Market Perspective
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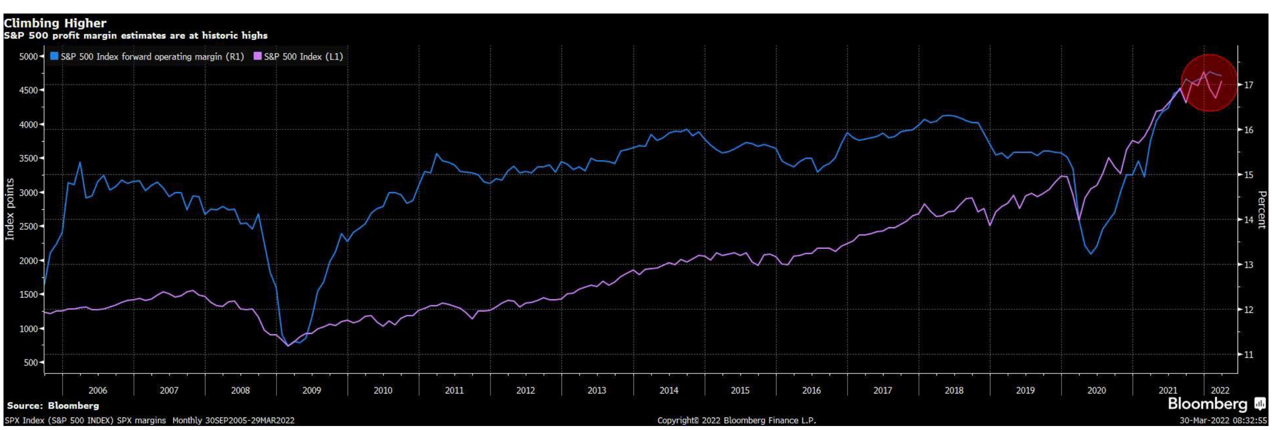
While the market began this year discounting our economic challenges, the disconnect between the returns on risky assets in the last two weeks vs the fundamental economic problems in our world is palpable. Since March 14 (through March 29):

- The S&P 500 has risen 11% (after falling 12% YTD through March 14)
- The "FANG" stocks are up 17% (after falling 26% YTD through March 14)
- High Yield Bonds are higher by 4% (after falling 8% YTD through March 14)

At the same time, it is increasingly clear that we are facing new challenges to our economic backdrop:

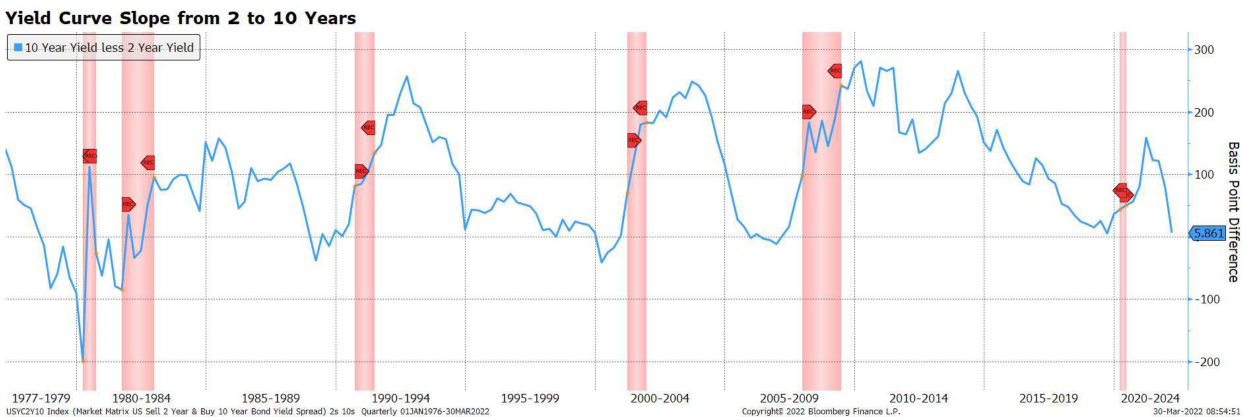
- Inflation (CPI) is running near 8%, with expectations for this measure to go higher in the coming months
- Responding to inflation, the FED has signaled that it will raise short-term rates from 0.5% to 2.75% over the next year
- The "market" has already responded by pushing the 10-Year Treasury Yield to 2.4% from 2.1% on March 14
- Commodity prices, due to the Russian invasion of Ukraine, have risen 27% this year!
- Wages and salaries increased 5% during 2021

These are all interesting facts, but the real question is what will happen to corporate earnings, the true driver of securities prices? Mike Wilson, Chief US Equity Strategist for Morgan Stanley wrote yesterday morning that inflationary pressures, led by wages, would put a crimp in profit margins going forward. He noted (as I did last quarter) that profit margins are at an all-time high and that they have been driving stock prices higher. Consider the following graph:

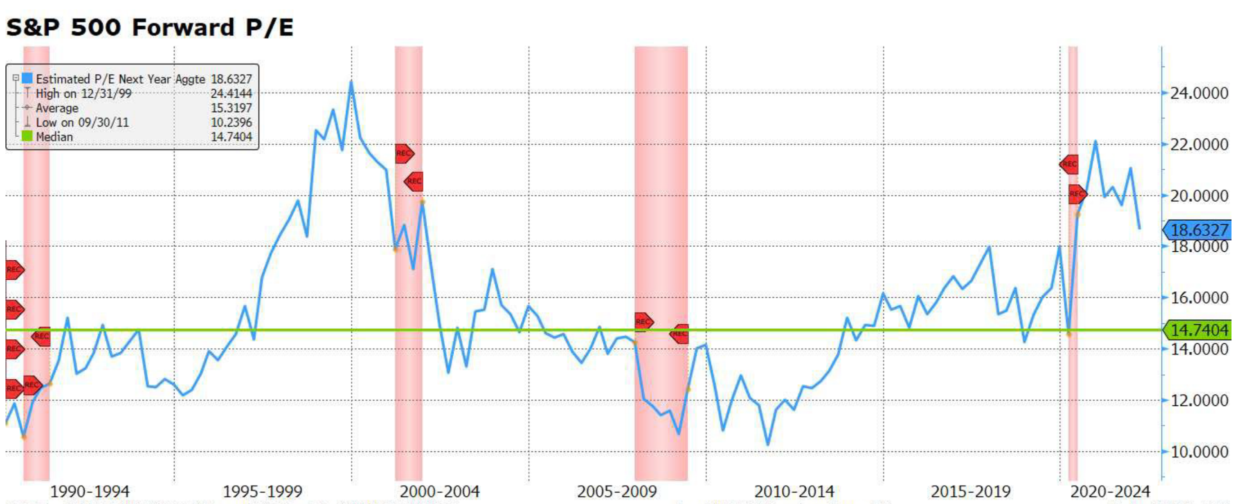


If companies can't pass along all their inflationary inputs, margins will inevitably decline. Last week, Gina Martin Adams, Chief Equity Strategist at Bloomberg Intelligence noted that the Producer Price Index (PPI) is running hotter than the Consumer Price Index (CPI), implying that the difference would be absorbed by margin declines.

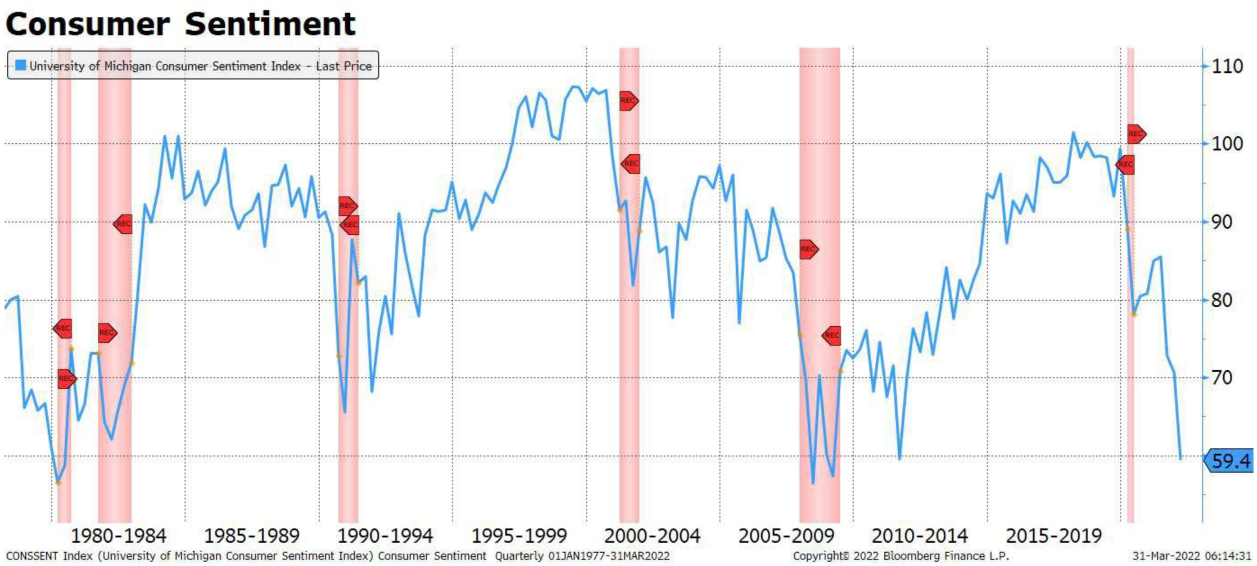
My commentary so far has related to the cost side of margins. But revenues are also at risk. As I indicated earlier this month there is a heightened probability that a recession will develop in the US during the next 12-18 months. The slope of the yield curve from two-year to 10-year Treasuries did invert this week, implying that investors see risks to longer-term economic activity. This indicator has a great track record at predicting recessions (the shaded red bars):



All of this is against a backdrop of continued high valuations on risk assets. Here's the forward P/E on the S&P 500 since 1990. While this measure has come down from where it was in 2021, it remains materially above the median of the last 30 years.



Since the 2008 financial crisis, the buying power of the US Consumer has been the bulwark against economic downturns. This measure no longer supports ever-increasing levels of optimism. The University of Michigan publishes its Consumer Sentiment Index each month. Here's the time series, dating back to 1978.



Note how, in line with yield curve inversions, dramatic declines in Consumer Sentiment reliably precede or are coincident with recessions.

It seems to me that these various metrics imply a need for caution against chasing the values of risk assets higher. Patience will provide a more attractive entry point.