Ridgetop Wealth Management
Market Update – May 2022

"Hey Mr. President. All your congressmen too. You got me frustrated and I don't know what to do. I'm trying to make a living, I can't save a cent. It takes all of my money just to eat and pay my rent…" – Inflation Blues by B.B. King.

Inflation
There is little doubt that inflation and corresponding Federal Reserve action is what this market is attempting to discount. This is the cause of Wall Street's carnage year to date and specifically this last month. Of course what is happening in Eastern Europe is a crisis event (especially from a humanitarian perspective), but the long-term record of these events show that weak holders of stocks quickly panic, followed by a rally that makes up all of decline and more over the next six months. The economic data as well remains on solid footing. There are ten key economic indicators we track in watching for a turning point, or contraction (recession) in the business cycle. The indicators span manufacturing and services activity, housing and labor markets, consumer and business confidence, financial conditions, etc. Although most of these indicators have peaked earlier in the economic cycle, none of them are reaching recession levels. In fact, seven out of ten are consistent with above-trend economic growth. Additionally, other leading indicators we follow, like the Conference Board's Leading Economic Index (LEI)[1], are running above trend, consistent with continued expansion over the near-term. In spite of the stock market, the economy remains strong and resilient. Over 80% of S&P 500 companies have beat quarterly earning expectations[2], and if people have jobs and continue to spend it will be hard to have a recession.

Lastly, as we have discussed many times before, the yield curve is historically an extremely accurate indicator to predict an impending recession. While this has made headlines as of late as the curve is exhibiting flattening action (curves flatten as the Fed raises short term interest rates to slow the economy and cool inflationary pressures, which allows short-term yields to rise more than long-term yields), we are not yet seeing confirmed signs of an emerging recession. Ned Davis Research models 45 different yield curve formations (5yr minus 3yr, 10yr minus 2yr, 10yr minus 6 month, etc.) over the last 60 years. With the exception of 1966, they found when the majority of these indicators inverted, a recession subsequently ensued. Currently fewer than one-quarter of the 45 indicators are inverted, which argues that it is premature to make a recession call at this time.

And Now For the Bad News
The S&P 500 drop through April 30th is the worst four months of the year since 1939[3]. We have now had three 10:1 down days without any intervening 10:1 up days. Said otherwise, declining volume on stocks is at least 10 times advancing volume. Said otherwise, market internals are a mess. Wednesday May 4th we had almost a 9:1 up day, but as we write this update the market has lost everything it gained and more. The S&P has been in a trading range

[1] The Conference Board
[2] FactSet
[3] Barrons

of 4155 – 4726 for a while now. We are currently hovering around this lower support level. If we meaningfully break below 4155 on a closing basis, we are likely headed lower.

Bulls & Bears

In a bearish scenario for the market, inflation numbers would surprise to the upside, leading to more hawkish Fed rate hike sentiment. A bullish scenario is that upcoming inflation numbers suggest that inflation is peaking, or at least stabilizing. Bond prices would move higher from their levels of excessive pessimism, and Fed rate high expectations would moderate. Of course we cannot predict what our indicators will tell us in the future, but we can stay in tune with them along the way. Right now the technical evidence warrants continued caution. Regardless of the positive economic factors, we are not currently excited about buying any market dips. We need to see positive market momentum and a couple 10:1 up days before we change our tune.

Bad Starts Don't Always End Badly

Looking back through history we can learn that a bad start to the year does not necessarily prevent a second-half rally. In other similar years that the markets fell big in the first four months, the S&P 500 rose 66.7% of the time in the latter half of the year by a median of 13.7%[4]. For now we will remain optimistic on the economy but cautious on the market in the intermediate term.

Sincerely,

Brian Pollak, CRPC
Private Wealth Advisor
Senior Vice President

Loran Ansberry
Private Wealth Advisor
First Vice President

Jim Stroud
Senior Vice President
Associate

Megan Grant
Senior Client Service

Randi Rich
Client Service Associate

[1] The Conference Board
[2] FactSet
[3] Barrons
[4] Ned Davis Research

Disclosures:

[4] Ned Davis Research

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