Market Risk Remains As Earnings Season Begins

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Weekly Market Recap With Adam Taggart

https://youtu.be/IqK_D3rRV7o

Administrator Note

As noted last week, my family and I traveled to Maiori, Italy, to visit our son, who lives in Germany. It was a great trip, and I look forward to sharing some stories on the *"Real Investment Show"* next week.

I am just returning home to get back to work, so this week's newsletter will again be a *"condensed"* version. However, I promise that next week everything will be back to normal.

In the meantime, I do appreciate your patience and understanding, and I hope you have a great week.

Here is one of my favorite photos from the balcony of Villa Scarletta, a home built in 1920 overlooking the ocean, of Maiori at night. *(For some reason, there were fireworks every night.)*



Market Trading Update

Over the last week, the market remained under pressure as a hotter-than-expected inflation report, and a more robust employment report gave the Fed room to hike rates more aggressively next week. While stocks rallied nicely on Friday, these 2%ish-up days remain better for selling than buying as follow-through has been inconsistent.



Nonetheless, the market did hold minor support setting a higher low from the recent bottom. The rally was also strong enough to keep the MACD buy signal intact while shorter-term sell signals reverse back to a *"buy"* signal, as shown above.

The market is now challenging the downtrend line from the March highs, and with the recent sell-off, this is the best chance we have had as of late to potentially push above that resistance. Unfortunately, the market will almost immediately contend with the 50-dma resistance level.

The market risk currently remains earnings. As discussed last week, analysts remain overly optimistic on earnings and have now begun cutting estimates sharply ahead of earnings season. The risk is the current cuts are not enough to offset incoming reports, which could be worse than expectations. Forward guidance from companies will also be a vital issue for markets.

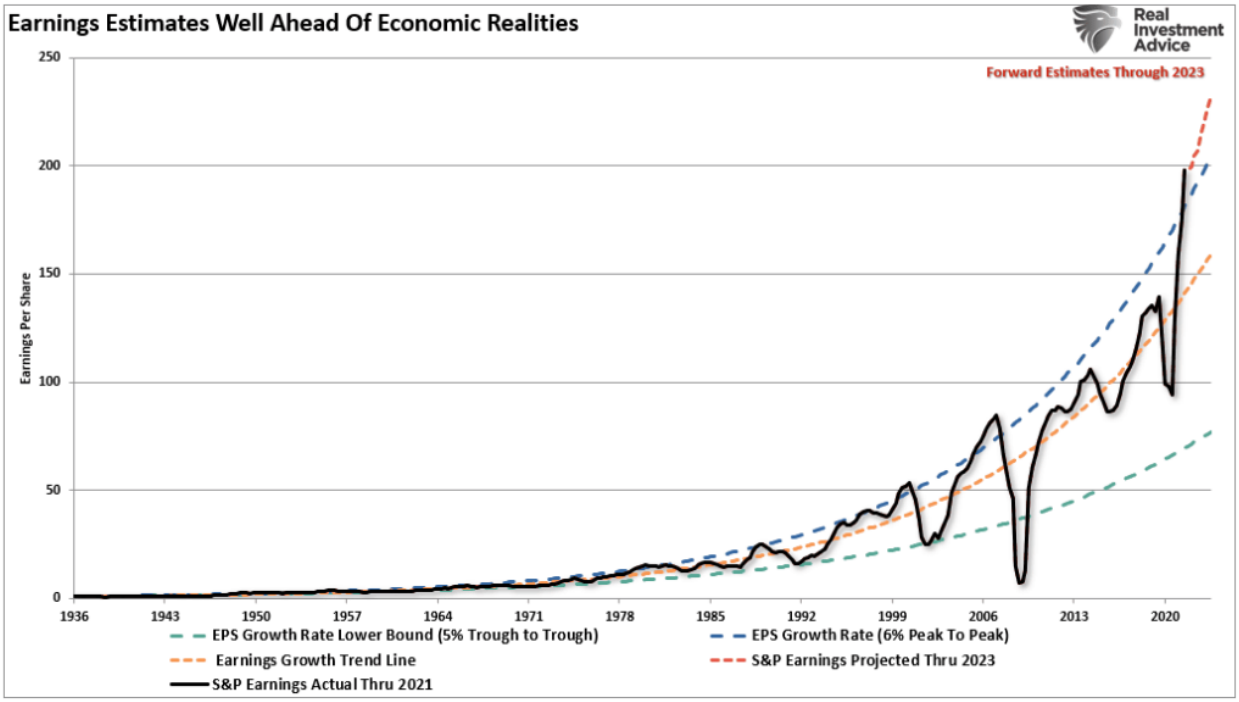
We will look for companies that announce earnings and give guidance below current estimates, but the stock price remains stable. Such would suggest that much of the bad news has been priced in and could provide opportunities to enter into selective positions.

As noted, the market risk remains high, so we remain cautious for now.

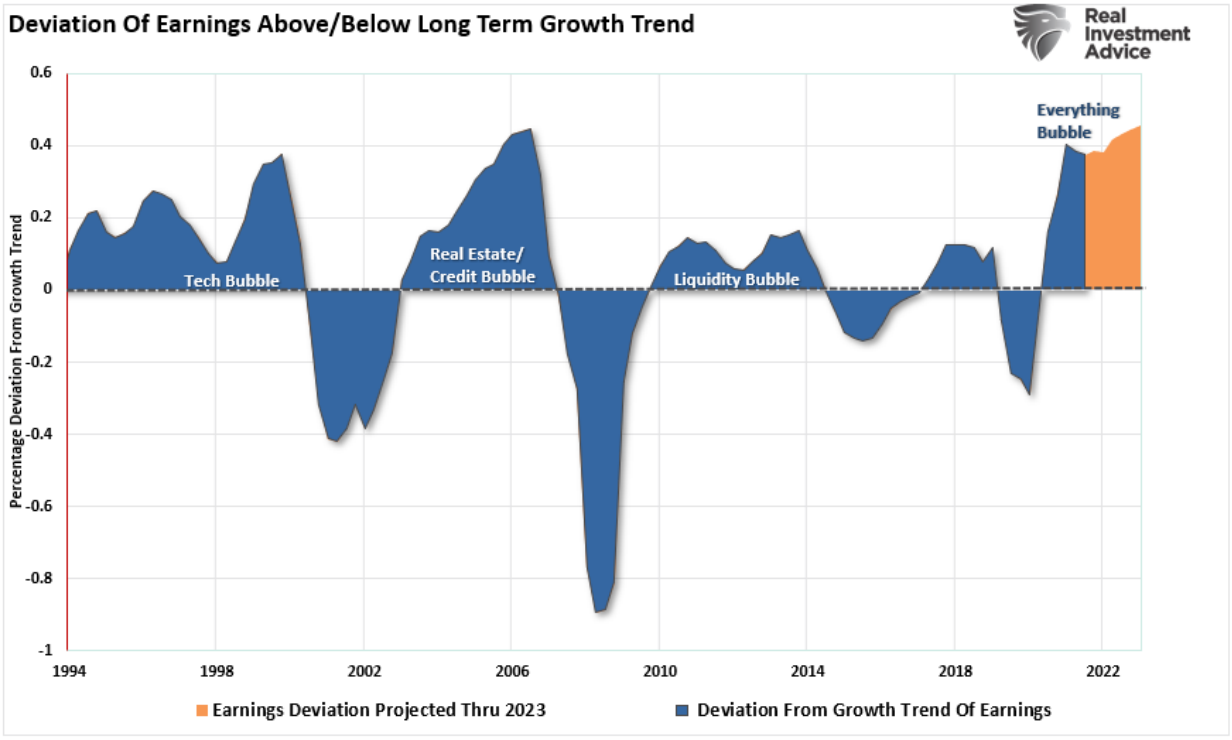
Market Risk Remains As Earnings Season Begins

As noted, the primary market risk to focus on over the next month will be earnings. To recap from last week:

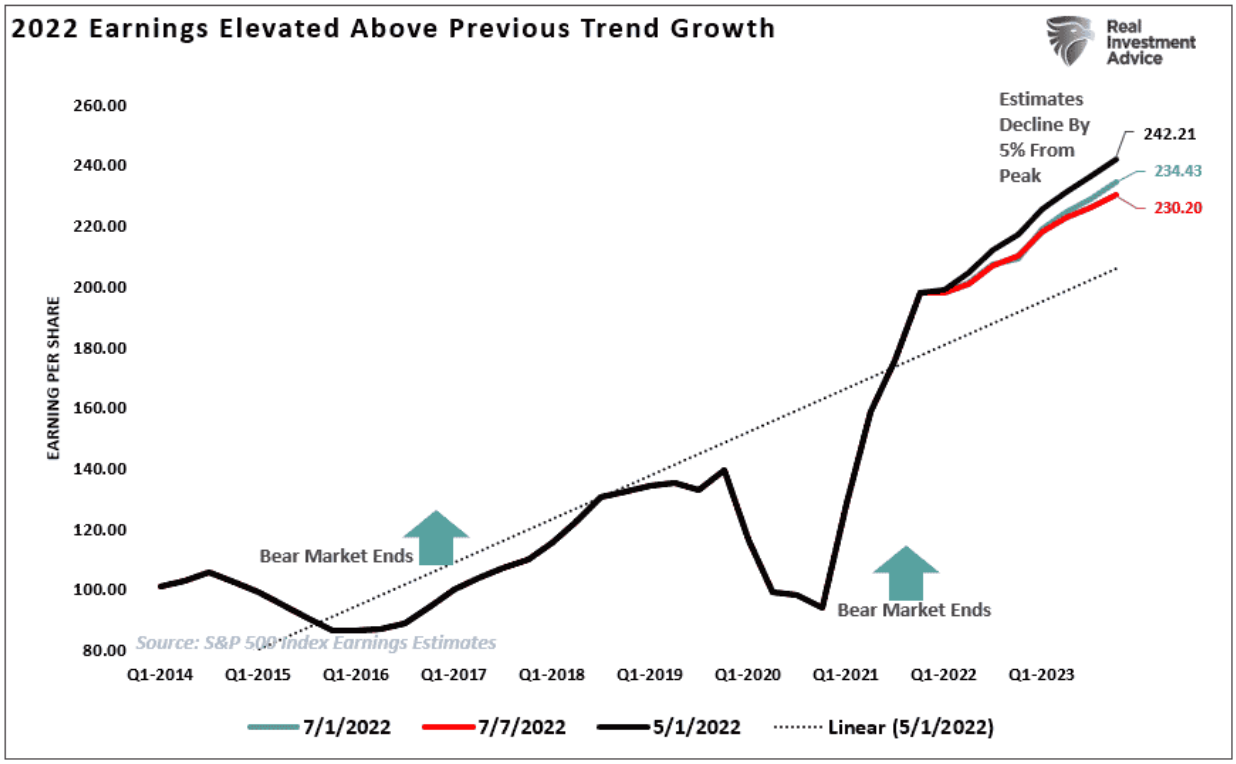
> *"Profits, which get reported to the IRS for tax purposes, also put current high estimates of earnings at risk. As we noted in **?Earnings Recession,?** the economy grows at about 6% historically. Therefore, earnings growth also runs at roughly ~6% on a peak-to-peak basis. However, analysts currently suggest that earnings growth into 2023 will run well above the historical growth rate despite forecasts of much slower economic activity."*



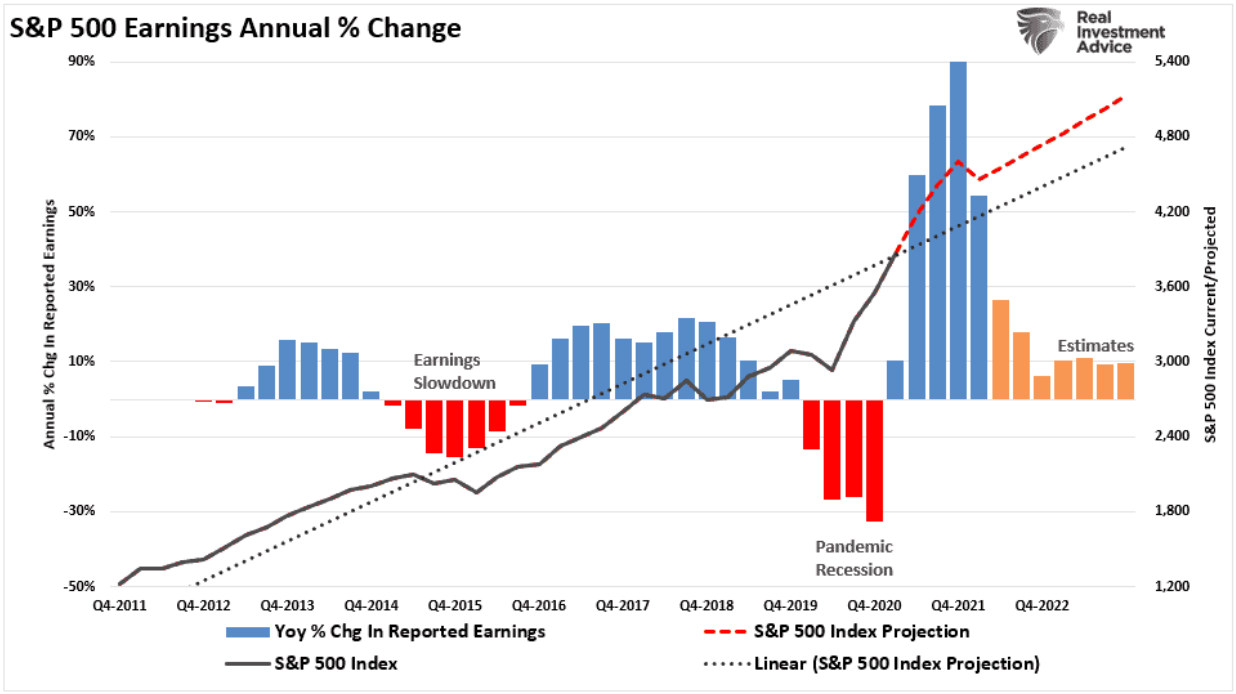
For perspective, analysts' estimates are currently at the most significant deviation above that 6% earnings growth trend.



In just the first week of July, analysts have drastically cut earnings estimates for the second quarter through the end of 2023 as the realization of a recession rises. The chart below shows estimates from S&P for June 1st, July 1st, and July 7th. The downward revision has been quite marked, and since May 1st, forward estimates have fallen 5% from their peak.



While this is a good start, such doesn't potentially account for normal reversions in earnings during recessionary periods. As shown below, earnings growth remains positive going into 2023. However, during previous economic downturns, negative earnings growth was the norm.



Given the massive surge in revenue and earnings growth was a function of enormous government interventions that created a surge in demand for goods and services, the reversal of that liquidity will be a challenge for businesses. If such is the case, as noted last week:

> *"Currently, earnings estimates for stocks are not accounting for slower economic activity. While the ?P? in the valuations (P/E) calculation has declined, the ?E? has not."*

If we are correct, market risk is higher than many realize.

MacroView



Giant Corporations Are Causing Inflation?

Written by Lance Roberts | Jul 15, 2022 | Investing

"Giant corporations are using inflation as cover to raise their prices & boost their profits....

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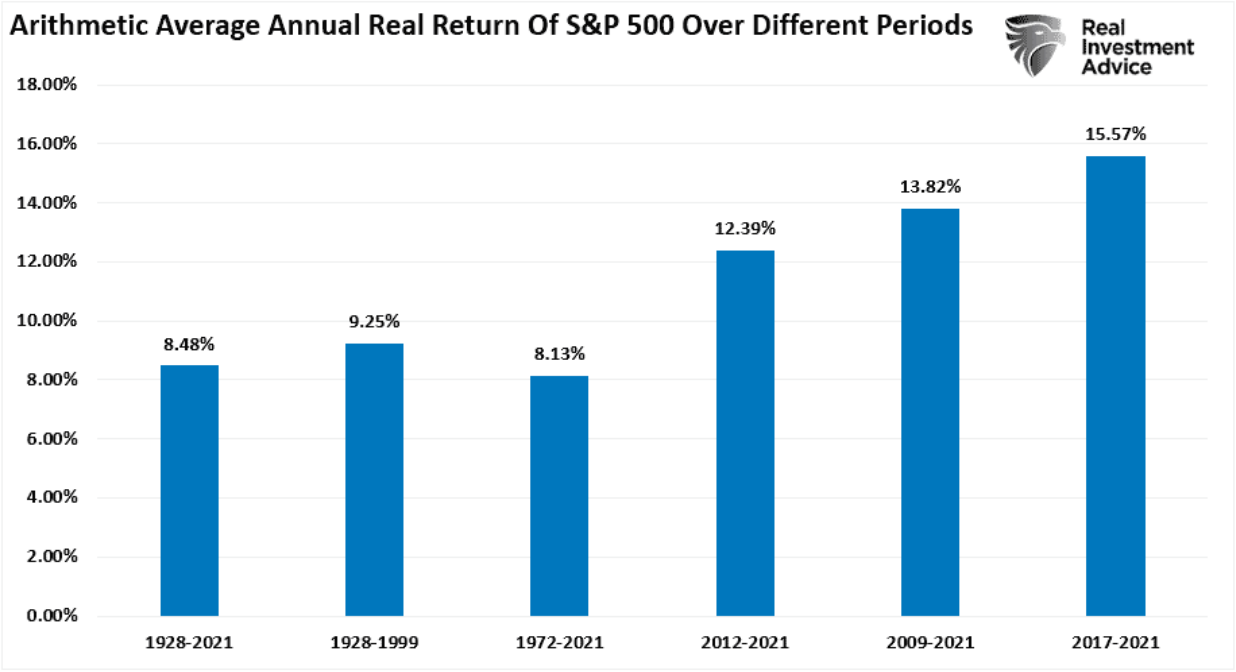
Mean Reversion In Market Returns

You will often hear advisors and the media state the following:

> *"Over the long-term, stocks have consistently returned 10%."*

While that is a true statement, it is very misleading. The chart below shows the average annual inflation-adjusted total returns (dividends included) since 1928. I used the total return data from Aswath Damodaran, a Stern School of Business professor at New York University. The chart

shows that from 1928 to 2021, the market returned 8.48% after inflation. However, notice that after the financial crisis in 2008, returns jumped by an average of 4 percentage points for the various periods.

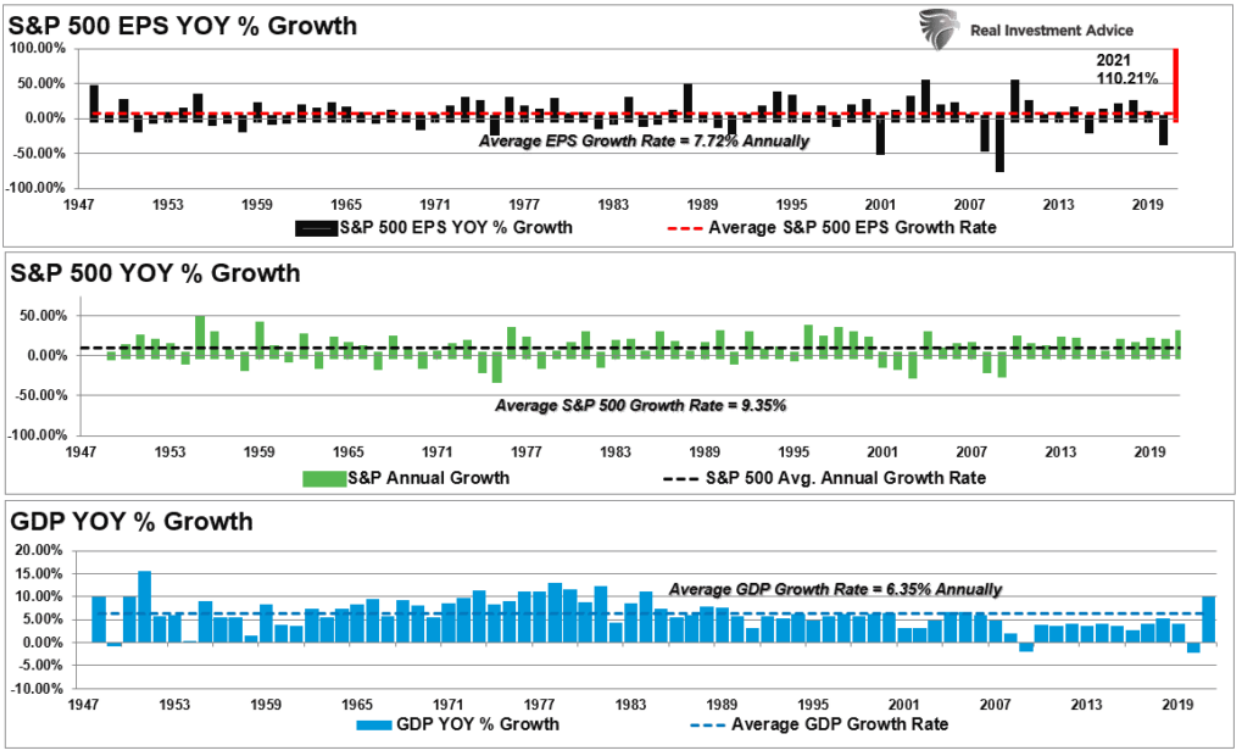


This return surge resulted from the Fed's repeated monetary interventions and zero interest rate policy, creating the most significant financial bubble in history.

Here is the problem.

While *"stocks may not* be the economy," the economy is where corporate earnings and revenues are derived from. As such, stocks can not indefinitely grow faster than the economy over long periods.

When stocks deviate from the underlying economy, the eventual resolution is lower stock prices. Over time, there is a close relationship between the economy, earnings, and asset prices. For example, the chart below compares the three from 1947 through 2021.



Since 1947, earnings per share have grown at 7.72%, while the economy has expanded by 6.35% annually. **That close relationship in growth rates is logical given the significant role that consumer spending has in the GDP equation.**

The slight difference is due to periods where earnings can grow faster than the economy when coming out of recession. However, while nominal stock prices have averaged 9.35% (including dividends), reversions to actual economic growth eventually occur. Such is because **corporate earnings are a function of consumptive spending, corporate investments, imports, and exports.**

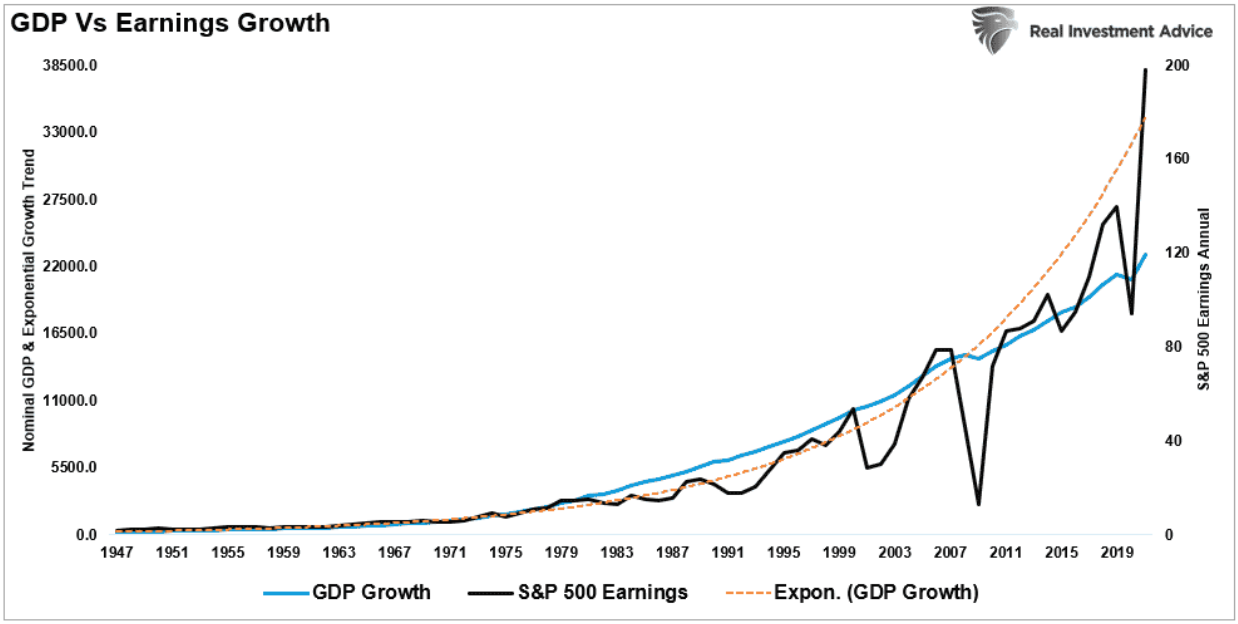
Stocks Vs. The Economy, Which Is Right?

The market disconnect from underlying economic activity is due to psychology. Such is particularly the case over the last decade, as successive rounds of monetary interventions led investors to believe *"this time is different."*

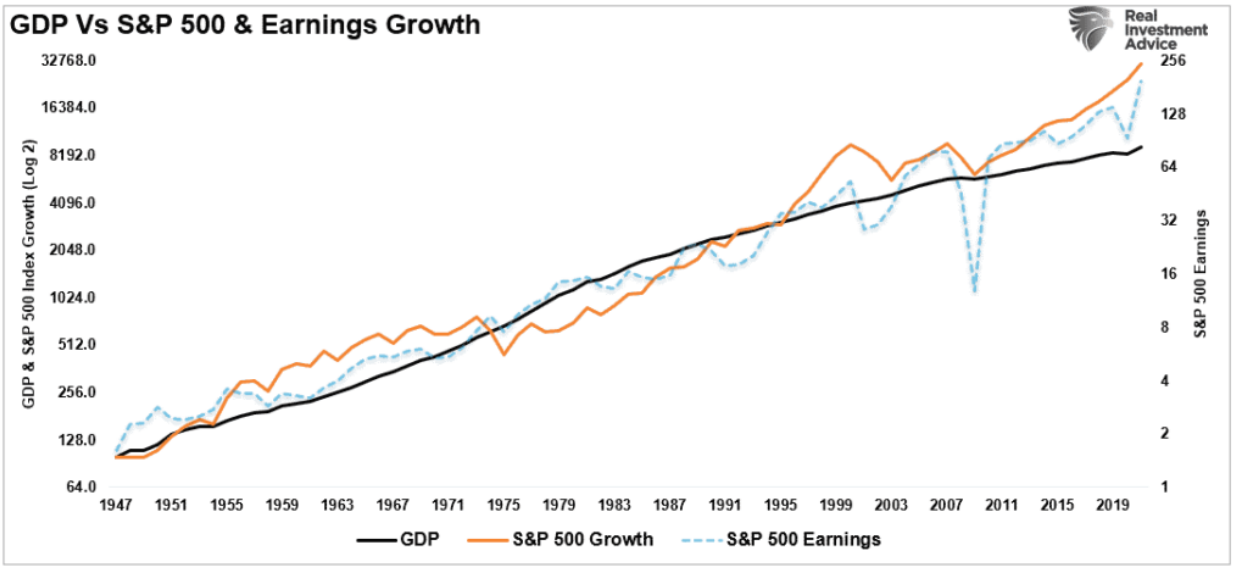
Unfortunately, it never is.

While not as precise, a correlation between economic activity and the rise and fall of equity prices does remain. For example, in 2000 and again in 2008, earnings contracted by 54% and 88%, respectively, as economic growth declined. Such was despite calls of never-ending earnings growth before both previous contractions.

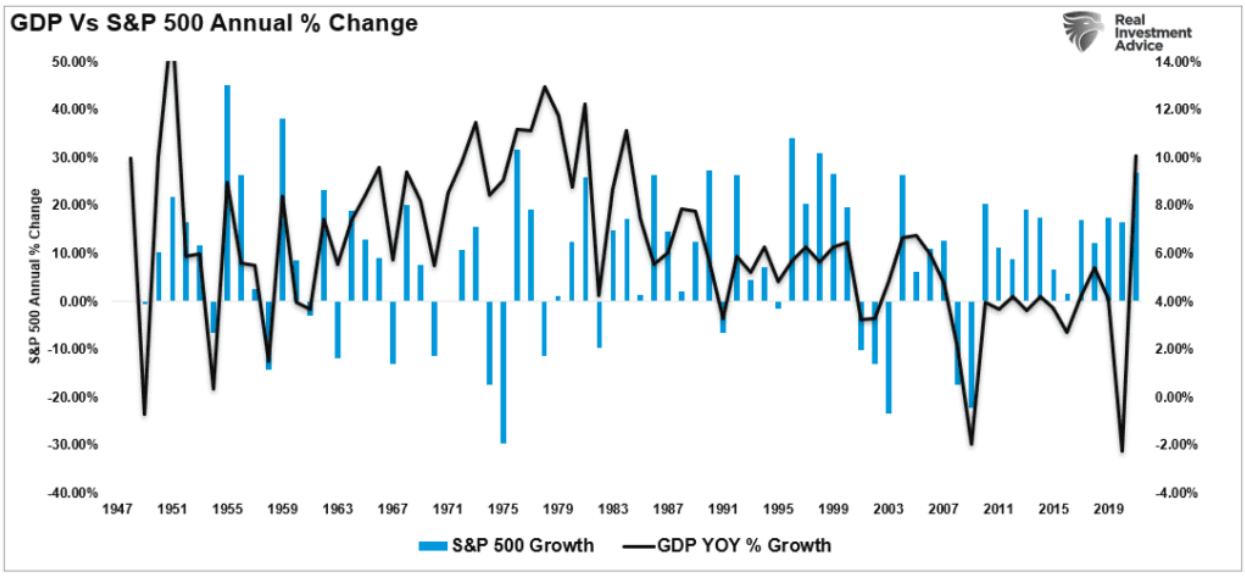
(Chart below are annual data through 2021)



As earnings disappointed, stock prices adjusted by nearly 50% to realign valuations with weaker than expected current earnings and slower future earnings growth. So while the stock market is once again detached from reality, looking at past earnings contractions suggests it won't be the case for long.



The relationship becomes more evident when looking at the annual change in stock prices relative to the yearly GDP change.



Again, since stock prices get driven by the *"psychology"* of market participants, there can be periods when markets disconnect from fundamentals.

However, most important to investors is that fundamentals never play *"catch up"* to stock prices.

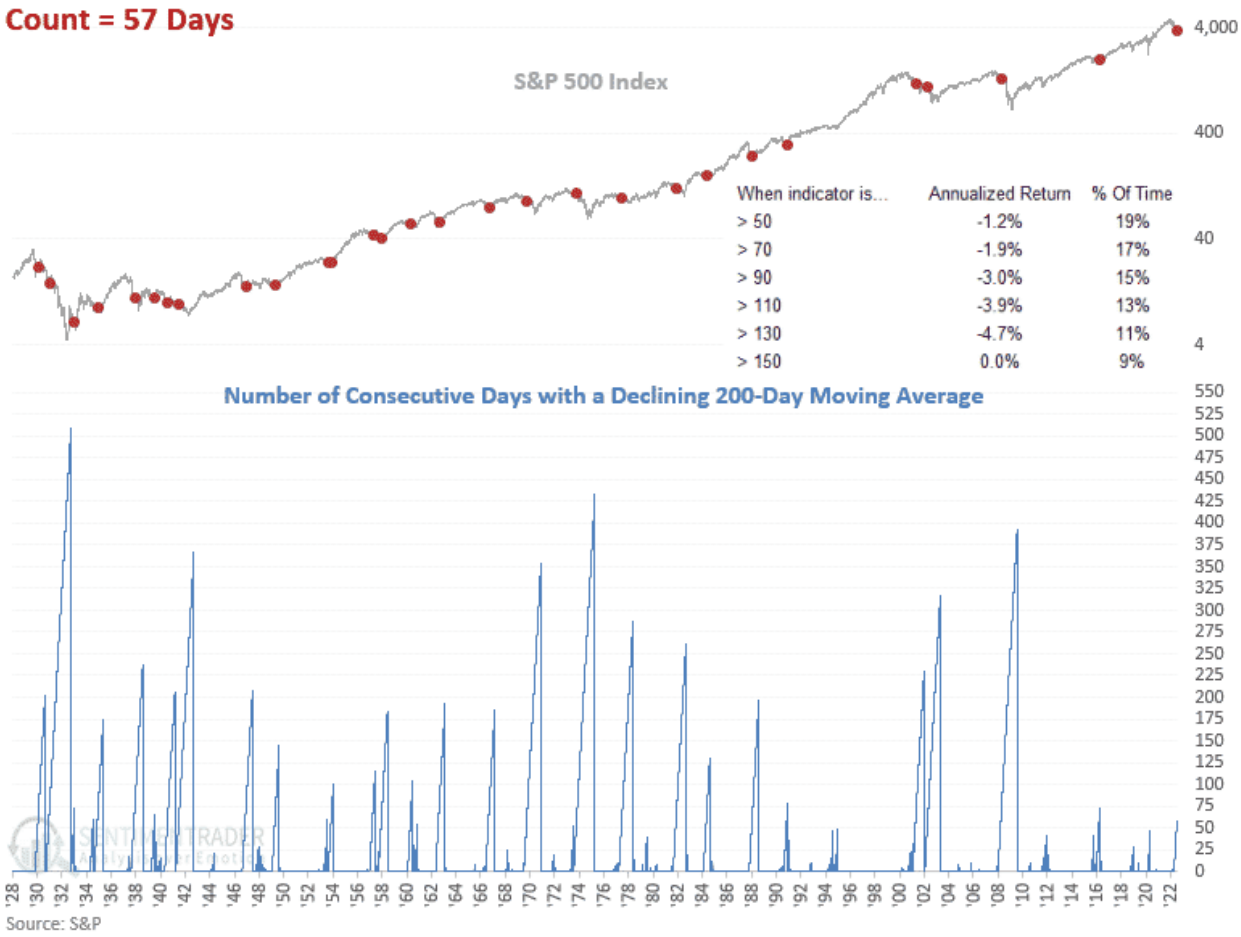
> *"**The conclusion is clear: this is not sustainable.** The market has outperformed historical returns by a wide margin since 2009. Much of this outsized performance came in the 2017 - 2021 period when returns were 2x higher than long-term historical average." - Kailash Concepts*

The market risk of overly optimistic earnings estimates is high, as are the long-term above-trend returns.

The Bear Market May Not Be Over

Sentiment Trader had a great post earlier this week on why the bear market may not be over just yet.

> *"For only the 5th time in more than two decades and the 29th time since 1928, the slope of the 200-day moving average has fallen for 57 consecutive days. While the current downtrend is well-established, the slope count remains low relative to other bear market periods."*



They note that there were only 67 other occurrences over the past 92 years. After the others, S&P 500 returns, win rates, and z-scores were unfavorable across short and medium-term time frames. The signal had a negative return at some point in the first three months in 57 out of 66 instances.

Sentiment Trader concluded with the following:

> ***"When the S&P 500 declines for 5 consecutive trading sessions and the slope of the 200-day moving average has fallen for 57 days or longer, we need to remember that the trend is not our friend.*** *Similar setups to what we're seeing now have preceded falling stock prices across short and medium-term time frames.* ***If the S&P 500 trades above a 21-day low when a signal occurs, performance looks even worse, and the odds suggest the bear market may not be over."***

Many investors are trying to *"fish"* a bottom in the market. The *"F.O.M.O."* of missing the bottom is also another sign the bottom is not likely in.

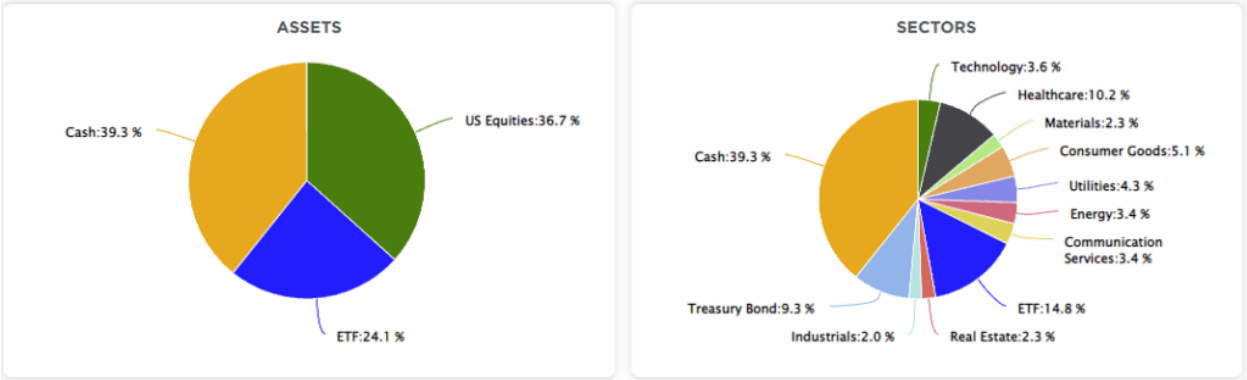
As we have noted previously, investors likely won't want to own stocks by the time the *"bear market"* is over. That is certainly not the case currently.

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Portfolio Update

As noted, there are many reasons to remain cautious about the markets. However, such does not mean the markets can't have a significant countertrend rally. Such a rally remains elusive currently, and earnings may pose another challenging headwind.

Therefore, noted last week, we continue carrying higher cash levels and focusing on risk management for now.



As I discussed previously, ***risk management is a process:***

> ***First, the only certainty is that there is no certainty. Second, every decision, as a consequence, is a matter of weighing probabilities. Third, despite uncertainty we must decide and we must act. And lastly, we need to judge decisions not only on the results, but on how they were made.***
>
> ***If there are no absolutes, then all decisions become matters of judging the probability of different outcomes, and the costs and benefits of each. Then, on that basis, you can make a good decision***.

Managing risk does not mean ***"being all in cash;"*** it only means navigating the risks that could cause permanent impairment to your financial plans.

If nothing happens, great. We simply put cash back to work. However, the alternative is being overly aggressive and being wrong.

Remain cautious for now.

1. ***Tighten stop-loss levels to*** *where you are comfortable selling if markets reverse again.*
2. ***Hedge portfolios*** *against significant market declines. (swap equity funds for money market, stable value, or bond funds.)*
3. ***Take profits in positions*** *that have been big winners (Rebalance funds that are above the normal weightings for your portfolio. Same with Company stock in your plan.)*
4. ***Sell laggards and losers.***
5. ***Raise cash and rebalance portfolios*** *to target weightings. (Rebalancing risk regularly keeps hidden risks somewhat mitigated.)*

Have a great week.

Market & Sector Analysis

Will Return Next Week

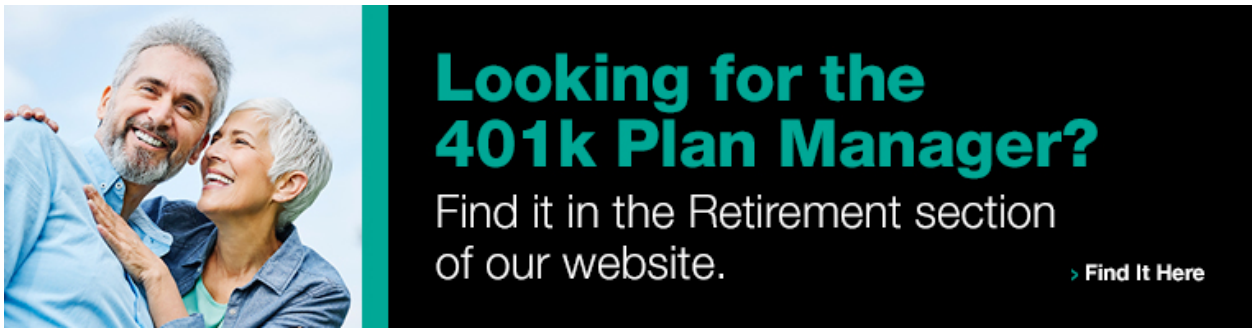
SimpleVisor Portfolio Changes

We post all of our portfolio changes as they occur at ***SimpleVisor:***

July 14

> *"Our technical models are rolling over, signaling an increasing likelihood the recent equity bounce from lows is ending. We sold our trading QQQ position last week in anticipation and are selling the remaining trading position in RSP (equal-weighted S&P 500) today. We also sold half of our IAU gold position as gold broke critical support at $1700. The price of gold has been in a bullish cup and handle pattern, but the handle appears to be giving out. We still hold a 2% position in IAU and are watching it closely."*

- ***Sell 100% of RSP***
- ***Sell 2% of IAU***



Lance Roberts, *CIO*

Have a great week!