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Weekly Market Commentary
May 23rd, 2022

Is This Going To Be A U Shaped Recovery?

This past week markets continued to face downward pressure, with Wednesday marking the biggest one-day decline in the S&P 500 since June 2020. Equity markets broadly are now down for the seventh week in a row, and the S&P 500 approached a technical bear market – or 20% pullback – but closed the week down about 18% year-to-date.

However, a recession is not a base-case scenario over the next 12 months, and markets may experience a gradual "U-shaped" recovery in the months ahead.

What's causing the market weakness? Fears of a recession and profit-margin pressures intensify

Markets were especially rattled last week by earnings reports from key retail giants like Walmart and Target. Both companies reported lower-than-expected operating margins, driven by higher input costs from areas like freight and fuel.
However, the retail giants stated that consumer traffic remained robust, underscoring a resilient U.S. consumer. For example, Target saw a solid 4% yearly increase in its store traffic in the first quarter. There was some shift in what consumers were purchasing, moving away from pandemic staples, and, in some cases, lower-end consumers did look for bargain brands or shopped less than average. But overall, the disappointment seemed to come more from the supply side than demand.

Markets nonetheless seemed to interpret these earnings as a signal that the worst was yet to come, fearing that peak consumer demand and peak margins may be behind us. However, Target's CEO highlighted that he continued to see strong foot traffic in May and that he expects some supply-chain and inventory issues to ease in the back half of the year.

A recession is still not the base-case scenario

As the earnings misses demonstrate, risks to growth are certainly rising in this backdrop. Elevated inflationary pressures, ongoing supply-chain issues, and a Federal Reserve that seems determined to raise rates aggressively, for now, have all driven market fears of a recession. In fact, with the S&P now down close to 18%, equity markets have priced in about a 75% chance of a recession.

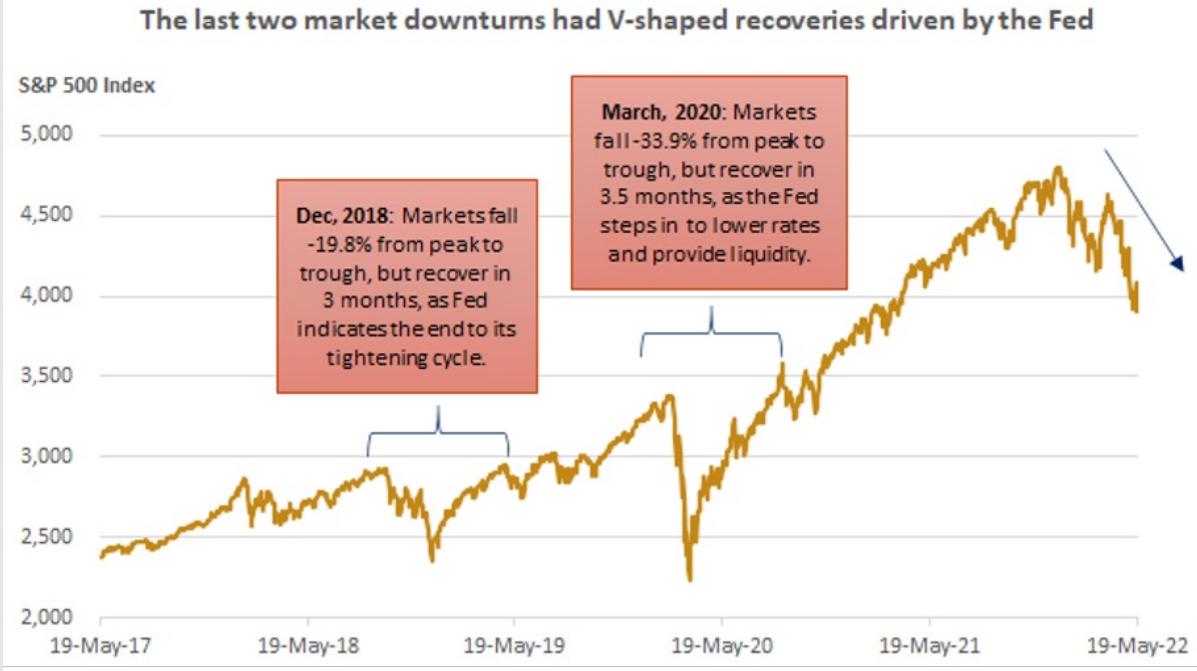
However, a recession is not a base-case scenario over the next 12 months. We continue to see solid economic fundamentals, including a healthy consumer, a tight labor market with low unemployment, rising wages, and corporate earnings growth that, while moderating, will likely remain in the mid-single digits. This past week we also saw retail sales figures that exceeded expectations for April and industrial production that also expanded at a monthly rate of 1.1%, above forecasts of 0.4%.

If we are experiencing a non-recessionary market correction today, history has offered a favorable outlook for these periods. Since 1970, the return is, on average, 17% in the six months after the market bottoms. Calling market bottoms (or tops) is notoriously difficult, but with equity market valuations having come down nearly 25% and a sizeable amount of recession fear priced in, the risk versus reward certainly looks more favorable here (and perhaps skewed towards an upside surprise).

Could markets rebound from here? A U-shaped recovery is plausible....

If this current downturn is a correction and not a recession-driven bear market, investors may be wondering if they should be "buying the dip". In recent history, the "buy the dip" mentality has worked well, as markets have quickly recovered losses after big pullbacks. However, if we do see a market recovery in the months ahead, it will likely take time to recover the losses we have seen – what we are calling a U-shaped rebound, versus the more recent V-shaped recoveries.

If you consider the last two major market downturns – the 2018 growth scare and the 2020 pandemic downturn – both had a couple of things in common. First, markets recovered their losses in these periods relatively quickly, around three months on average. Second, what drove the recovery was that the Federal Reserve stepped in and signaled lower interest rates ahead.



Source: FactSet

The chart displays the last two corrections which recovered quickly in a 'V' shape.

Past performance is not a guarantee of future results. The S&P 500 is an unmanaged account and cannot be invested indirectly.

The key difference in the current pullback is, of course, that the Federal Reserve is on a mission right now to raise rates and fight inflation. Fed Chair Jerome Powell has indicated that the Fed will continue to raise rates steadily until it sees "clear and convincing" evidence that inflation is moving lower.

The current view is that inflation will likely moderate in the months ahead, but it will come down gradually. We see headline inflation heading towards 5% - 6% this year, driven by tougher yearly comparisons and better supply-and-demand dynamics. If the Fed sees a trend of lower inflation, perhaps confirmed by three or four lower readings, we could see a shift in its rhetoric and pace of rate hikes. Consequently, the U-shaped recovery is more likely a scenario than a quick V-shaped recovery.

(Source: oXYGen & Jones)

Markets For The Week

INDEX	CLOSE	WEEK
Dow Jones Industrial Average	31,262	-2.90%
S&P 500 Index	3,901	-3.06%
NASDAQ	11,355	-3.81%
MSCI EAFE	1,973	3.35%
10-yr Treasury Yield	2.79%	-4.78%
Gold	$1,847	1.99%
Bonds	$103.16	.62%

Source: Reuters/Wall Street Journal

Coca Cola Unveils New Bottle With The Cap Attached

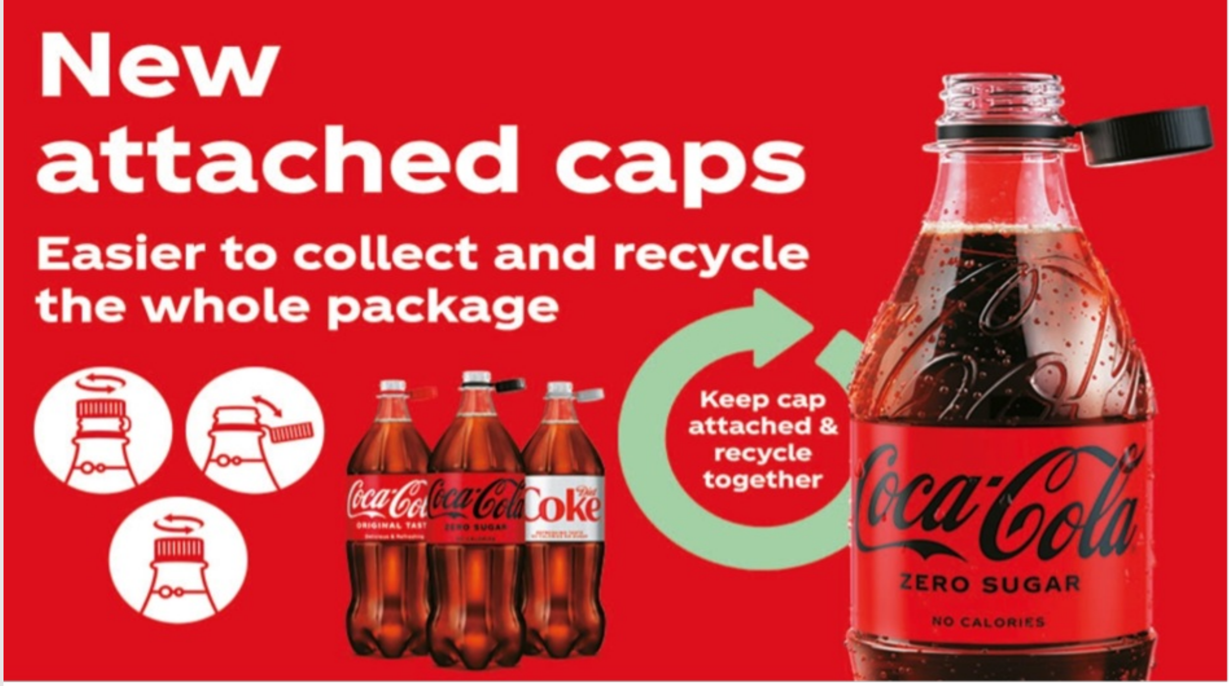
No longer will consumers be troubled with a capless Coke bottle.

Aiming to bolster recycling and curb misplacing nuisances, the Coca-Cola company said earlier this week in a news release that it's changing the way its bottles are manufactured.

The first wave of a new era in Coke bottles began in the United Kingdom earlier this week as the British arm of the company unveiled newer plastic bottles with the cap attached – a slight but significant change from the longstanding twist caps unattached to the bottle.

The company said its caps often end up in the trash and don't find their way to the recycling bin with their corresponding bottles. The new bottles are meant to make recycling the entire product much simpler.

The products with new plastic bottles on the horizon are coming out in the next two years and include Coke, Coke Zero Sugar, Diet Coke, Fanta, Sprite, and Dr. Pepper. They're expected to have the bottles by 2024; the transition applies only to U.K. bottles.



"This is a small change that we hope will have a big impact, ensuring that when consumers recycle our bottles, no cap gets left behind," Coca-Cola Great Britain general manager Jon Woods said in a statement this week.

The move comes on the heels of the European Union requiring that caps be attached to some plastic bottles as part of its directive on single-use plastics. Many companies have until the end of 2024 to comply.

Responding to environmental concerns, Coca-Cola created the World Without Waste initiative, outlining plans to have better recycling habits with its consumers by 2030. Also, part of the initiative: is to make all its cans and bottles with 50% recycled material as well as packaging 100% recyclable.

Plastic waste, largely fueled by bottles from companies like Coca-Cola, is an environmental problem because plastics end up hurting marine life by showing up on beaches or in landfills.

Earnings Highlights This Week

Lowe's: Lowe's missed Wall Street's revenue expectations for the first quarter, as cooler spring weather hurt demand for supplies for outdoor do-it-yourself projects. Net sales fell to $23.66 billion from $24.42 billion last year and missed analysts' expectations of $23.76 billion. Lowe's results diverged from those of its competitor, Home Depot. On Tuesday, Home Depot surged beyond Wall Street's expectations for quarterly earnings and revenue.

Target: Target shares dropped sharply on Wednesday after the company said its quarterly profits got hit by supply chain troubles, higher fuel costs, and lower than expected sales of discretionary merchandise. The big-box retailer said it saw a healthy customer, but a shift to experience-based purchases, such as toys for birthday parties and luggage for trips. Target reiterated its revenue forecast, which calls for mid-single-digit growth this year and beyond.

Bath & Body Works: Bath & Body Works cut its profit outlook for the year, in part due to expected increases in inflationary pressures. The company now expects to take a hit of between $225 million and $250 million from inflation this fiscal year, or about $75 million more than originally planned.

Cisco: Cisco missed on the top line in the fiscal third quarter and issued a worse-than-expected revenue forecast for the current quarter. Analysts at Citigroup said last month that competitors are taking networking switch market share from Cisco.

Palo Alto Networks: Palo Alto Networks surpassed expectations on the top and bottom lines and on full-year guidance. The company announced software to help companies deal with virtual supply-chain issues.

News and Notes

Be Careful About The Marriage Tax Penalty In 2022

What exactly is a marriage penalty…hopefully you picked the right person to marry?

- If you are happily saying "I DO" this year, beware the IRS can be a real buzzkill.
- A "marriage penalty" means you could end up paying more taxes when you get married than if you remained single.
- It can happen when tax-bracket thresholds, deductions, and credits are not double what's allowed for single filers. For example, your income remains the same, but your deductions will go down meaning you will pay more income tax as a married couple.

Does this affect only couples who earn a lot of income?

- Not necessarily. For lower-income couples, it could affect their ability to use the earned income tax credit?
- For higher-income couples it could increase your Medicare taxes and the SALT (State and Local Tax Deduction) is capped at $10,000 (you don't get 20k being married).
- Also, check your state. States like Maryland may move you into a higher state tax bracket as well when you get married depending on your income.

What about the cost of a wedding, will that cost more this year?

- Expected to have 2.5 million weddings, up 30% from one year ago and the most in four decades.
- A wedding in 2021 was over $27,000. In 2020, it was roughly $20,000. That's a 30% increase and is expected to be higher in 2022.
- Many couples make trade-offs and rethink priorities- including doing a weekday wedding, but inflation and the number of weddings are really driving prices up.

From the team at J M Brown Financial Partners
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