Palouse Capital Management, Inc.
1Q22 Commentary
April 2022

1Q22 Recap

After a good quarter to end 2021, markets softened in 1Q22 due mostly to continued macroeconomic worries (please see below) and the war in Ukraine. The S&P 500® index dropped about 12% through mid-March and then recovered nicely through the end of the quarter, possibly as a result of what I am not sure I should call "positive developments" in Ukraine. Contrary to the recent trend, value stocks significantly outperformed growth stocks in 1Q22 as investors looked for less cyclical names. Small caps were down about 7.6% in 1Q22, a lot worse than the 4.6% drop in large caps. High dividend large caps outperformed all of the categories just mentioned.

There were two sectors up and nine down in 1Q22. The best sector was energy, once again, due to a sharp move up in crude prices. Utilities were also up for the quarter. The worst sector was communications services. Shares of both Netflix Inc. ("NFLX") and Meta Platforms, Inc. ("FB") were off well over 30% in 1Q22 and softness in the communications services sector was likely due to those moves and the very large size of those companies. NFLX shares dropped after its 4Q21 earnings report and post-earnings decrease in earnings expectations. FB shares also fell after earnings and a second consecutive quarterly reduction in earnings expectations.

1Q22 Analysis

The last time I wrote a commentary letter (in January of this year), I identified the primary issues with the equity market backdrop as Covid-19, inflation, interest rates and monetary policy. A few months later, the "headline" issues have remained about the same, although they have certainly evolved over time. In this commentary I will discuss how each of these issues has evolved, what that means for the equity market right now, and what that might mean for markets in the near future.

Covid-19

To state the obvious, the Covid-19 pandemic has improved markedly in the past few months. Average daily new case counts have fallen from over 800,000 to the current level of 23,000. Covid-19 has occupied very little news space recently, which would be refreshing if it were not replaced by the horrendous news coming out of Ukraine. Many have speculated that the pandemic is over, although it seems likely that, given what has happened in the recent past, another variant will pop up. While Covid-19 is obviously still an issue for humanity, it is not really an issue for the equity market at this point.

Inflation and Energy Prices

As all readers know, the inflation situation became considerably worse during 1Q22. There is a range of theories on where the current spate of inflation has come from, but most market observers probably agree that the pandemic (and government responses to it) is a root cause. I think that a lot of current inflation is both a direct and indirect result of energy price increases, which is something caused largely by the pandemic.

At the end of 2019, when the annual inflation rate was 2.6%, the price of crude was about $60 per barrel and gasoline was averaging $2.58 per gallon. At that time the world was supplying and consuming about 101 million barrels of crude per day. When the pandemic ramped up, crude consumption dropped to about 82 million barrels per day as total world quantity supplied of crude only fell to 99.4 million barrels per day. As economic principles would portend, crude dropped below $20 per barrel during the summer of 2020 as a result of this imbalance. Exploration activity dropped off to the lowest levels ever recorded as explorers reevaluated the economics of producing and drilling given extremely low and volatile oil prices.

As economies reopened all over the world, crude consumption increased back to about 102 million barrels per day quickly as total world supply dropped back to 98 million barrels per day by the end of 2021. While that was going on, as one would expect, crude rose back to $75 per barrel and gasoline rose to $3.37 per gallon. Exploration activity has improved, but it still remains well off pre-pandemic levels.

The energy crisis and inflation issue worsened in 1Q22 as the economy heated up and the war in Ukraine (and the world's response to it) affected the world economy. It seems unlikely that energy prices will moderate any time soon. As of the time of writing, crude is trading at $102 per barrel, about 41% higher than the pre-pandemic level. The average price of gasoline is now $4.09 per gallon, about 58% higher than pre-pandemic levels.

A lot of people seem to be blaming the US government for the energy crisis, but I think that is a red herring. While the USA is the largest producer of petroleum and other liquids in the world (if you do not consider OPEC to be a single producer), the USA accounts for about 20% of total world production and therefore our government can clearly not control world production any more than it can directly control energy prices. The situation will resolve itself over time as production and exploration ramp up, but it will take time. It will take even longer for dropping oil prices to work their way into general price levels in the world economy.

Interest Rates and Monetary Policy

During 2021 the Fed referred to the inflation situation as "transitory" and they therefore did not feel it necessary to start increasing interest rates in 2021. That stance changed quickly in 1Q22; not only did the Fed raise the Fed Funds range in March (as expected), but comments from the Fed after the March meeting have become quite hawkish for the first time in a long time. Fed Chairman Powell admitted that the Fed underestimated inflationary pressures in his comments given after the March Fed meeting. Fed Reserve Governor Lael Brainard recently said that inflation was "much too high" and that the Fed balance sheet will "shrink considerably more rapidly than in the previous recovery".

During 1Q22 the treasury yield curve moved sharply upward as one would expect given the inflation and monetary policy backdrop. All treasury rates moved higher with the largest basis point moves occurring in the one to three year range. The ten year rate moved up 125 basis points, from 1.51% to 2.76%, between the beginning of the year and the time of writing. The two to ten year spread is now about 34 basis points, a low number, although it looks better than it did when it went negative briefly a few weeks ago (i.e. a negative two to ten spread has been a harbinger of recessions in the past). The average mortgage rate is now 5.27%, up a whopping 245 basis points since the low achieved in February of 2021 and 220 basis points since last November. While mortgage origination data for 1Q22 is not out yet, anecdotal evidence indicates a deceleration in mortgage lending in 1Q22; both JP Morgan Chase & Co. and Wells Fargo & Co. announced that their 1Q22 home lending originations were way down due to rising mortgage rates.

Employment Situation

The 1Q22 monthly change in non-farm payrolls averaged 562,000, the same as the average monthly payroll additions in 2021. Before the pandemic began, the monthly change in payrolls was running in the sub 100,000 to 250,000 range. While the pandemic economic recovery has created a lot of new jobs, the cumulative job loss from March of 2020 to now is still -1.6 million. There are now 5.95 million unemployed people, essentially the same as in February of 2020, and the unemployment rate is 3.6%, equivalent to the pre-pandemic level. Unemployment is now about as low as it can go.

One curious recent development relates to the number of job openings relative to the number of unemployed people. There are now about 11 million job openings in the USA, by far the largest number in the time series going back to 2001. There are now 1.8 job openings per unemployed person, also by far the highest number in the time series. During the early 2000s recession the ratio bottomed out at 0.33 (i.e. there were three unemployed people per job opening). During the following recovery it peaked at about 0.70 in 2007. During the next recession the ratio bottomed at about 0.20 when the unemployment rate was 10%. Since then, the ratio rose steadily and surpassed 1.0 (i.e. there were more job openings than unemployed people) in 2018. Before the pandemic, the ratio was about 1.2. During the quick pandemic recession the ratio dropped back to 0.20 before recovering extremely rapidly to the present baffling level. If the current level of job openings reflects the aggregate business plan for our economy then it seems likely that the plan will never come to fruition – and the economy is at a point where it cannot reach its potential unless the labor force participation rate increases (which has not happened in over twenty years).

Market Model and Outlook

Our 1,000 stock market upside model, which is based only on average sell side target prices, now suggests a 19.1% one year upside potential to the all cap market, a high number in the historical context. I am calculating the market's forward P/E multiple at 18.6x, also a relatively high number. About 89% of the Top 1,000 are showing positive upside to target prices, which is less than average.

While it is still too early to conclude much on 1Q22 earnings season, things are going well so far - although dropping mortgage originations are concerning. I am still calculating forward earnings growth for the Top 1,000 at about 14%, suggesting that the market ought to do fine if projections and multiples hold.

Given what is going on with inflation and the labor market, it is fairly easy to conclude that the economy is running very hot. The potential for recession is increasing due to both "normal" business cycle factors and the Fed's likely response to combat inflation. The "R" word is now being brought up regularly in the news, almost like it was before the pandemic started – except now we have the highest rate of inflation in 40 years, which exacerbates the issue.

While our economy and equity market have grown very well and consistently over very long periods of time, down times are normal but also occasional. By my analysis, there have been four bear markets since 1971 spanning a total of 29 quarters. In other words, the market has been in bull market mode about 86% of the time. That is not to say that the market is up 86% of the time – in fact, 66% of the quarters since 1971 were positive for the equity markets. It is normal to have down quarters during normally pervasive bull markets, and those are often great times to buy stocks. The median return for up quarters since 1971 was 5.6%. The median return for down quarters since 1971 was -3.93%. What has driven the market for a very long time is that it is positive more than it is negative and the positive quarters outpace the negative quarters.

It is obvious that any investor's return would be better by avoiding bear markets, but the problem is that it is impossible to accurately time them, and it is a bad idea to try. It is also a bad idea to raise cash when its purchasing power is dropping every day (like right now). While fixed income investments are important for asset allocation and portfolio diversification, increasing fixed income exposure when you know that interest rates are going to rise is usually not a great idea.

While trying to figure out when a recession might occur is really difficult, the probability of one is higher now than it has been in a while. A bear market will happen at some point and it will almost surely occur if we get a recession. I reiterate that equity investments are great in the long run, and we would probably see any market decline as a good buying opportunity. We will continue to apply our value approach and we will monitor all economic developments as we have done for a long time. I hope that the large black bear visiting my front yard last night was not a bad omen (true story)!

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All analysis in this report was provided by Bryn Harman, CFA, PCM's Chief Executive Officer and Chief Investment Officer. Mr. Harman can be reached directly at 509-220-4253 or bharman@palousecap.com.

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The PCM market model examines the universe of the 1,000 largest actively traded equities trading in the United States (referred to as the "Top 1,000"). The "Price to Earnings Ratio" is calculated by comparing the total capitalization for each market cap range and each sector to the total estimated net income (from sell side estimates) for the respective market capitalization range or sector. The "Price to Book Value Ratio" is calculated by comparing the total capitalization for each market cap range and each sector to the total last reported shareholder's equity for the respective market capitalization range or sector. "Upside to Target" is calculated using float adjusted market capitalization weightings and the one year upside potential to the average sell side target price for each security.

"Market cap" means market capitalization.

"LCV" refers to PCM's Large Cap Value Strategy.

"TR" means our Large Cap Total Return Strategy.

"SMID" means Small to Mid Capitalization and also refers to our Small/Mid Cap Value Strategy in certain contexts.

"ACT" means our All Cap Tilt Strategy.

"DI" means our Diversified Income Strategy.

"SPX" refers to the Standard & Poors® 500 Index ("S&P® 500"). The Standard and Poor's 500 Index is a free-float capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic equity market. The S&P 500 equal weighted index is the equal weighted version of the SPX. The S&P® High Dividend Yield Index measures the performance of 80 high dividend yield equities within the SPX. The S&P SmallCap 600® index is a capitalization weighted index that measures the performance of 600 small capitalization stocks.

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