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TPW ADVISORY

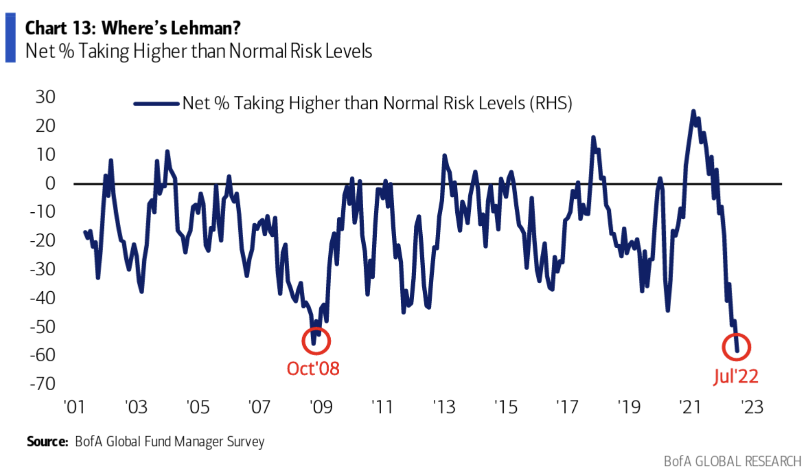
TPW Advisory Monthly: Coincidence? I Hope Not
August 5, 2022

I enjoyed it when it didn't rain on our camping trip and felt that we were washed clean of all negative vibes after getting in four different bodies of water on the hottest weekend of the year (to date). But what really sold me was driving up to our rented vacation home up in the Catskills and noting the address: The Middle Way! I kid you not.

Regular readers know we have been sketching out what we have called the "middle way" or "middle path" between the towers of ever higher inflation and the depths of pitiless recession for [several months](). So to see the same phrase become my home address for two weeks of vacation made me think, ok maybe things are not so bad… after all, this can't just be a coincidence, can it?

When at dusk on our 2nd night there a black bear emerged from the underbrush some 100 yards or so from the house, I thought to myself, ok this is wild (no pun intended)! After all the back and forth about inflation, recession, bear markets, etc. to have a real live black bear getting up on his hind legs to get a better look at me made the "Middle Way" address all too real.

Chart 1 – Worse Than 2008-9?

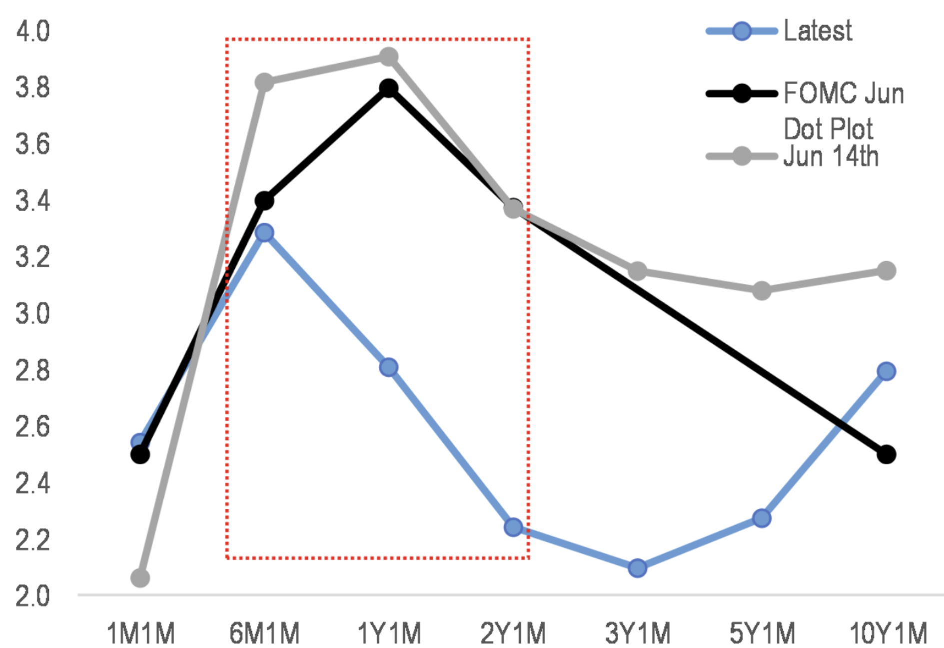


So while resolutely not looking at the markets at all – never turned on Bloomberg for a solid week - and then realizing that last week was the best week in a few years resulting in July recovering much of the June swoon I felt like ok, I know what to write for the Monthly intro & viola!

Such big down & up moves in the S&P have only happened a handful of times since WW2 – 12M forward returns average 30% according to Bloomberg. Looking forward to the 2H, it continues to seem as if the title fight between inflation and earnings will dictate how risk assets perform. Last week was another round for the earnings challenger who has finally won a few rounds as the inflation champ looks a little peaked (or maybe past peak). The bond market has been leading the way with equities, FX and Commodities following; bonds are clearly suggesting inflation is not going to be the problem folks thought it was just a mere month or so ago.

Chart 2 – Past Peak Fed Hawkishness?

Figure 8: Market expectations have changed a lot from peak hawkishness in mid-June

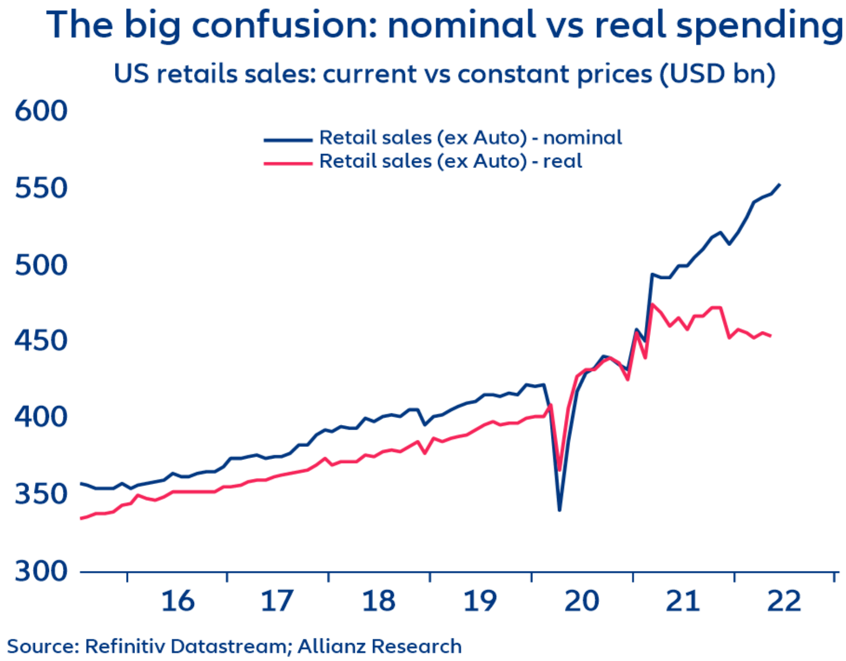


Source: J.P. Morgan

Q2 Earnings have continued to defy the doomsters and with roughly 80% + reported in the US, beats are running at roughly a 75% clip while over in Europe, which if one just read the papers would think is nothing but grown over, rusted out machinery given the energy situation, JPM reports earnings beats are running close to 65%. JPM further reports that earnings are up roughly 10% Y/Y in the US and 22% in Europe while top line growth is running at 15% Y/Y in the US and 36% y/y in Europe. Those are some impressive numbers.

We highlighted the importance of the current high nominal growth rate environment to earnings two weeks ago where we noted the likelihood of an earnings bridge to get us to the other side of peak inflation. We noted further how most investors are unfamiliar with such a backdrop & so they have persisted in calling for a sharp earnings shortfall. As we have noted when nominal GDP is running at 8-10% y/y as it is in both Europe & the US then nominal sales revenues and nominal earnings should be able to beat a low, 5% y/y earnings bar.

Chart 3 – High Nominal Growth Makes a Difference



The 2H focus will be on peak inflation vs recession. Stocks tend to do quite well following an inflation peak, while they tend to do quite poorly in a bear market combined with recession. The US has recorded two consecutive negative Qs of GDP growth but we are leery of the recession call given record low UER, solid balance sheets & loan growth etc. The economy is clearly slowing even if shrinking remains an open question. Today's US jobs report further calls into question the idea of a current recession.

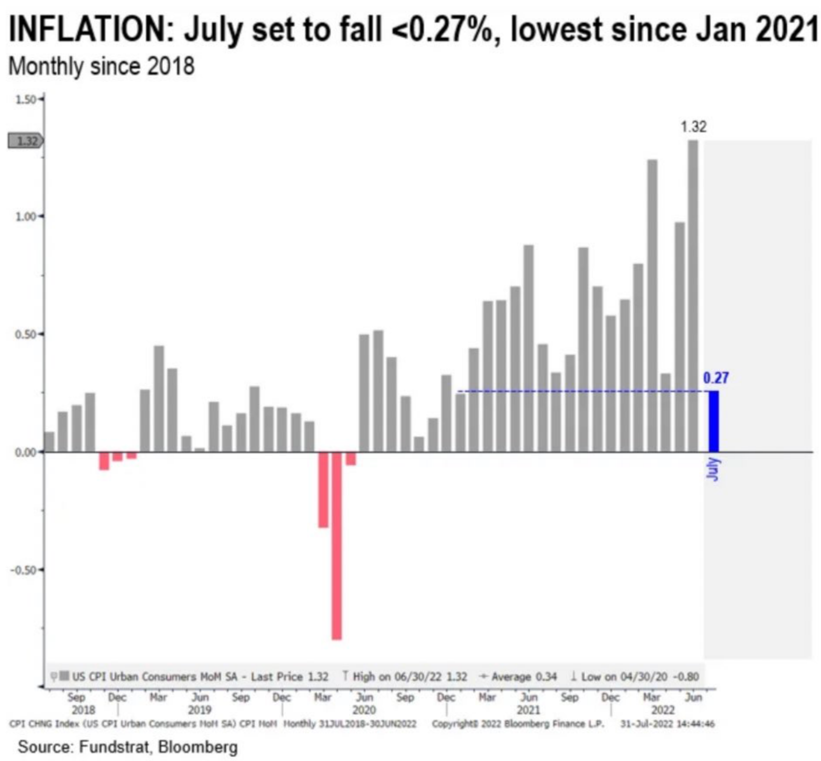
Led by Growth & High Beta, the SPY is roughly 13% off its mid-June low and Nasdaq close to marking a new bull market, up 20% or so from its low. It's possible that the market is already reflecting inflation's peak. This would be very much in keeping with our Market Speed concept; however, should the Fed raise rates more aggressively than currently expected, another leg down could result.

From a Tri Polar point of view, we believe one can encapsulate 2H keys as follows: how fast does US inflation roll over, what will Europe's energy price path look like & how smoothly will China learn to live with Covid? We believe the answers to these three key questions will drive cross asset prices across the Tri Polar World.

Chart 4 – EU Gas Prices a Key Catalyst

Technical analysis remains key in ahistorical environments like this and clearly there has been some significant repair work done to the technical picture. More needs to occur; on the positive side we are focused on a sharp rollover in inflation (Cleveland Fed July inflation print is running at .3% or so, the lowest since Jan 2021 & a 3.4% annualized rate vs the 9-12% annualized #s YTD - Fundstrat); more negatively, some sort of collapse in the job market that sends the bears marauding will tell the tale.

Chart 5 – How Fast Will Inflation Roll Over?



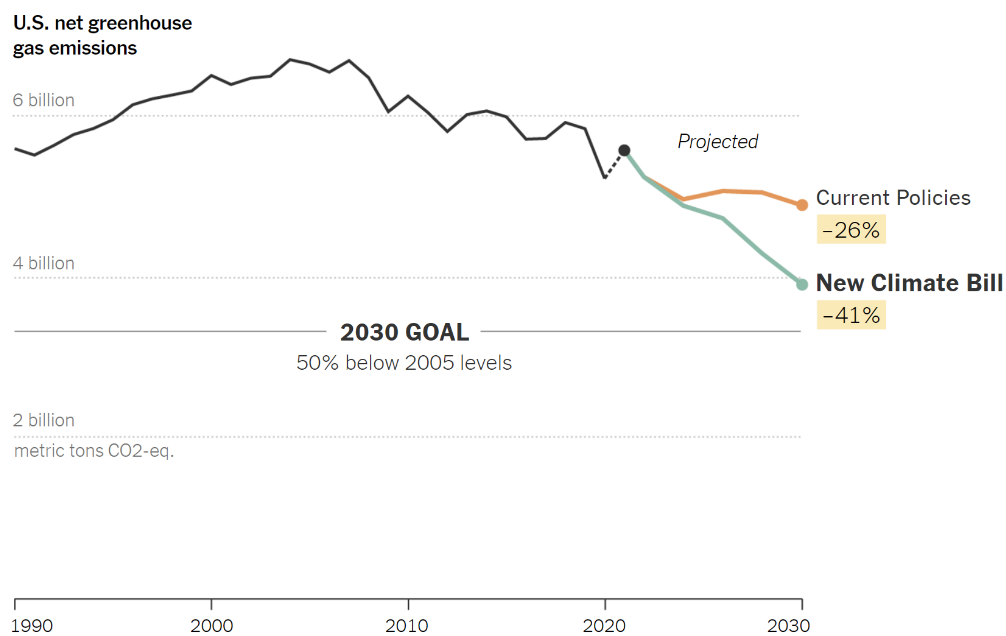
Let's use our trusty Global Risk Nexus (GRN) system to plot the way forward via: Climate, Economics, Politics, Policy; as usual we will conclude with what it all means for global cross asset markets.

CLIMATE

After months of gnashing of teeth and general wailing about how the US can't get anything done, it seems as if a slimmed down version of the Biden Build Back Better plan will become law under the aptly named Inflation Reduction Act of 2022. There is enough intrigue to write a book about what brought Senator Manchin back to the table but for our purposes, suffice to say the US will be back in the Climate game should the legislation pass as presented.

With roughly $370B dedicated to Climate action across the board, there is great hope that the US will have a shot to meet its carbon targets for the years ahead. Much is dedicated to the EV revolution both in terms of building out a national charging grid as well as subsidizing EV purchases. A national charging grid with stations every 50 miles along the US highway system looks to be coming to fruition. That is good news for the US and for the globe.

Chart 6 - US Climate Bill Can Make a Difference



Source: REPEAT Project, E.P.A. | Notes: Net emissions include land carbon sinks. Historical emissions for 2021 are estimated. Projected emissions reflect average model estimates. Modeling for the new climate bill is based on draft legislation released on July 27, 2022.

Elsewhere, the growing risk of power shortages and the rising cost of natural gas, coal & to a lesser extent crude oil has meant that Governments from Japan to Germany and many in between are reconsidering their plans to shut or further reduce their nuclear power capability.

The tie in between rising dependence on nuclear power for baseload purposes as countries shift more and more to renewables seems to be gradually winning the day with Germany's Green Party for example, which is able to move in this direction only because it is better than succumbing to Putin's energy blackmail.

ECONOMICS

The tug of war between growth and inflation remains the key fight of the day – one that will likely remain so for the coming year. It's all about how fast and far inflation falls vs how persistent the Fed/ECB will need to be and how deeply rapidly rising rates impact growth in the US and Europe. We continue to think that the desynchronized nature of the Tri Polar World economic outlook: slowing in the US and Europe, recovering in China should go a far way to limiting the downside risk on a global basis.

Our old MS college Stephen Jen wrote recently about the significant gap between actual and potential global output & suggested that as the Covid related price pressures ebb, underlying inflation could fall away more rapidly than currently expected. This resonates given how it would be in keeping with the rest of this cycle – namely very much at speed with very little going as expected or conforming to history. This would also sync up with the rapid rally in long bond yields, which are clearly suggesting inflation's imminent peak and potential sharp fall off.

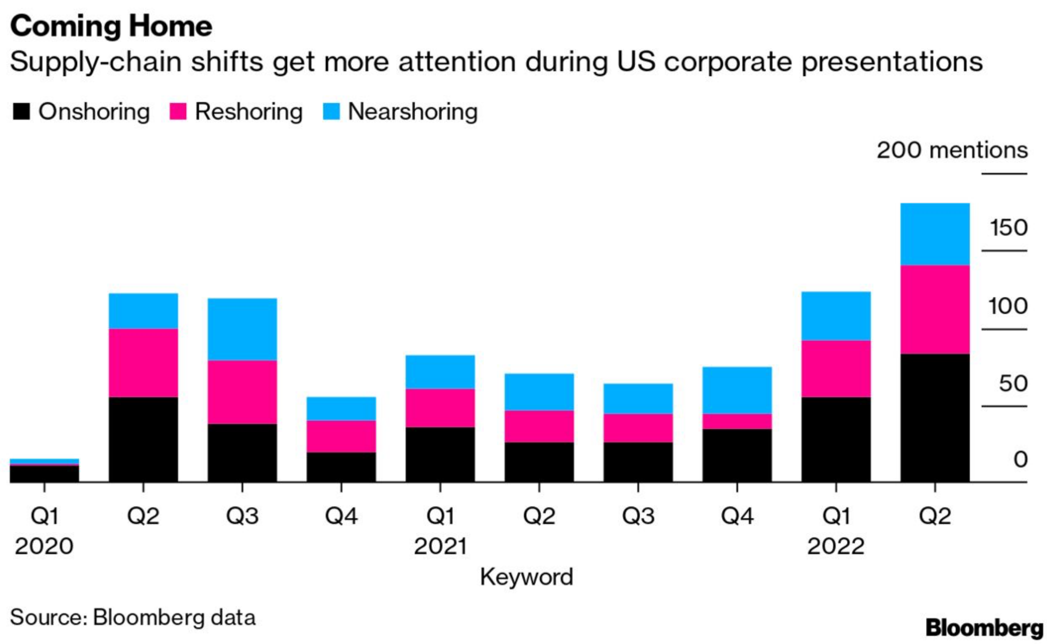
Of course, a sharp falloff in inflation would ease pressure on the Fed and ECB to continue to tighten aggressively and lead to some significant shifts in sell side forecasting given how most are expecting a more hawkish Fed than the bond market is pricing in. Sharp falls in US gasoline prices (down 50 days running), housing prices, shipping costs, food prices etc. suggests that much of the Covid inspired inflation pressures have ebbed. This week's ISM report and its prices paid subcomponent supports that thesis.

Chart 7 – Inflation Pressures Easing

This in turn would validate the Fed pivot talk & reduce the likelihood of anything beyond a modest recession, allowing earnings to remain relatively robust and gradually leading those to recognize the June bottom was in fact the market bottom for this cycle. A modest recession comports with the robust labor market, strong corporate and consumer balance sheets, stable credit backdrop, low real rates & financial conditions that while tighter than they were, are far from strangulation levels.

July's ISM Manuf data support this outlook coming in at 52.8, down slightly from June but well above the 50 mark while the Atlanta Fed's Q3 GDP Nowcast is at 2.1% growth. Cap ex remains strong as well with US companies increasing their cap ex spending 20% y/y in Q2, well above that for dividends or stock buybacks. This represents a sharp shift from the capital allocation processes of the past few years – one in line with our cap ex boom construct as companies & Govts address the 3Cs of Covid, Climate & Conflict.

Chart 8 – Cap Ex Boom Ahead?



As Bloomberg columnist Conor Sen noted recently: "When gasoline prices are sub-$4/gallon, mortgage rates are 4.75%, retailers have worked down their inventory levels, automakers have semiconductor supplies, and supply chains are fixed. What part of the economy are we supposed to be worried about again"? It's a good question.

European recession risk is clearly growing though one would not know it by the stronger than expected Q2 GDP growth of 0.7% Q/Q (2.8% annualized) and 4% Y/Y, much stronger than the US. The positive power of Covid lockdowns' end far outweighed the negative impacts of the Russian invasion related surge in EU energy prices (something we suggested might occur).

Going forward however recent PMI data suggest continued slowing in Europe and especially in Germany. Much as in the US a modest recession cannot be ruled out in the coming quarters.

Chart 9 – Global Economy Better Than Expected

Chart 3: The J.P. Morgan Global All-Industry PMI suggest the global economy looks to be regaining its footing

Source: J.P. Morgan

In Asia, much depends on how China approaches its economic path – to date it appears that the Xi Government will play it cool, avoiding any heavy-handed stimulus measures and counting on the US and European evidence of the power of the post Covid lockdown spending pattern to help grow the economy this year. We do expect growth to pick up in China and throughout the Asian region over the course of the 2H. There is growing evidence that China is shifting ever so subtly to a learn to live with Covid mentality – should that become clearer it should support both economic activity and Chinese risk assets.

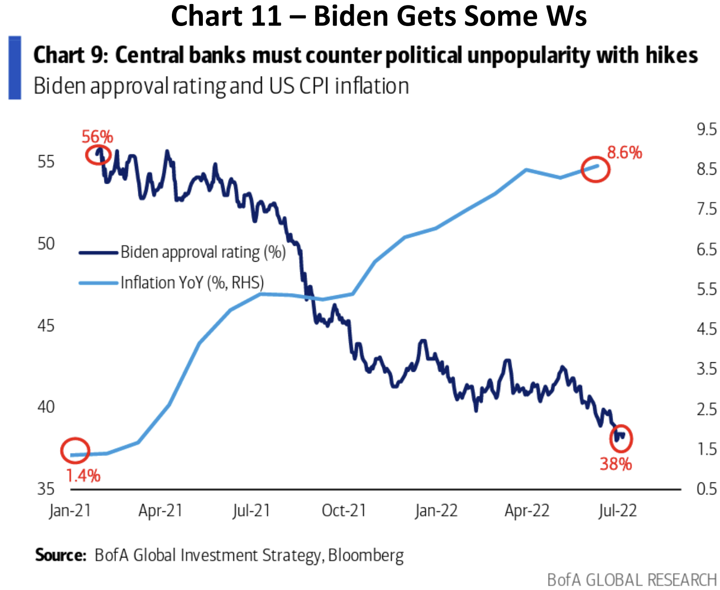
Chart 10 – Desynchronized Global Economy?

POLITICS

As noted above, the Biden Win on climate and its corollary on deficit reduction and tax structures suggests July was a good month for the President even as he came down with Covid twice, thankfully with no significant ill effects. The passage of the CHIPS bill, a limited but still important gun control bill among others, suggest the legislative accomplishments of the Pres & his party are building up.

With the US mid-term elections less than 100 days away, there will be much to parse in the coming weeks. Recent Supreme Court decisions on abortion, the Jan 6th hearings (one of the US Govt's finest moments) and perhaps a continuation of falling gasoline prices all suggest the nadir of Biden popularity might have already been reached, a la peak inflation.

Chart 11 – Biden Gets Some Ws



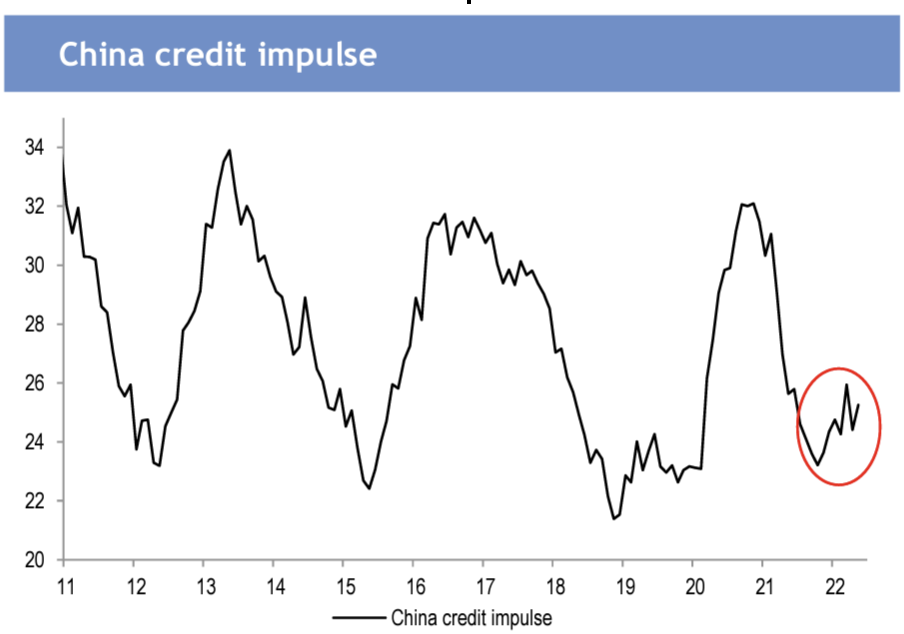
Further south, Brazil goes to the polls in October with former President Lula running against current incumbent Bolsonaro. The polls favor Lula, but the incumbent is using the power of his office to increase cash handouts to the poor in an effort to win voters. One of the best buying opportunities in Brazil's history was when Lula ran & won the first time as Wall Street had gone into full sell mode prior to the election. Once Lula governed as a more moderate figure, Brazilian risk assets took off… let's see what happens this time around.

Europe's political focus extends from Ukraine and Russia to Italy and on to Germany. The push back to the EC's suggested 15% energy rationing by the Southern peripheral states was quite interesting – reminding Germany that others also recognize how poorly played its recent energy decision making has been and why they may not want to sacrifice for Germany much as Germany pushed back on joint sacrifice during in the EU bank crisis of 2012.

Italy's upcoming election (late September) will be one to watch even as early fears that a governing crisis may occur have proven to be unfounded. As is the case in several countries around the world the simple black – white boxes of 2016 and 2020 no longer apply and this is the case in Italy. Markets appear to recognize such given the rally in the German – Italian spread.

Asia's big upcoming political event will be the China's People Party Congress in late Fall where President Xi is expected to win a near unprecedented third term. This continues to be the base case and the absence of rushed or overly aggressive economic policy actions suggests that President Xi feels quite comfortable that he will win that 3rd term.

Chart 12 – China Picks Up While US – EU Slow



Source: Bloomberg Finance L.P.

POLICY

After years of crisis driven policy-making, the 2H of the year may foreshadow a period of more stable policy where investors can look to history once again for clues as to how risk assets may respond to more normal policy making. The 1st half has certainly been unique in that US GDP fell while employment rose, something not seen since the late 1940s.

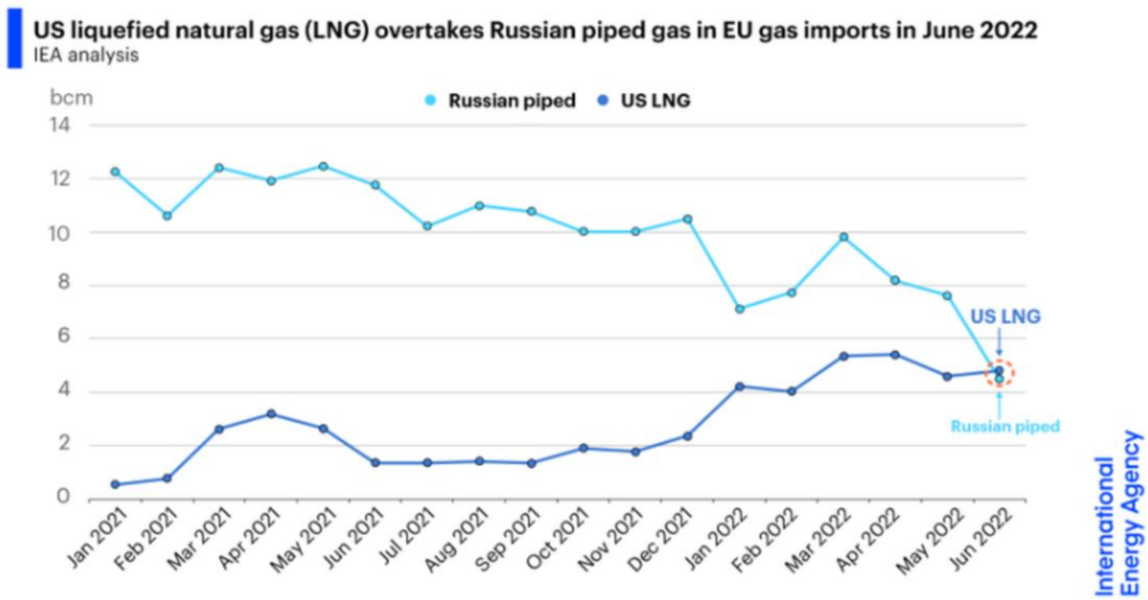
In Asia the policy making community seems comfortable with the status quo for the most part. For example, China is limiting its policy responses to more targeted approaches as seen most recently in the property sector as unrest grows over the failure of developers to finish homes that have already been paid for. China maintains strong potential to act in both fiscal and monetary policy; it may be that President Xi and his team are waiting out the PPC and will then act more aggressively to boost the economy in the 2023-2024 period.

Japan’s policy mix also seems set with the BOJ clearly not for turning on it Yield Curve Control (YCC) strategy, forcing short yen speculators to take heavy losses in the past month as the yen rallied from 139 to the low 130s. Fiscal support is being maintained while a better economic tone in the Asian region should support tourism which is a big winner for Japan. MS suggests that the region as a whole should be closing in on the end of its rate hiking cycle.

Chart 13 – Japan A Big Winner From China Recovery

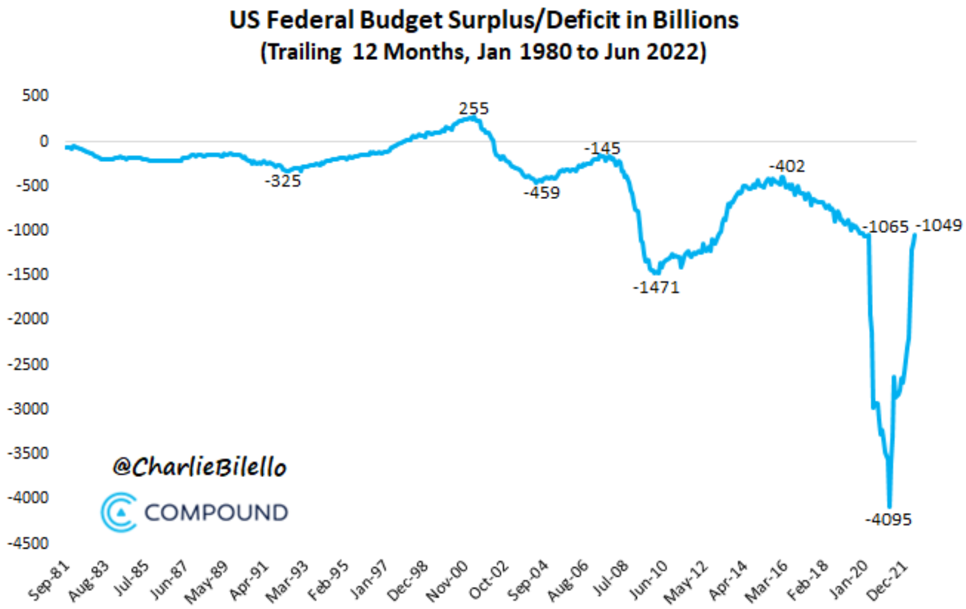
In Europe, the ECB is primed to raise rates further come September in an effort to ensure energy-driven price spikes do not spread into the overall economy. Fiscal support remains quite strong in Europe with the Next Gen spending program and the Fit for 55 clean energy program should both remain active over the coming years. The battle of wills between Putin's decision to limit gas exports and Europe's ability to avoid major energy shortages this winter will be key.

Chart 14 – Putin's Gas Vs. EU Energy Needs



It's in the US where policy might shift the most in the coming quarters. The shift has already occurred on the fiscal side with dramatic expansion giving way to aggressive reduction. Should the Inflation Act be passed, that should continue next year. The Fed seems set to continue to raise rates thru year end with an additional 100 bps priced into the market. As noted above the sell side on average expects it to do more, perhaps as much as another 50 bps before swiftly turning to rate cuts by the middle or so of 2023.

Chart 15 – US Fiscal & Monetary Tightening

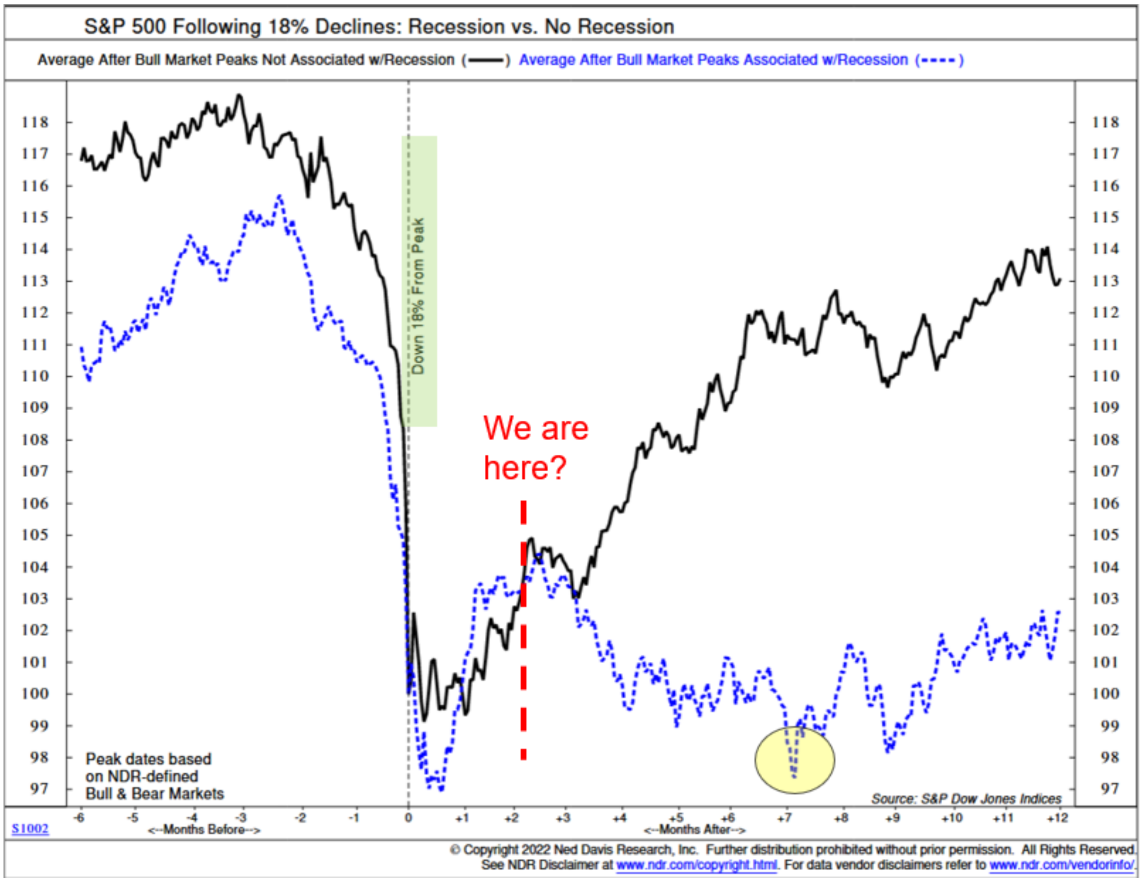


Much remains to be seen, of course, but the potential for a sharp shift from rate hikes to rate cuts would clearly be in sync with our “Market Speed” construct. Given our growth view we are not as confident in the rate cut scenario, especially post the July jobs report.

MARKETS

It has been very easy to get chopped up in these fast moving, aggressive markets. Here’s a fun stat: the April 29th S&P close was 4131… the July 29th close was 4130. From the June swoon to the July bounce, from rapidly rising rates to the reverse, especially at the US – EU long end & on to the Commodity space where it has been a bit of pick your poison. Even in the FX markets King dollar ruled the roost until it too took a breather. Amidst a plethora of bad news, markets have reminded us once again that sometimes the news just has to get less bad.

Chart 16 – To Be Or Not To Be?



We have maintained a pretty stable outlook for both our model portfolios, the Global Multi Asset (GMA) and our TPW 20 thematic model. We have argued that those first into the bear market were in the early stages of bottoming (China tech, ARKK and innovation) over the late Spring and early Summer. As a result, we had added to Growth in the GMA model while adding to Climate names in the TPW 20. With Q2 global funding for startups down over 20% Q/Q, we see that as supporting existing public market innovation stocks. We did complete our exit from Crypto over the past few months.

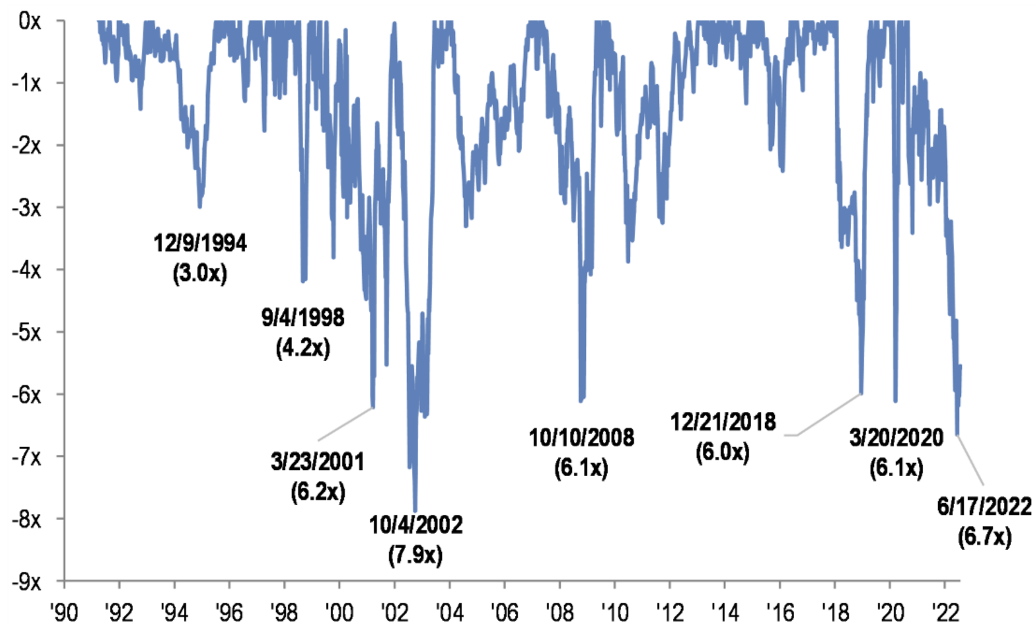
Where to from here remains to be seen. We lean toward the June low as being THE low but remind ourselves that bottoming is a process not a point in time. Markets have gone from oversold to overbought very quickly and the whipsaw action is dangerous to one's portfolio. While making up some good ground last month, there is still much to play for in the 2H.

JPM argues that a mild recession is already built into the price of risk assets across the globe and we tend to agree, noting JPM's point that the SPY has experienced its 2nd sharpest derating in the last 30 years of 6.7x vs average of 4.5x in prior recessions. It further notes that the 12M rolling peak to trough drawdown for a multi asset portfolio has bottomed near the March 2020 low and well below the average seen over mid cycle slowdowns during the past 20 years.

Chart 17 – A lot Is In The Price

Figure 10: 12M Rolling Multiple Drawdown 2nd Highest in Last 30 Years

S&P 500 NTM P/E Multiple



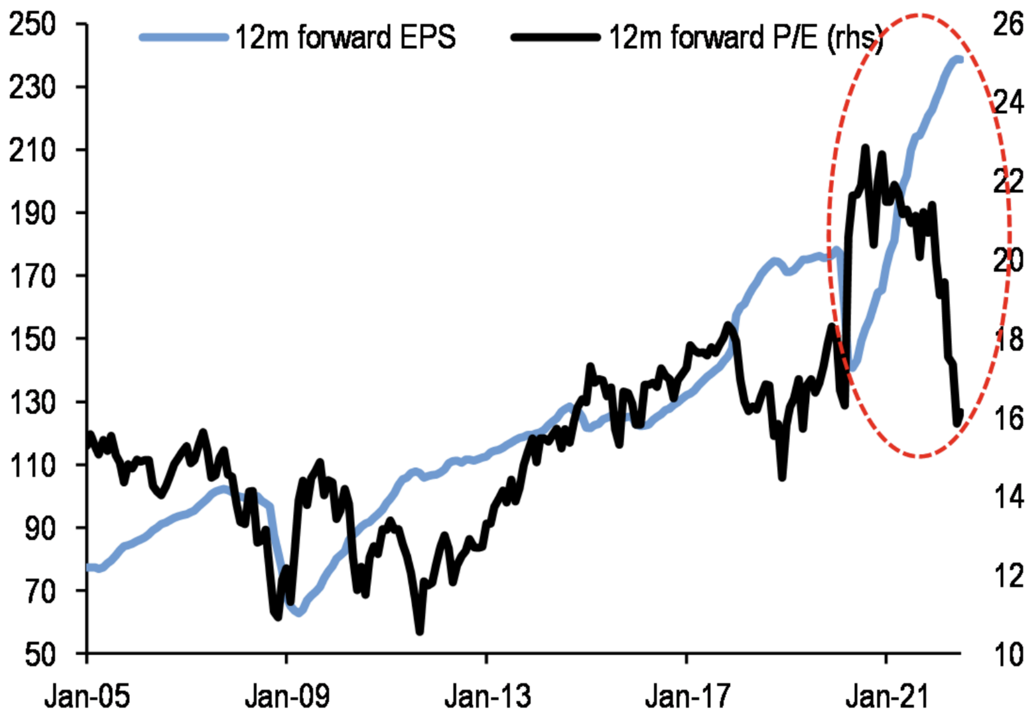
Source: J.P. Morgan Equity Macro Research, Bloomberg Finance L.P.

We continue to see the "Middle Way" as most likely amid the potential for inflation to peak and rollover much faster than most expect. The high nominal growth environment should continue which gives us comfort on the earnings front through YE. We note that while the 2H EPS estimates have come in somewhat they remain in positive territory while 2023 consensus estimates remain pretty stable. Seasonality is not equity friendly for the coming few months but then we enter a positive frame especially in mid term years. A heathy degree of skepticism provides further buying power for stocks as does continued large short positions.

Wild cards remain: a Russian gas shutoff to Europe, China – Taiwan risk (we ascribe low odds here), a more aggressive Fed (hard to see if inflation rolls over in the coming months as we expect), a sharp collapse in the labor markets of Europe or the US, a sudden collapse in earnings. TBH, none of these seem to have great odds. Yet, JPM notes a record wide gap between 12M forward PEs coming down from 23 to 16 while 12M forward earnings remain robust. Sustained insider buying, especially of tech stocks, are another positive signal.

Chart 18 – Earnings Bridge Ahead

Figure 14: Disconnect between EPS and multiples

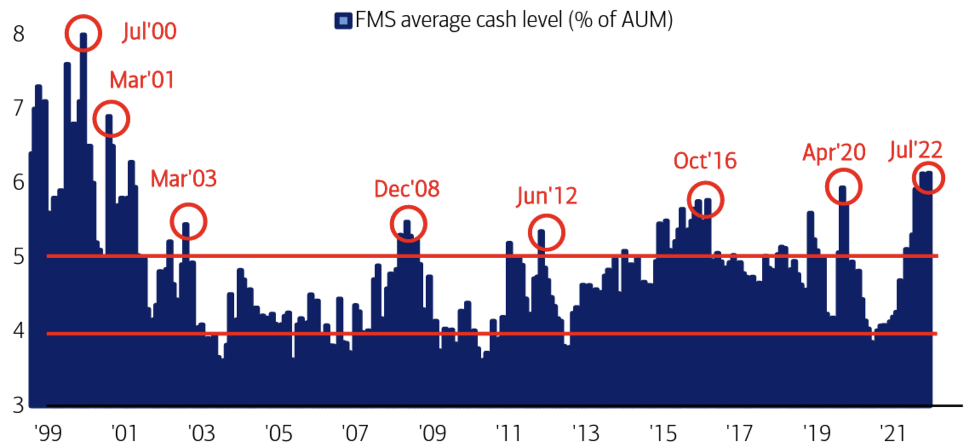


Source: J.P. Morgan.

A period of digestion would make sense – both stocks and bonds have come a long way in a short period and now approach significant resistance levels. It's August, volumes are thin, much of last month's buying power resulted from short covering. If we are right that policy risk may be stabilizing the current lull in the volatility indices for both stocks and bonds could continue. As time passes though and our earnings bridge holds up the case for BTD would seem to grow.

Chart 19 – Lots of Cash Available to Buy Stocks

Chart 8: Cash levels highest since 2001
FMS average cash balance, %



Source: BofA Global Fund Manager Survey

BofA GLOBAL RESEARCH

Buying the 10 yr. UST at 2.65% doesn't seem that attractive, selling oil at Brent $100 doesn't either. We remain OW equity within our GMA, OW non US, including Japan where corporate FY2023 av Yen rate of 119 suggest lots of EPS upside given current rate over 130. We remain OW SCs and are thinking through our Growth-Value tilt; while energy for ex remains attractive given multiple cash metrics we have tilted back to Growth over the past few months. Within our TPW 20 model we remain focused on Climate and Tech Innovation as our two main segments.

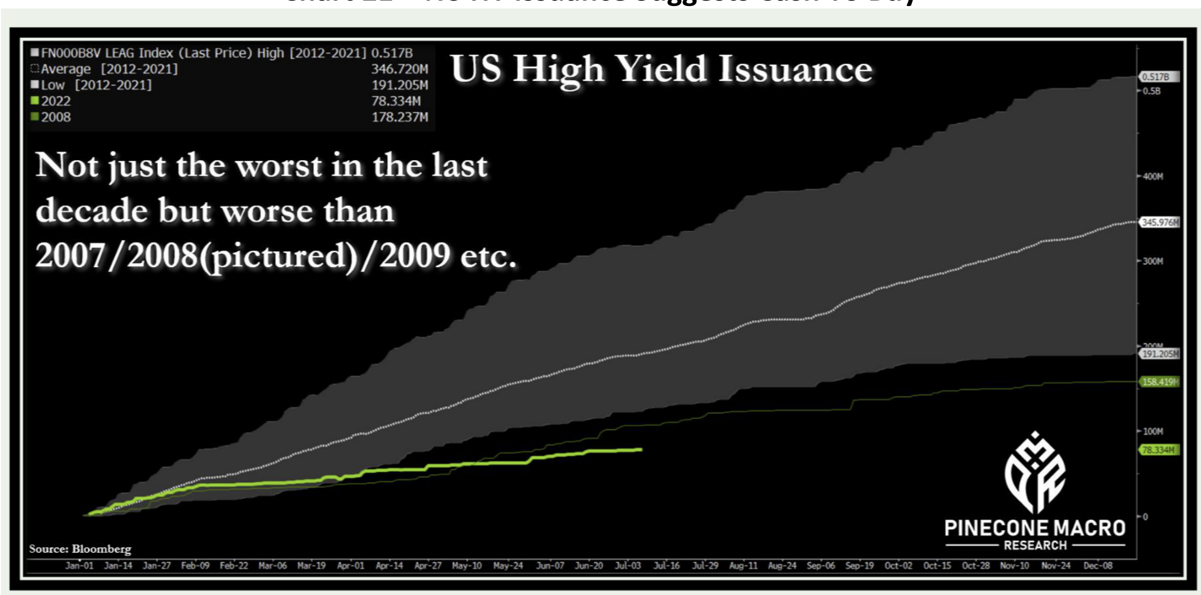
Chart 20 – Market Speed

US equities have de-rated at the fastest pace on record

Source: Factset, Bloomberg, Refinitiv, SG Cross Asset Research/US Equity Strategy

We remain UW bonds, esp. sovereign (ex China) and express a positive view on credit both in the US and EM Asia. Credit conditions remain pretty good in the US with no default cycle evident, no refi mountain for years and very little issuance suggesting cash should be piling up in managers' coffers. We are watching the 3M- 10 yr. UST spread carefully as we view it as more accurate a read on recession risk that the 2-10 yr. spread.

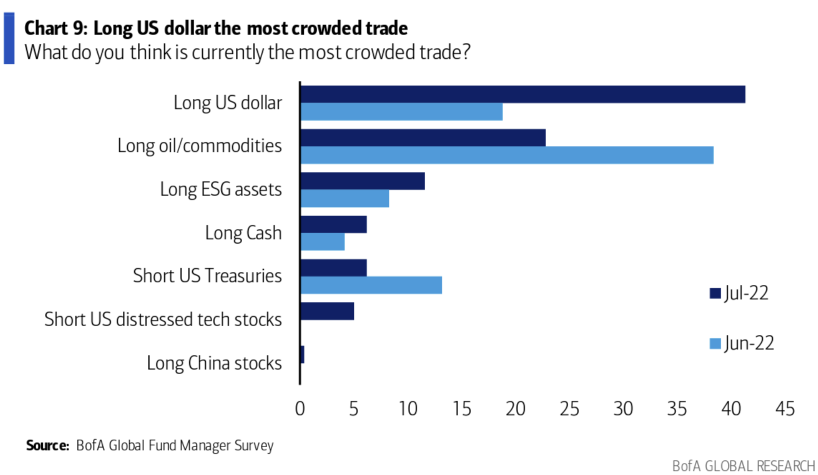
Chart 21 – No HY Issuance Suggests Cash To Buy



Commodities have given with one hand and taken with the other. After a huge rally the CRB index has fallen for 2 months in a row, the first such back-to-back decline in several years. We have maintained an OW position based on our view that deep recession is unlikely and once it's clear that inflation has peaked and the Fed does not need to go full on with its rate tightening, the USD should weaken and commodities take another leg up. We remain believers in a secular bull market for broad commodities. Gold might even have a chance to surprise to the upside as real rates stabilize given elevated short positions. Crescat Capital points out GDX now has a dividend yield equal to the 10 yr. at 2.6%, its highest yield in a decade or more.

Chart 22 – Secular Bull Market in Commodities

Chart 23 – Has the USD Peaked?



Most crowded trades in Jul'22…

1. Longest US dollar (41%)
2. Long oil/commodities (23%)
3. Long ESG assets (12%)
4. Long cash (6%)
5. Short US Treasuries (6%)
6. Short US distressed tech stocks (5%)
7. Long China stocks (0.4%)

A coda to our bear visit story; several nights later, a loud commotion broke out around midnight… the bear had returned, climbed the stairs to the 2nd floor deck and attacked the gas grill, shredding its covering & moving the heavy grill itself several feet as it tried to get to the drip tray. After a while, it gave up and left… it took much longer for sleep to return.