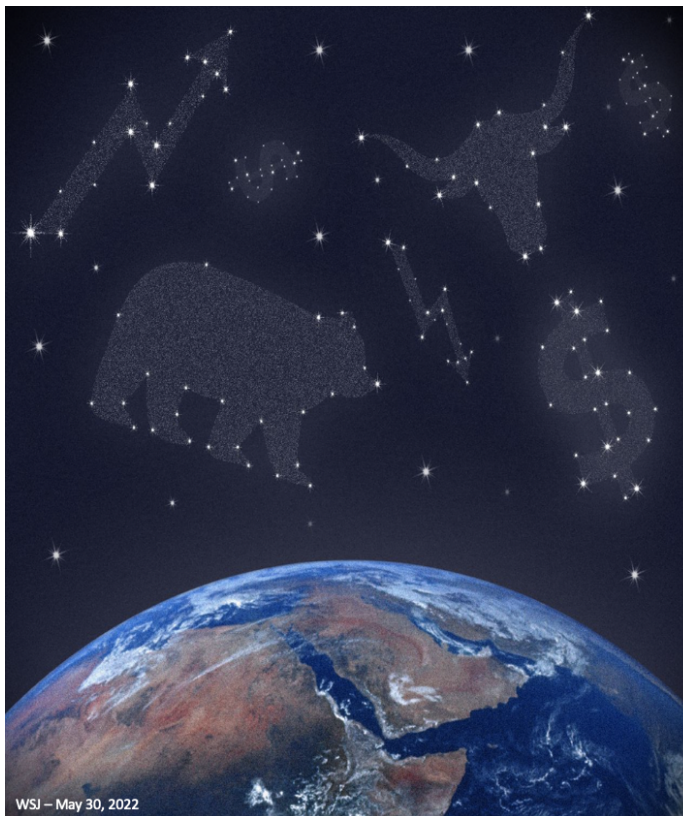
Longer-term forecasts have turned sharply downwards this month



Bloomberg

Can inflation be tamed without a recession? Here is our verdict.

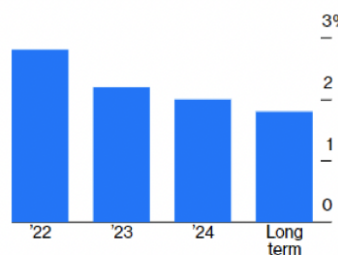
While it's possible inflation can be controlled without a recession, it is unlikely. The Fed hopes to tame the job market by reducing the number of job openings rather than actual jobs. If they can do this and wage growth declines, maybe they can tame inflation without causing a recession. Not impossible, but unlikely. They likely blink once growth slows and revert to their easy-money policies. While the market may like this in the short term, dealing with entrenched inflation down the road will require an even more severe recession: short-term gain and longer-term pain. To add a little levity to ease the tension of the current situation, we remember a quote by Woody Allen: "More than any other time in history, humankind faces a crossroads. One path leads to despair and utter hopelessness. The other to total extinction. Let us pray we have the wisdom to choose correctly." Of course, this dramatically overstates our current predicament but conveys policymakers' tough choices. We would accept a mild recession now, even if it means a 32-37% drawdown in the S&P 500, if it sets us up for more sustainable growth in the future. But, of course, it's not our decision. Central Banks remain the judge and jury of this market.



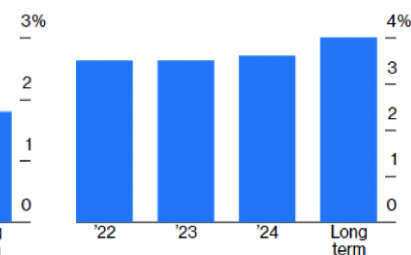
More Explanation Needed

The Fed expects inflation to cool even without much of a rise in the unemployment rate. Why?

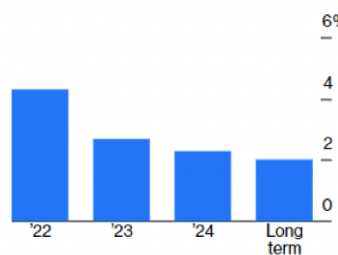
Real GDP



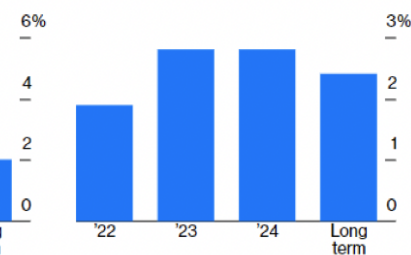
Unemployment rate (Q4)



PCE inflation



Federal funds rate (Q4)



Source: Federal Reserve

Bloomberg - June 1, 2022

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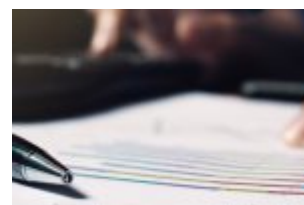


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