



Southern Capital Perspective

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Some Glimmers of Light on the Horizon

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As we work our way through this bear market with the depressing headlines regarding recession and market losses, it becomes all too easy to only see darkness. However, there are glimmers of light that may be indicating a brighter future. This is not to say that the bear is finished, but that there are events that could start to change the course. We have identified six of these factors that may be the basis of this course change.

✦ **Glimmer #1.** China is allowing its cities to start being released from the Covid-lockdowns. The devastating impact of the lockdowns is evidenced in the following: "According to data from Shanghai's statistics agency, the city's industrial output fell by 61.5% in April compared to a year earlier. Retail sales fell by 48.3% over the same period." Also, from the same Fortune article by Nicholas Gordon, "Analysts from the Russell Group estimate that China's lockdowns - which hit several cities beside Shanghai - had cost global trade about \$28 billion."

This economic disruption was not confined to China because of the interdependency of global trade. Supply chains were disrupted in the US as well as worldwide. The liberation from these lockdowns is still a glimmer and not a full-fledged light for two reasons: first, another outbreak could be met with a similar response. And second, even if Covid does not re-emerge, restarting the Chinese economy will take some time and will need assistance. The Chinese government recognizes this and has indicated that they will be taking measures to stimulate the economy.

✦ **Glimmer #2.** The potential for a resolution to the Ukraine-Russian war could be reached. The Brookings Institution has described this war as a tragedy and a disaster. It is a tragedy for the Ukrainian people because they did nothing to provoke or justify being invaded by Putin's Russia. The Ukrainians suffered thousands of civilian and military casualties as well as enormous damage to their homes and infrastructure.

This war has also been a disaster for Russia. They have lost tens of thousands of soldiers either killed or wounded, major equipment losses, and sanctions causing real economic pain. The glimmer comes from the prospect of a cessation of hostilities, not from the prospect of a fair and just outcome.

Putin is threatening to cut-off natural gas to Europe as winter approaches. He is also barring Ukraine from shipping wheat, thereby causing famine in some parts of the world. He feels these threats will cause Europe to put pressure on President Zelensky to negotiate a peace that is acceptable to Russia. If Putin gets his way, it will likely bring down the price of energy and wheat. Markets and economies would benefit from this even if, sadly, it does not benefit the Ukrainian people.

✦ **Glimmer #3.** Shipping deliveries have begun to flow. During the pandemic, supply chains were severely disrupted and goods on store shelves were sparse. The big retailers, like Walmart placed orders, but shipping delays due to backed-up ports kept them from receiving the merchandise. At the same time, the government was sending out checks to people. The restaurants and entertainment venues were shut down, so people wanted to buy things for their homes, but the stores did not have the stock they had ordered to sell.

Since then, the shipping delays from the bottlenecked ports have eased and the stores received their back orders which has resulted in a glut of inventory. The restaurants and entertainment venues have re-opened so people are not wanting to purchase the excess inventory the stores had ordered.

Walmart Inc. has stated it needs another two quarters or so to work through an inventory surge that prompted markdowns. This means that there will be discounts and sales and lower prices. Most big retailers are doing the same thing, which puts downward pressure on inflation. This ray of sunshine will help to slow the inflation surge.

✦ **Glimmer #4.** Corporate earnings expectations (from credible sources) are stronger than what would be anticipated considering the bear market and a risk of recession. The stock market's value is measured by the Price to Earnings ratio (PE ratio). The bear market has brought the PE ratio down from overvalued to historic fair value levels. This indicates that the downward pressure on stocks may be losing momentum, unless, of course, if the "E" or earnings level drops, then for the ratio to remain similar the "P" or price would have to fall.

The consensus of the analysts is forecasting that the earnings on the S&P 500 for the third quarter of 2022 will increase by 10.7% and by 13.0% in the fourth quarter. However, a renowned economist has estimated the increases at a much more modest 5.8% and 5.5%. The point is that whether its 5% or 10%, it is an increase, and an increasing "E" will bring about an increasing "P" to keep the ratio in the same range. For this ray of light to come to pass, the analysts and the experts need to be correct in their earnings call.

✦ **Glimmer #5.** The low approval ratings of the Administration may begin to bring pressure (especially with the fast approaching mid-term elections) to change some of their policies. In the Monmouth University poll, the President's approval reached a new low of 36% and the poll regarding the direction of the country, shows 88% feel that the US is on the wrong track.

Energy policy is the primary concern because of its widespread impact and its link with inflation. High gasoline prices affect almost everyone and most businesses that deal with retail customers. High diesel costs affect everything that has to be shipped including agricultural products, manufactured products, and the transportation fuels themselves. Political pressure may bring about an easing of the restrictions on the

production of oil and gas which would be a great benefit to consumers and also bring down inflation pressures through lower energy costs.

✦ **Glimmer #6.** The actions of the Federal Reserve (Fed) could be the brightest glimmer of all. The Fed is engaged in a campaign to fight inflation by raising interest rates and restricting the money supply. There are strong arguments that they should have begun this process a year earlier; however, they are now resolutely doing rate hikes (later this month another 75 basis points or three quarters of a percent) with the goal of getting inflation under control. But they also have another mandate of maximum employment.

If the Fed's rate hikes prove to contract the economy, increase unemployment, and throw the US into a recession, then in 2023 or even possibly in late 2022 they may have to reverse course and start lowering interest rates. Although the Fed does not expect that sequence of events, they are aware of the possibility.

"When asked if the U.S. would see rate cuts next year because of a potential recession, Loretta Mester, president of the Federal Reserve Bank of Cleveland, said Wednesday: 'I don't see that in my baseline, but again we're just going to have to assess economic conditions on the ground as we go forward.'"

Clearly, if the Fed decides to reduce rates, the markets will view that favorably as a return to the easy money policies of the last fifteen years, although it would probably be better for our nation if Powell and the Fed finished the fight against inflation as Chairman Paul Volker did 40+ years ago which led to two decades of prosperity.

These six glimmers represent potential game changers, but at present they are still distant rays of light. The bear is still with us for now, so we will not change our defensive stance.

OUTLOOK

The year 2022 has been very difficult and extremely volatile. In the beginning of the year, it looked like we were experiencing a typical ten percent correction and then it kept declining until we were in a bear market. We added some inflation hedges and shifted from growth and value funds to almost exclusively value-oriented funds. This strategy helped to soften the hit, but in a bear market virtually everything suffers to some degree.

The third and fourth quarters of 2022 will likely continue to be volatile. We cannot foretell the end of the bear, but if Forbes is correct, the bear maybe getting "long in the tooth." If history is any guide, we could be around halfway into a bear market in terms of timing, and over halfway in terms of stock declines."

When we see clear signs that the market is about to reverse course, we plan to gradually move back into a more balanced blend of growth and value. As always our plans are subject to change as events may unfold differently from our expectations.

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