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July 1, 2022

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S&P 500

A June Crash-The Bear Market Spares None

The S&P 500 (SPX) entered a Bear Market on June 13th when it closed at 3,749.63, down 21.8% from the high on January 3, 2022. For the month of June alone, the SPX was down 8%. But, importantly, virtually nothing was spared in the move downward in June. Even the energy stocks, which previously had been rising through the year and bolstered our performance, were hit very badly. Chevron, for example reached an all-time high of $181.3 on June 8th but then fell 20% through the end of the month (currently up 23% for year). Similarly, Marathon Oil hit $32.17 on June 7th before plunging 30% (still up 37% for year). Commodity-related stocks were also hit very hard. Archer Daniels Midland, for example, which at one point was up more than 40% this year, declined 14% in June. Cyclical stocks have suffered all year. United Rentals, which rents construction equipment, was down 18% for the month and 27% for the year. Applied Materials, which makes manufacturing equipment for semiconductor manufacturers, was off 22% (-42%), and iron ore miner and steel producer Cleveland Cliffs was down a stunning 33% in June (-29%).

Multiple members of the Federal Reserve, including Chairman Jerome Powell, made definitive statements in June that the Fed would tighten monetary policy aggressively in order to get inflation back to 2%, and that a recession is a possibility. The news shocked many participants in the markets. The Fed Funds rate was raised 0.25% in March, 0.50% in May, and 0.75% in June. Furthermore, additional increases of 0.75% are expected following the meetings on July 27th and September 21st. The Fed's determination to attack inflation can also be seen in other measures besides interest rates. The Fed's balance sheet is finally shrinking, the monetary base (bank reserves and currency) as of May 31st is down 7.5%, year-over-year (Chart 1), and the broad M2 money supply is down over the past two months while the year-to-year growth rate has fallen to 6.5% (Chart 2). Excess liquidity, which was created in response to the pandemic, is the primary source of the inflation, and the withdrawal of liquidity will be the ultimate cure for the inflation.

Chart 1

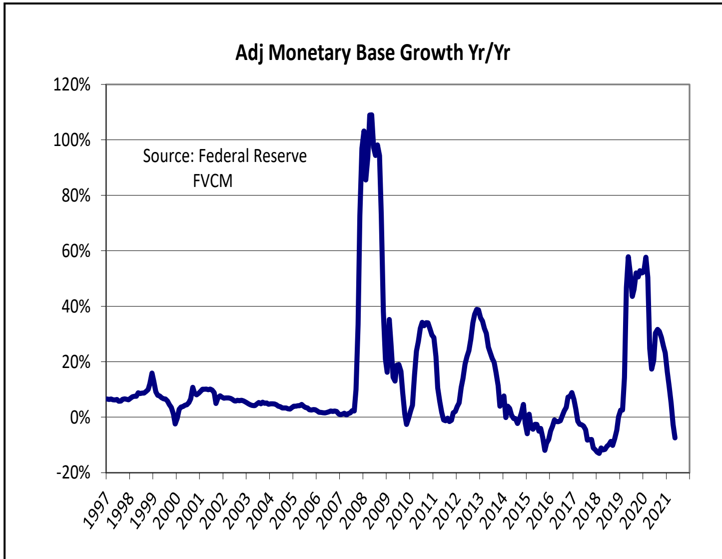
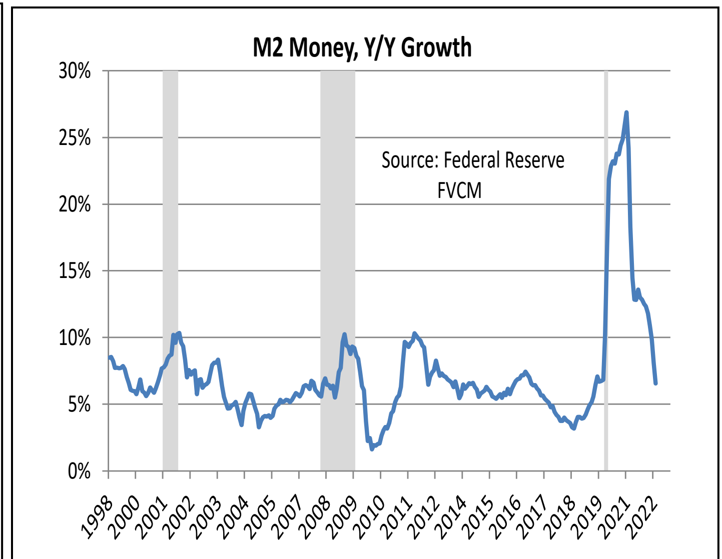


Chart 2



The Fed's aggressive attack on inflation obviously is having some immediate negative effects on portfolio values, especially economically sensitive stocks, but we see it as the correct way to deal with the current surge in inflation. For certain, excess money creation ultimately leads to the rapid spending growth that causes inflation. But people's willingness to hold a currency is another factor. If people lose confidence, the currency becomes like a hot potato that you want to pass along as fast as possible. Through its aggressiveness, the Fed is more likely to instill confidence. Such confidence itself will reduce the amount of monetary tightening that will be necessary. Is this causing pain in the short term? Clearly that is the case in the capital markets but not yet in labor market. But this is all good for two reasons: 1. Inflation is corrosive and distorts capital markets and commerce (not to mention it causes societal problems), and 2. The downward movement in stocks will not last. Many stocks are now trading at excellent values and once this hysterical reaction plays out, we will very cheerfully use all available liquidity to buy more stock for the next upward leg.

Some of the extremism in the June stock declines reflect volatility caused by hedge funds. We think the answer to these unpredictable moves is not to join the dance, but to exploit the opportunities that arise. JPMorgan reported on extreme hedge fund selling in mid-June while Deutsche Bank said equity fund exposure on the part of volatility control funds was only in the 3rd percentile, and risk parity funds' equity weight was the lowest in almost two years with the pickup in volatility. Both volume control funds and risk parity funds sell equities when volatility rises, which naturally has the perverse effect of causing volatility to increase and then such funds sell even more. Multiple firms also noted a meaningful pickup in hedge fund shorts and resultant decline in net leverage levels. Buying and selling by these algorithmic funds, because they take no account of valuation, create chances to buy stocks cheap. Their track records are often not impressive either, even when run by multiple Nobel Prize winners (see Long-Term Capital Management).

Cyclical stocks highlight the kind of opportunity we see. We like the chart below, courtesy of Credit Suisse. P/E’s of cyclical stocks naturally spiked as earnings fell during the pandemic recession, but P/E’s are now reaching nearly two standard deviations below the mean. As we see it, that implies that the stocks are already pricing in falling earnings that a recession would bring. That being the case, an actual recession would seem to present little additional risk to cyclical stocks. Such are the opportunities that are created when mechanical sellers push stock prices below their intrinsic value. It next becomes a question of when the markets begin to see the other side of the valley. Just as stock prices fall before an actual recession, stock prices tend to rise before an actual recovery. Perfectly timing purchases are impossible, but we will get excellent signals from the inflation data in the months ahead. Early signs that inflation has peaked will likely start to put a floor under stock prices and a signal that purchases are timely.

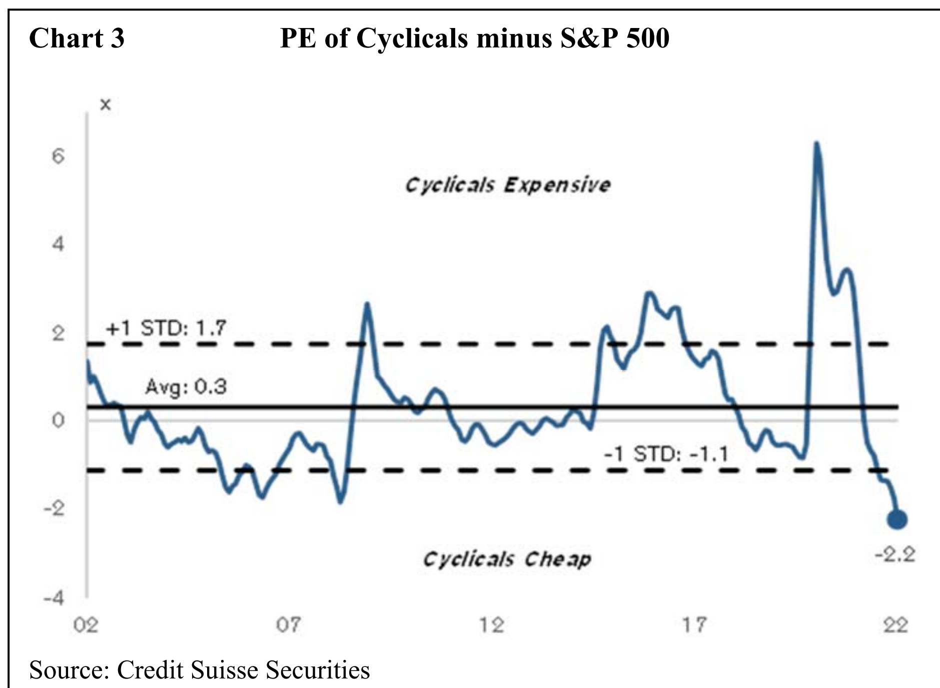


Chart 3 **PE of Cyclicals minus S&P 500**

Source: Credit Suisse Securities

June aside, and even as inflation comes down, we expect Value stocks to continue to outperform Growth stocks for some years. Speculative and risky investments, which includes growth stocks whose promises of high profitability lie in the future, require easy money, and low interest rates to shine. They also require a low inflation environment because distant earnings are worth less as inflation rises. Some may think that as the Fed is ultimately successful in taming inflation, growth stocks will resume leadership. But we doubt this. Many growth stocks are still carrying very high P/E ratios that are difficult to justify. Secondly, growth stocks had an outstanding run from 2009 through about 2021. These trends tend to move back and forth and last for a period of many years. This unexpected rise in inflation will create a lasting concern that it could return. Investors are very unlikely to again rush back into the more speculative areas of the market until a long period of calm has passed. The Netflix’s and Bitcoins of the world are likely entering a long period of consolidation. Energy, industrials, and other solid businesses that generate cash should stand out. Therefore, we will maintain our portfolio over-weights in these areas in anticipation of a resumption of positive momentum as inflation fears eventually recede and a Bull market resumes.

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