Investor Insights & Outlook

July 2022 2nd Quarter Concorde Investment Management

Domestic Economic Overview

A Message from Concorde Investment Management

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Last quarter we wrote that "It's difficult to describe the current economic activity in the United States". That still seems to be the case. While we had a negative real GDP number in Q1 (-1.4%) and are expecting another for Q2 (meaning the US economy will technically be in a recession, regardless of changing definitions), nominal GDP is going through the roof. Anyone that has done any traveling this summer will observe that activity at airports, hotels, and dining are not giving any indication of a recession. The US consumer is out and spending. If we have a recession it will be the weirdest feeling one we've had. Cyclical sectors are within the noise of typical averages, and in some cases are below their historical averages, meaning we aren't seeing cyclical indicators at tops and getting ready to decline. Residential investment as a percent of GDP is increasing (at its average), business fixed investment as a percentage of GDP is not decreasing (slightly above its average), and light vehicle sales are below their average. The line an economist used was "If we are going into a recession it will feel like falling off a curb rather than a cliff". The job market continues to be extraordinarily tight relative to history. Layoffs are at 22-year lows, people are quitting and finding new work, and the ratio of job openings to job seekers is 2.0! Lots of leverage for someone seeking a new job to negotiate higher wages.

The other important data point when looking at a recession or concern of one is consumer leverage. In a rising rate environment, consumers that are using credit cards or other floating rate debt instruments like a line of credit are going to have their debt service burden increase which in turn can reduce spending. Household debt service ratio is currently running at 9.5%, effectively an all-time low when excluding pandemic related ratios (people got so much "free" money the household debt service ratio touched 8.5%). The US consumer has some runway before they will reduce any spending that might hamper US GDP.

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International Economic Overview

Internationally is another story. Multiple issues are arriving at the same time that are going to negatively affect the international economy; energy shortfalls, food security, and the strong US Dollar are all going to be headwinds outside of the US. The International Monetary Fund issued a report on 7/26 which cut its global growth forecasts for the third quarter in a row, raised inflation projections, and warned that risks are 'overwhelmingly tilted to the downside".

The Ukraine War started in late February when Vladmir Putin decided to send his troops across the border into Ukraine. At the time, the concern of Russian oil being effectively embargoed drove Brent prices as high as $133/barrel. While rightly concerned about the reduction in Russian crude and related products, the immediate concern should have been what Russia and Putin would do to Europe with regards to natural gas. European countries were/are beholden to Russian energy and Putin will use all his tools and leverage to inflect max pain on European governments (while making excess money from high energy prices to finance his war) to both keep them out of the war and to force them to deal with their own populations unrest. Currently, Europeans are paying 5-10x more for electricity than US consumers given the dependence on Russian gas, and that is before winter arrives. Wood burning appliances have sold out in Germany as they are preparing to be without enough natural gas to heat their homes during winter. Typically, during the summer months, the Europeans fill their storage tanks to prepare for winter but with record breaking heat and short supply of natural gas, storage tanks are not being filled. This is also going to impact European businesses that require natural gas to operate. Margin compression and decreasing activity will happen. Combine those issues, even with a weakening Euro, and energy shortages destroy any competitive advantage Germany and other large European manufacturing economies maintained over other parts of the globe.

We mentioned the food issue in our last letter and that continues to be a concern. Fertilizer shortages combined with missing planting seasons in Ukraine are going to dramatically affect wheat prices and we will have shortfalls globally. Famine is likely to cause political unrest in Northern Africa and the Middle East given all their wheat comes from Ukraine. Other countries which can't produce enough to feed their populations without abundant crop yields are going to have shortfalls due to fertilizer shortfalls. The energy and food issues combined with a strong US dollar (meaning exporting countries with dollar denominated debt will have increased debt burdens) will continue to cause international economic turmoil.

Fixed Income

Domestic bond markets continued to be a subject of the investing spotlight as higher yields and wider corporate spreads had a negative impact on fixed income and equity performance. From our perspective these significant trends, which have been in force for about three quarters, have resulted from the normalization of yields from artificially supported levels, the surge in inflation and the current concern over potential economic weakness in the near future. These trends have generated large (PIMCO describes as a "massive selloff" in a recent call) negative total returns in credit markets and damaged valuations in equity markets, particularly in higher growth sectors.

To update the yield tables we included last quarter, 10-year USTN yields have risen from 1.52% at 9/30/21 to 2.98% at 6/30/22 (actually rose to 3.50% in mid-June) and from 2.3% to 5.03% for BBB corporate issues over the same period. This is one of the most rapid percentage increases across sectors and maturities ever.

Regarding the key question of the likelihood of a continuation of this trend or the attractiveness of current pricing, inflation will likely be the key. Inflation expectations, which we primarily monitor through the relation between nominal 5 and 10 year Treasury yields and the respective TIPS yields, have actually headed down over the last couple of months. This is encouraging but we are wary especially if labor inflation becomes more embedded in the economy. We also believe that elevated pricing in many energy and commodity markets are likely to persist. With that said, the dramatic moves have made short to medium term (1-5 year) Treasury and investment grade debt attractive, even though yielding below current inflation figures. Our most likely scenario of at least modestly lower inflation that settles above what we experienced over the last ten years supports investment in the above-described sectors as a reasonable path to generating income and some stability in portfolios. Our short-term maturity emphasis over recent years has limited damage but there has been no escaping this transition. We have begun to modestly reinvest to capture higher yields but have room to adjust more if yields move higher.

Equity Markets

Equity markets both in the U.S. and internationally incurred losses for the quarter, and in some cases more than reversed small gains from the first quarter. All eleven S&P 500 sectors had negative total returns for the quarter, with the defensive consumer staples segment recording the "best" performance at -4.6%. Energy, the only group with a positive first quarter return, lost 5.2% in Q2.

The pressure on valuations caused by rising bond yields, persistent inflation and global trade and conflict issues are clearly the major factors creating this weakness as the economic outlook for the balance of 2022 and 2023 has become more uncertain. From our perspective, the stock market pullback has resulted from a combination of a correction in excessive valuations and anticipation of weaker than previously expected earnings and cash flow for companies that had been valued reasonably. Although equity investments should be looked at on a case-by-case basis, we believe valuations of many established market leading businesses now reflect at least a slowing economy for the next couple of years and are at prices that represent a good entry point and surely are at levels where they should be held, not sold. There could be more downside if there is some liquidation selling or if the next two years are much weaker than currently anticipated. Having some dry powder is prudent but maintaining investments with long term capital is recommended. Sectors where we find attractive valuations at this point include financials, health care and selective commodity and energy businesses with our continued emphasis on North American revenues. Some growth-oriented stocks have corrected enough to warrant consideration, however value-oriented equities, which have performed well over the last two years, still appear attractive as a group.

		YTD @ 6/30/22
S&P 500	U.S. Large Cap	-20.0%
NASDAQ Composite	U.S. Growth	-29.2%
STOXX 50	Europe	-17.4%
Nikkei 225	Japan	-7.3%
Hang Seng	Hong Kong	-4.8%
Shenzhen	China	-11.4%

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Understanding Your True Risk Tolerance

The recent stock market volatility, the bear market, the ever-growing inflation rate, and ongoing supply issues have taken a severe toll on the American psyche. For some, it has forever altered how they perceive and manage risk. Understanding your risk tolerance is considered one of the most important elements of investing.

Many people see risk tolerance as a measure of their financial ability to withstand losses. In theory, the more risk you take, the more potential for reward, and more potential for loss. For example, a person who can withstand a heavy loss in their portfolio without it compromising their ability to meet their goals may choose to invest more aggressively than someone who has a lower tolerance for loss. There are several factors to consider when determining your risk tolerance including income, net worth, liquidity, and time horizon. A financial professional can help you assess your situation and determine a level of risk that's suitable for you and your goals.

Emotional Risk Tolerance
The emotional component of risk tolerance can have far more influence over your decisions than your financial capacity. Emotions are powerful enough to override logic and can drive people to decisions that may not be aligned with their overall financial plan. The main emotions to be mindful of are fear and exuberance; both can be triggered by the irrational behavior of reactionary crowds and media. This response is powerful enough to lead people to flee the stock market en masse after it's already fallen and draw people into a raging market near its peak. In both scenarios, individual risk tolerance is being skewed by emotions, which leads to divisions that do not reflect their long-term strategy.

Emotions are an important element of risk tolerance and shouldn't be overlooked. Understanding that emotions are reactionary mechanisms that tend to flare up over short-term events may keep you in check when looking at the context of your long-term strategy. It would be hard to not lose sleep if the market suddenly crashed. It's a natural human response. But, realizing that, you don't have to act on those sudden emotional responses, especially if it works against you in the long run.

Focus on the Long-Term
It's generally believed that people who focus primarily on the markets will experience a roller coaster of emotions. Because of this, their confidence may be tied to their market performance. On the other hand, investors that focus on their long-term strategy need only to have confidence in their strategy. If the plan is well-balanced, diversified, and managed through proper rebalancing for evolving risk tolerance, short-term market events may have less impact.

Asset allocation and diversification do not ensure a profit or protect against losses in declining markets.

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