ICON Insights

Market Commentary - August 2022

By Craig Callahan, DBA | ICON Founder & President **Published 8’2’2022**

Equities

After tumbling 8.34% in June, the S&P 1500 Index rebounded and gained 9.33% in July. The decline in June was due to analysts’ fears that tighter monetary policy would have a severe and negative effect on corporate earnings. In July, however, companies reported their second quarter earnings, and they turned out better than analysts feared. Through July 29, 659 of the companies in the S&P 1500 Index reported earnings and, on average, they beat estimates by 4.55%. Companies in the Energy sector have had the biggest surprise, beating estimated earnings by 10.7%. Healthcare and Utilities were second and third, beating estimates by 7.7% and 6.53%, respectively. The better-than-expected earnings provided a nice base for the stock market advance in July and makes June appear to be an overreaction by analysts and investors.

Unfortunately, there are only two tools available to policy makers to bring down inflation over a short period of time, such as a year. One is raising taxes. The other is monetary tightening, or slowing the growth of the money supply (M1). Both are harsh and are intended to slow the economy. Monetary tightening is underway as the Federal Reserve (Fed) has raised its Federal Funds target rate four times this year. Through the second quarter, ending in June 2022, the money supply has contracted at an annual pace of -3.1%. When we see the money supply for July and August, after the Fed raised its Federal Funds target rate in late July, we would expect contraction of the money supply to be at a 4% or even 5% annual pace.

The big question for investors now is: how far will the Fed have to go to get inflation down to its 2.0% target and will it send the economy into recession? The next question, given the drop in the stock market this year: is the worst-case economic scenario already built into stock prices? There are extreme variations in opinions regarding these questions. On financial TV, one analyst says the Fed is about done tightening and inflation will fade. The next guest says the Fed will need to take the Federal Funds rate to over 4% and throw the economy into recession to fight inflation. At ICON, we are in the moderate camp and see some natural downward pressure on inflation as supply and demand become aligned. We expect the Fed to tighten some more as they have clearly stated how determined they are to get inflation down to target.

We are not managing money by guessing what the Fed will do or by listening to the guesses of others. We have between 18% and 22% cash in our capital appreciation-oriented portfolios. We do not see the conditions and behaviors often seen at market bottoms, yet with a market Value/Price (V/P) ratio of 1.09, we do not see the need for big market drops from here. As for sectors, over the last few months we have increased exposure to Healthcare and Consumer Staples and reduced Information Technology and Consumer Discretionary.

Bonds

Beginning in our May Portfolio Update we talked about the potential for short-term interest rates and long-term interest rates to become decoupled, meaning short term rates would increase as the Fed tightened, but long-term rates would not tag along on the upward path. Our reason was the Fed can influence short term rates but that, in our opinion, long term rates were more determined by inflation expectations. At some point, investors would realize that he Fed was serious about, and quite capable of, reducing inflation. Once bond investors believed in the likelihood of lower inflation, long term bond yields would quit increasing. The yield on the 10-year Treasury note hit a high of 3.48% on June 14 but has fallen to 2.65% to end July. Over that same period, the yield on 13-week Treasury Bills increased from 1.93% to 2.45%. During the remainder of 2022, we expect the Fed to increase short-term interest rates but we do not expect longer rates to participate in the upward move.

Summary

There is debate underway whether the economy will enter, or is already in, a recession. It almost appears to be a game of semantics, where each analyst has her own definition of recession. There is an old joke on Wall Street that it’s a recession when your neighbor loses his job, but it is a depression when you lose your job. We are not entering that guessing game. We are content holding much higher levels of cash than normal. We are looking for the conditions and behaviors that often accompany market bottoms. We see some, but not enough yet.

The data quoted represents past performance, which is no guarantee of future results. *Opinions and forecasts regarding sectors, industries, companies, countries and/or themes, and portfolio composition and holdings, are all subject to change at any time, based on market and other conditions, and should not be construed as a recommendation of any specific security, industry, or sector.*

Investing in securities involves inherent risks, including the risk that you can lose the value of your investment. An investment concentrated in sectors and industries may involve greater risk and volatility than a more diversified investment. Investments in international securities may entail unique risks, including political, market, regulatory and currency risks. In general, there is less governmental supervision of foreign stock exchanges and securities brokers and issuers. Investing in fixed income securities such as bonds involves interest rate risk. When interest rates rise, the value of fixed income securities generally decreases.

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ICON's value-based investing model is an analytical, quantitative approach to investing that employs various factors, including projected earnings growth estimates and bond yields, in an effort to determine whether securities are over- or underpriced relative to ICON's estimates of their intrinsic value. ICON's value approach involves forward-looking statements and assumptions based on judgments and projections that are neither predictive nor guarantees of future results. Value readings are contingent on several variables including, without limitation, earnings, growth estimates, interest rates and overall market conditions. Although valuation readings serve as guidelines for our investment decisions, we retain the discretion to buy and sell securities that fall beyond these guidelines as needed. Value investing involves risks and uncertainties and does not guarantee better performance or lower costs than other investment methodologies.

ICON's value-to-price ratio is a ratio of the intrinsic value, as calculated using ICON's proprietary valuation methodology, of a broad range of domestic and international securities within ICON's system as compared to the current market price of those securities. According to our methodology, a V/P reading of 1.00 indicates stocks are priced at intrinsic value. We believe stocks with a V/P reading below 1.00 are overvalued while stocks with a V/P reading above 1.00 are undervalued. For example, we interpret a V/P reading of 1.15 to mean that for every $1.00 of market value, there is $1.15 of intrinsic value which has not yet been realized in the market price.

The unmanaged Standard & Poor's Composite 1500 (S&P 1500) Index is a broad-based capitalization-weighted index comprising 1,500 stocks of Large-cap, Mid-cap, and Small-cap U.S. companies.

Federal Funds: In the United States, the federal funds rate is the interest rate at which private depository institutions (mostly banks) lend (federal funds) at the Federal Reserve to other depository institutions, usually overnight. Changing the target rate is one form of open market operations that the Chairman of the Federal Reserve uses to regulate the supply of money in the U.S. economy.

All earnings and earnings estimate numbers are compiled by and provided by Bloomberg.

M1 is one measure of the money supply that includes all coins, currency held by the public, traveler's checks, checking account balances, NOW accounts, automatic transfer service accounts, and balances in credit unions.

The 10-year yield is the benchmark 10-year yield to maturity reflected by the current issue 10 year U.S. Treasury note.

T-Bill: A Treasury bill (T-Bill) is a short-term debt obligation backed by the Treasury Dept. of the U.S. government with a maturity of less than one year. T-bills can have maturities of just a few days or up to a maximum of 52 weeks, but common maturities are 4, 8, 13, 26, and 52 weeks. The longer the maturity date, the higher the interest rate that the T-Bill will pay to the investor.

Sources: Bloomberg

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8480 E Orchard Road, Suite 1200
Greenwood Village, CO 80111
1-800-828-4881 • ICONAdvisers.com