Traub Capital Management
Quarterly Outlook Q4 2022
October 3, 2022

Introduction

The first three quarters of 2022 have been difficult ones. In spite of our forecast of the economy and our outlook last December being more pessimistic than most, we did not contemplate the magnitude of the market sell-off. Part of the unanticipated sell-off can be attributed to the Ukraine war, but most of it can be contributed to the very uncharacteristic recovery coupled with the market's very limited history to economic gyrations of this magnitude. To analyze the pattern going forward is going to be a bit of an arduous exercise and we apologize for that. For those looking for the short answer, the Wall Street Journal on October 1st had this quote: "Individual investors are particularly glum. Bearish sentiment, or expectations that stock prices will fall over the next six months rose to its highest level since March 2009. This in a recent poll by the American Association of Individual Investors."

March 2009 actually marked the very bottom of the bear market ensuing from the 2008 financial crisis. It is common that when investor sentiment is near a low, market bottoms soon follow, a contrarian indicator. History may be repeating itself here and those of you who don't want to wade through the analysis can just skip to this Outlook's Conclusion.

Oscillating Economic Recovery Pattern

The COVID shutdown heralded an unprecedented spike in the US economy – first down very sharply, and then up very sharply. Most economic recoveries are substantially slower and of substantially less magnitude. But, as a result of the sharpness and the contracted time-frame, the effect of inventories have become pronounced. This inventory effect produces an oscillating recovery pattern that would be expected but is very poorly understood in the markets and in the business community in general. Businesses normally manage inventories very well. As they are normally well controlled, they don't usually have much impact on a forecast of the economy, so there are almost no economic forecasters focusing on this effect, yet it is extremely important; so we will look a bit more deeply.

Figure 1 shows Personal Consumption Expenditures and Total Business Inventories over the past three recessions.

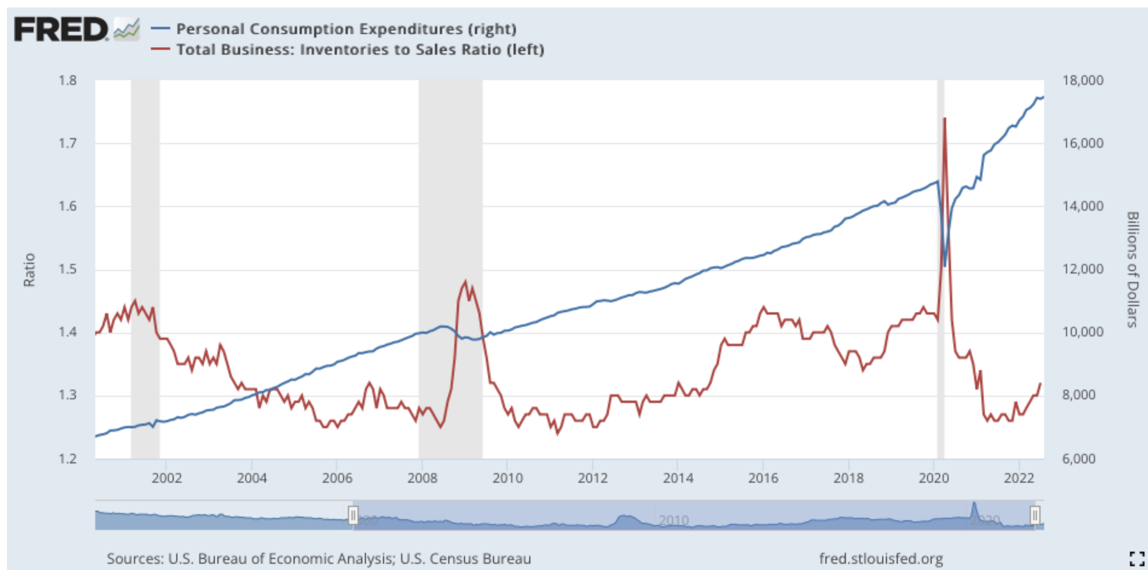

Figure 1

Personal consumption is in blue and business inventory is in red. Generally a slowdown in consumption precedes an inventory build-up. But in 2020, these happened simultaneously and in a greater magnitude than we had seen since World War II. Inventories in 2020 skyrocketed as personal consumption plummeted with the COVID lockdowns and businesses said "Hey, I have too much stuff".

The natural reaction would be to cut production to cut inventories, but since personal consumption declined markedly, this led simply to dramatically cutting production.

Then when the COVID lockdowns eased, personal consumption picked back up sharply spurred on by massive government cash distributions. Everybody said "Hey, I don't have enough stuff to meet this demand". Producers were not ready. The economy responded sharply as production came on line. Everyone was scrambling. Materials everywhere were in short supply. Short supply and high demand leads to higher prices.

Then in January of this year, inventories started to build and everybody said "Hey, I've actually got more than enough stuff", and they started to cut back again.

We saw this effect with Amazon, who built too many warehouses and hired way too many people. Walmart ordered unprecedented numbers of shipping containers that ports could not handle, etc. What people expect is that when production is cut, it marks a decline in personal consumption and a decline in personal consumption typically leads to a recession.

Here, in 2022, there is no decline in personal consumption. That consumption is simply being fueled partly by a reduction in inventory, rather than an uptick in production. Inventory reductions, however, show up as a subtraction from the Gross Domestic Product (GDP), which resulted in a two quarter mild decline in GDP. That is behind us. But with the two quarter decline in GDP came the chorus of headlines declaring "Recession", even though there was and is no real recession.

The economic fluctuations are a normal response pattern to a massive spike in demand. However, this impact has not been felt for nearly 100 years, so it is not surprising to see the response in the markets. Markets thought that the economy had reached a tremendous expansion trajectory late in 2021. That response was exuberance late in 2021 and the opposite so far in 2022. Both responses are over reactions to a normal pattern of fluctuation that follows a major economic disruption.

The economy itself is in decent shape. Personal consumption continues to grow nicely, industrial production has seen no let-up. The housing supply is declining at the same time prices are going down. Housing inventory is not building like it has in every recession since WWII. Lots of people are working, near all-time highs. And as of March, inventories of goods have started to move back to a normal level.

What happens next?

The next phase is to level off, as inventories, production and consumption all come back into balance. The economy should expand following the continued expansion in personal consumption. Personal consumption, in turn follows the number of people working, both of which continue to expand nicely. It is all positive news for the economy in terms of key factors: economic growth (which should be positive in 2022 Q3 and Q4) and unemployment that is near all-time lows.

These positive signs, however, are basically unnoticed in the news. Instead the focus is completely on the negatives – rising interest rates, negative GDP growth in 2022 Q1 and Q2, rampant inflation, Federal Reserve out of control, odds of a global recession at 98% according to Ned Davis Research (but much lower for the US), and war in the Ukraine, to name a few.

What is actually happening in the economy is an economic oscillation and pretty much normal for an economic shock as happened with COVID. We are now back on the upside. The upside will not be anywhere near as sharp as the first upturn that happened last year, but it is an upturn, nonetheless.

With most of the media and most of the investors focused on the negatives and little mention of positives, the positives will, at some point, lead to a surprise positive and a concomitant positive market reaction.

Inflation – Where is it Going?

Inflation continues to dominate headlines. The Federal Reserve made a large error in their assessment throughout all of 2021 that inflation was "transient" and no action was necessary. Faithful readers of this Outlook know that we dismissed the "transient" notion right from the beginning. The inflation we are experiencing is not transient. It is not going away, but it is going to wane as we discuss below.

Somewhat more worrisome is the source of the inflation. Onshoring of jobs and production back to this country is going to raise costs. If manufacturing were not cheaper in China, American companies would not have gone there in the first place. Onshoring of production is a political response. It is going to cost us something, but it does bring jobs back to the US. Jobs mean economic growth. Higher costs, however, drive inflation and higher costs from onshoring of production is not going to be impacted by actions of the Fed.

Inflation is a lagging indicator. During the COVID recovery, prices rose in response to constrained supply. But prices take time to increase and they take time to fall back.

Inflation is measured by the chain-type Price Index. This index, shown by the blue line, along with the price of crude oil (the red line) is shown in Figure 2.

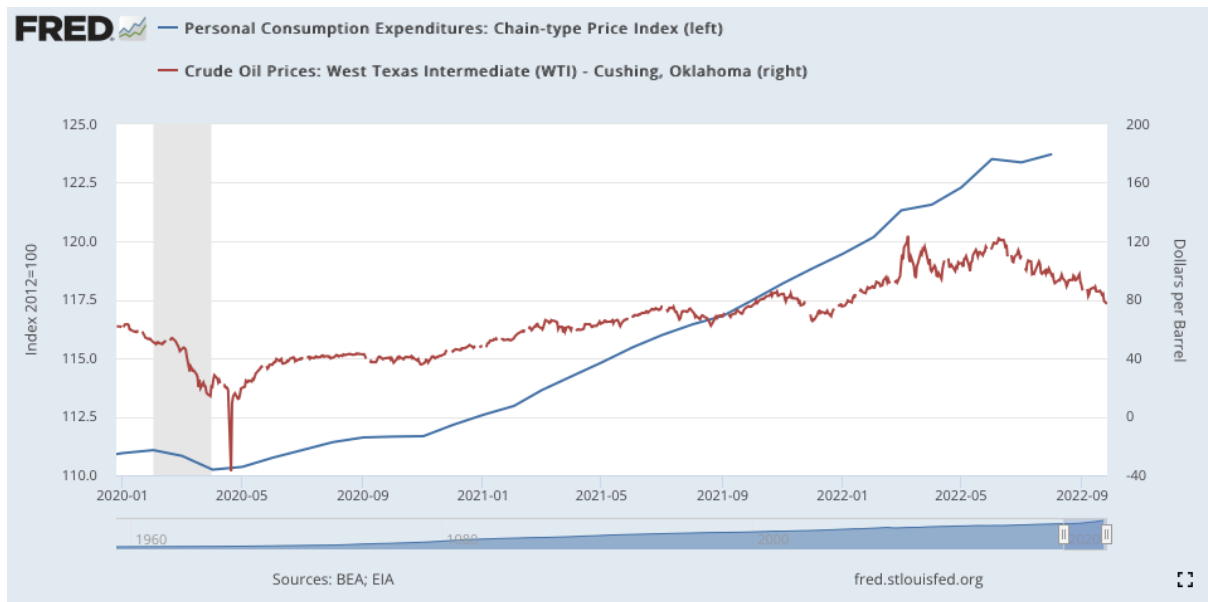

Figure 2

There are two telling indications in this graph. First, the index of inflation for June was 123.512. For July, it was 123.369 and for August, the last data point on the blue line, it was 123.721. It was virtually flat with no increase for the past three months. A flat index means no inflation. All of the inflation numbers that are being quoted are because most reports of inflation are looking at the year on year change! The comparison is to the much lower values for the Person Consumption Price Index a year ago. If we simply continue the way we have for the past three months, inflation will take care of itself pretty quickly. But alas, it will not continue as it has the past three months and so we will some inflation, but a notable decline from what took place around the first half of the year.

Also shown in Figure 2 is the price of oil. Oil prices and the Consumer Price Index have an uncanny correlation. The interesting point is that we already know that the price of oil has declined markedly during September. Just the decrease in the price of oil, should keep the Consumer Price Index flat or bring it down in September. Now a flat index for three months is not a flat index for a full year, but it is a really good start.

Inflation – The Rest of the Story and Will the Fed Let up?

Inflation is a lagging indicator. It also is a many-headed hydra. Even though a lower price of oil helps a lot, inflation is not going to be controlled simply by lower oil prices. The Federal Reserve (Fed) is tackling inflation with higher interest rates on Federal Funds (Fed Funds). The Fed has control over the extremely short term Federal Funds rate, which is the rate at which banks pay to the Federal Reserve to borrow money from the Fed overnight. Loans for longer terms generally follow the Fed Funds rate, but not in lock step, and are determined by the market. Higher interest rates also make it more expensive for businesses to borrow money to invest in projects they deem advisable.

Unfortunately, inflation is complex. Higher interest rates make home mortgages more expensive. Higher mortgage rates should make housing more expensive and increase the number of homes for

sale because people cannot buy them. Less affordable housing should drive rents up. Cost for rent is the biggest component in how we measure inflation. Higher rents will result in higher inflation. But rents respond to market conditions with significant lags, partly because most rents only change once a year.

Similarly, bringing production back from low cost places like China to higher cost places like the US adds costs. This process of onshoring adds to inflation but it is driven by considerations well outside of interest rates. Better productivity lowers costs and lowers inflation. Ramping up production generally means added expenses for utilizing less productive tools, since businesses would use the best and lowest cost tools first.

A lot of what is going on is counterintuitive. The overall impact on inflation is far from clear. The effects take a long time to manifest themselves and great portions of the influencing factors are outside the simple control of interest rates.

It is possible that we might luck out and have inflation wane as noted in the section above or we might not. We might wind up with lower inflation because we have higher interest rates, but higher rates alone might not bring inflation back to the Fed's target of 2%.

The real risk is that we do not get notably lower inflation, but the Fed continues to raise interest rates continuously higher to try to squeeze inflation out, when there are so many factors contributing to inflation that do not respond to interest rates and many react only with significant time delays. We are not likely going to get back to inflation of less than 2% in the next couple of years. Our forecast is for inflation to come down to 4% by year-end and to continue under 4% through 2023 with Fed Funds rising to a like amount around 4 1/2%. But inflation is the sum of many parts and simply raising short-term interest rates is not the whole story. The risk is that the Federal Reserve misses this point, or simply does not care. This is a non-zero risk and will likely lead to recession if Fed Funds continue to rise beyond 5%. Our scenario says the Fed will stop by then and recognize inflation below 4% is acceptable for now and that lower than that is not something that they can control and certainly not control quickly. The risk is that the Fed does not figure this out and simply keeps squeezing. It will be squeezing on something that it cannot fully control and that will be negative for the economy.

No Recession in 2022 and Increased Earnings

The US economy is going through a normal fluctuating pattern but is holding up very well overall. Personal consumption is up and continues to be strong. Automobile companies can still sell all the cars they can make and production is ramping up with more chips available. Airline travel is around record heights. Housing inventory, as noted above is not increasing. Unemployment remains low. People keep coming into the workplace and there are jobs for them. Overall economic growth in the US has slowed from over 5% in 2021. In fact, overall economic growth turned slightly negative in the first two quarters of 2021. This slight downturn was driven by the reduction in inventory, not by any waning of demand. The inventory cycle is flattening out, so we will not see the negative inventory impact in Q3 or Q4 of 2022 and overall economic growth should be positive in Q3 and subsequent quarters.

Overall corporate earnings should continue to improve with our forecast going from $211 in 2021 to $215 in 2022 to $225 in 2023.

Nothing we see points to recession, except a continued over-reaction by the Fed to attempt to control something they do not have full control over. We are betting that the Fed will not make this mistake.

Uncertainty and Surprise

Earnings are the fundamental driver of value, but their impact is amplified by or mitigated by uncertainty and surprise. In the short-term, uncertainty is a driver of the stock market and it is quite high at the moment. The volatility index (VIX), a measure of expected stock market volatility, is over 30, much higher than normal.

In November, political uncertainty will wane after the elections. Odds are very good of the Republicans retaking control of either the US House and/or the US Senate. Republican control of either body of Congress will result in a two party split in Washington. Two party splits virtually guarantee that nothing of consequence actually gets accomplished. Both political parties will decry

the “nothing gets done” situation, but markets usually love it. Nothing getting done means that there will be no major legislation redirecting wealth and no major tax packages.

In the Ukraine war, the picture is getting a little more clear. The tide has turned in favor of the Ukrainians. Russian energy is turned off to Europe, but their winter gas inventories are almost completely full and no one in Europe is freezing in the dark. Putin has mobilized troops in Russia. He will use most any “logic” to justify his actions in the war there, but he has chosen a mobilization over the use of nuclear weapons. Clearly, to him, mobilization is the lesser of the two evils. Two key nations, China and India, who have supported Putin to some degree would not stand by his use of nuclear weapons and loss of China and India support would be a major blow to his efforts. We, of course, are not clear how, or when, the war will end, but we have seen that the world’s energy markets are coming into balance. Crude oil prices peaked in June at $120 per barrel and are now at $80. There is extra oil production capacity in the world and OPEC is lowering its production limits.

A little less uncertainty and a set of positive surprises would be the catalyst needed to see a very positive reaction in the stock market.

Stock Market Reaction Higher Earnings, Lower P/E ratio

It is hard to argue that the stock market is overpriced. P/E ratios are well below the average of the last 10 years. Corporate earnings are forecast to increase in 2022 vs. 2021. Today’s lower values in the market are sentiment based and that sentiment is very low. Sentiment can turn very quickly. Earlier this year, the S&P 500 increased 17% in two months. At the same time, the rate on Fed Funds increased from 1.75 to 2.5%. Higher Fed Funds do not equate to lower stock market values.

Reduced uncertainty, better earnings, positive surprise events and a continued strong economy should combine to produce a stronger stock market.

Bond yields should stabilize with inflation cooling down. We are also starting to see meaningful returns on holding cash and bonds. Should the stock market return to previous levels raising cash or bonds may be a reasonable thing to do depending on your individual circumstances.

Conclusion

What we are seeing today in the headlines does not reflect what we see in the overall economic picture. Rather, the economy is simply going through what would be a normal pattern when exposed to the massive contraction and rebound from the COVID epidemic. We have not seen this kind of economic correction and rebound for nearly 100 years, so it is understandable that the pattern is not well recognized. But the positive leg of the pattern should become clear in Q4.

We are expecting to see a turnaround in the market and by year-end, and the S&P 500 should be well above its present value of 3,585.