Why we finally bought

The financial headlines shifted last week from Inflation & Invasion to Recession, resulting in another banner headline from the WSJ on Thursday:

Recession Fears Drive Down Stocks

Blue chips, S&P 500 suffer their worst percentage losses since June 2020

BY ORLA MCCAFFREY AND CAITLIN OSTROFF

Stocks fell sharply, with two of the major indexes suffering their worst day since 2020, as the latest set of disappointing earnings from large retailers raised investors' fears of a recession.

The Dow Jones Industrial Average closed Wednesday down 1,164.52 points, or 3.6%, to 31490.07, its lowest closing level since March 2021. The S&P 500 dropped more than 4%, or 165.17 points, to 3923.68, while the tech-focused Nasdaq Composite slid 4.7%, or 566.37 points, to 11418.15. The Dow and S&P recorded their worst percentage declines since June 11, 2020. The moves marked a U-turn from a day earlier, when technology shares led a rebound.

The selloff continued in Asia early Thursday. Japan's Nikkei 225 was down 2.5%, while Hong Kong's Hang Seng Index was down 3.2%. ...

Major retailers said their profits were hurt by rising costs, sluggish sales and supply-chain disruptions. Shares of Target Corp. sank 25% ... after the company posted quarterly earnings that missed analysts' expectations, its worst one-day performance since Black Monday in 1987. Shares of Dollar Tree, Dollar General and Costco Wholesale recorded their largest single-day declines in years—in Costco's case, since 2003.

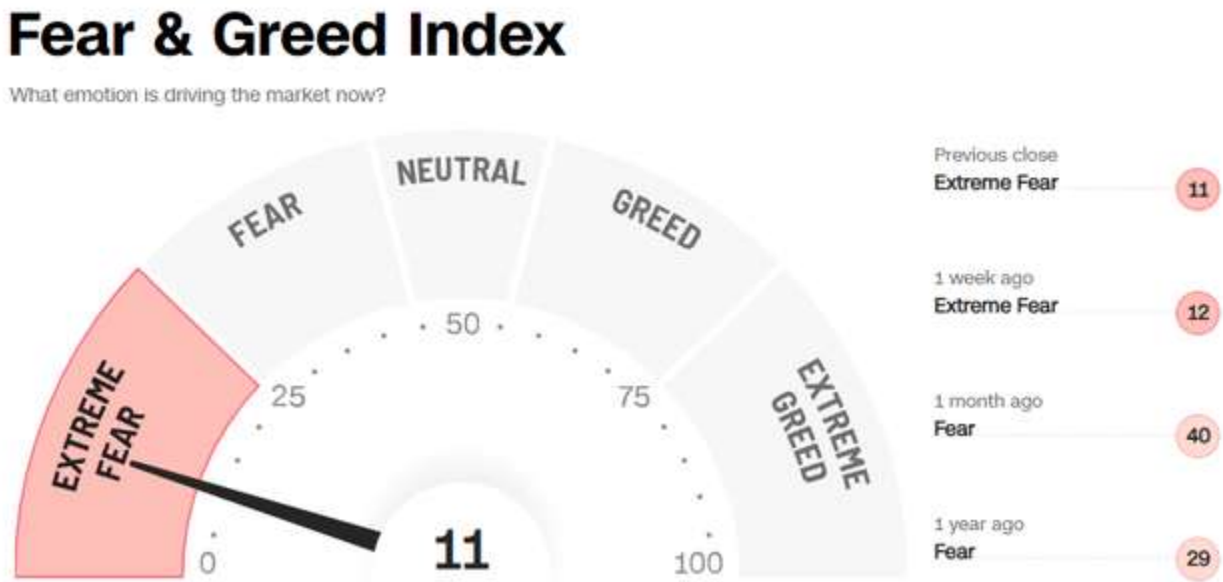
The results are prompting Wall Street to wrestle anew with the idea that the global economy could be headed for a recession. Though that debate is far from settled, it has rattled stocks and other risky assets throughout the year, with the latest data illustrating the degree to which inflation has hit U.S. consumers. ...

At the forefront of investors' minds is decades-high inflation in the U.S., how much policy makers are willing to do to subdue it and what changes in monetary policy mean for economic growth. Federal Reserve Chairman Jerome Powell said Tuesday that the central bank's resolve in combating inflation shouldn't be questioned, even if the steps required push up unemployment. Walmart shares fell 6.8% ... extending losses from Tuesday after the retailer reported that it is getting squeezed by higher food prices and other rising costs. Lowe's fell 5.3% ... after the home-improvement retailer posted a drop in first-quarter sales Wednesday. ...

Consumer discretionary and consumer staples were the worst-performing sectors in the S&P 500 Wednesday. Both recorded their largest single-day percentage losses since March 2020. ...

Our repeated warnings about inflation, and speculative excesses, has been accompanied by cash building in most of the accounts we manage. On Monday we bought AFCG (see below), only the 3rd individual stock YTD, as opportunities have been surprisingly slim, until now, during this correction/bear market. We also received notice from Grandeur Peak that they were reopening 6 of their funds to existing clients, including GPMCX (see below). We added it on Tuesday, and also increased foreign exposure by bringing ISCF for 3 clients, and WCMSX for 2 to 10% allocations. As stocks were capitulating on Wednesday, we added to domestic funds, resulting in all of our clients now being fully invested.

While pessimism has reached an extreme (see our SentimenTrader update), and we believe that stocks are near enough to a bottom, that doesn't mean they won't continue to slide. From High Dividend Opportunities this morning:

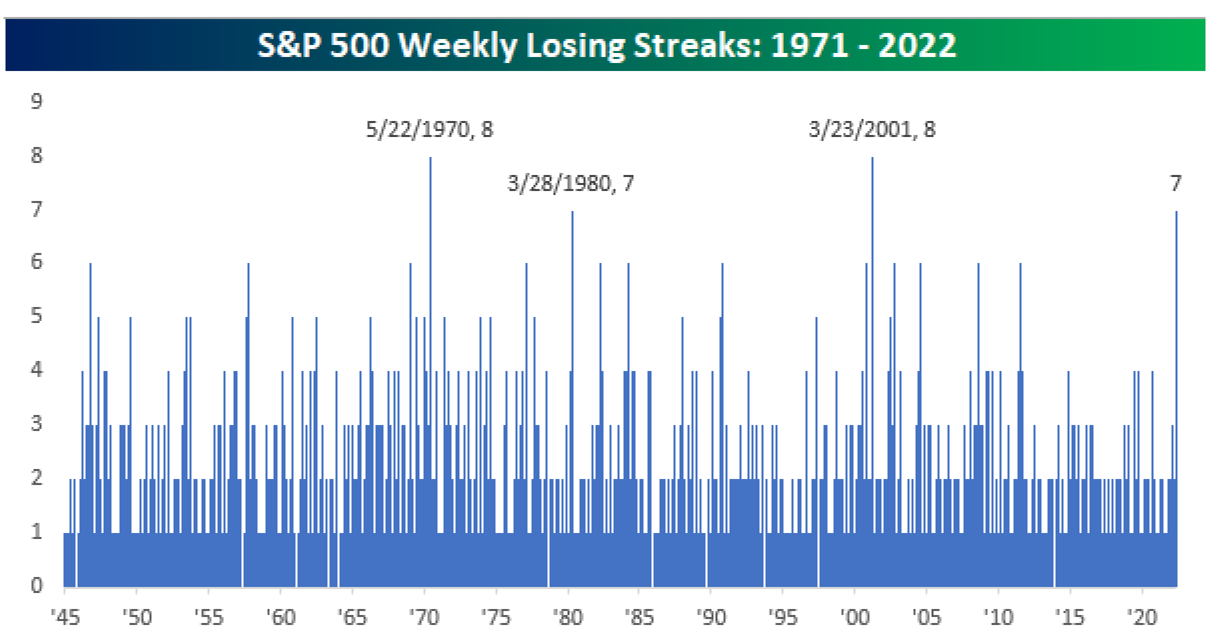


CNN

"Extreme Fear", must be time to load up. Some investors will see this signal, go out and load up. Some might even max out their margin accounts to benefit the most from the rebound. That is a terrible idea. Why?

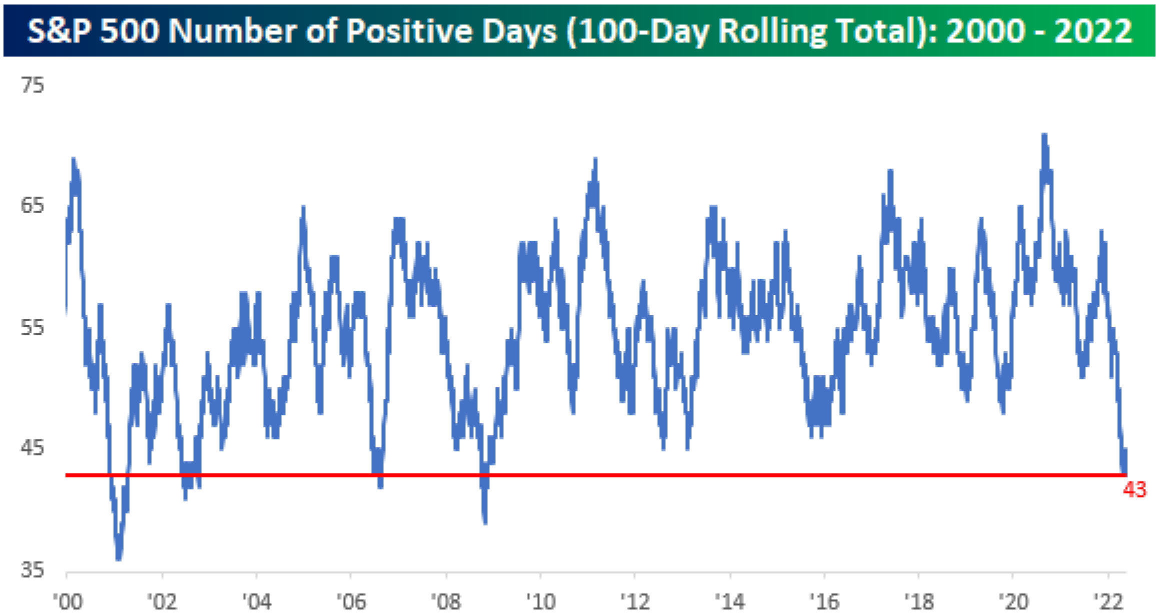
Well, "extreme fear" was also the reading in January, February, and March. Every month was a potential bottom. As we know looking in the rearview, the indexes had much further to fall.

Two charts from Bespoke on Friday:



The first shows historical weekly losing streaks for the S&P 500. At 7 consecutive down weeks (and counting), this is the longest losing streak for the US stock market since 2001. There have only been three prior 7-week losing streaks since WW2, and none have lasted longer than 8 weeks. We are quickly approaching uncharted territory if the market doesn't see a respite from selling soon.

Our second chart highlights the number of positive trading days seen over all rolling 100-day periods since 2000. With just 43 positive days in the last 100, there hasn't been a lower frequency of positive days since October 2008 at the depths of the Financial Crisis!



As for the odds of a recession, this from Global Investment Strategy on Friday:

Goldilocks: A Skeptical Q&A

Back to Bullish

We wrote a report on April 22nd arguing that global equities were heading towards a "last hurrah" in the second half of the year as a Goldilocks environment of falling inflation and supply-side led growth emerges. Last week, we operationalized this view by tactically upgrading stocks to overweight after having downgraded them (to Neutral) in late February.

This highly out-of-consensus view change, coming at a time when surveys by the American Association of Individual Investors and other outfits show extreme levels of bearishness, has garnered a lot of attention. In this week's report, we answer some of the most common questions from the perspective of a skeptical reader.

Q: Inflation is at multi-decade highs, global growth is faltering, and central banks are about to hike rates faster than we have seen in years. Isn't it too early to turn bullish?

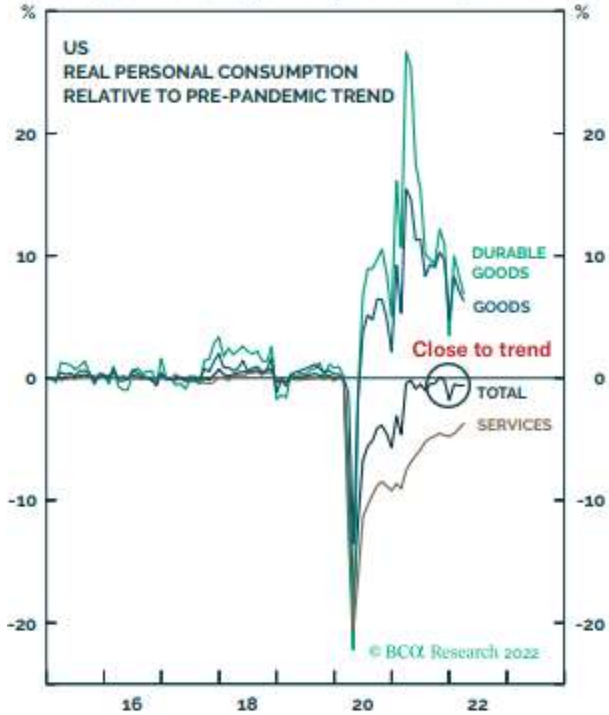
A: We need to focus on how the world will look like in six months, not how it looks like now. Inflation has likely peaked and many of the forces that have slowed growth, such as China's Covid lockdown and the war in Ukraine (while the risk of Russia's invasion of Ukraine spreading has diminished, we don't believe the war will "abate" in the foreseeable future) , could abate.

Q: What is the evidence that inflation has peaked? And may I remind you, even if inflation does decline later this year, this is something that most investors and central banks are already banking on. Inflation would need to fall by more than expected for your bullish scenario to play out.

A: That’s true, but there is good reason to think that this is precisely what will happen.

Overall spending in the US is close to its pre-pandemic trend. However, spending on goods remains above trend while spending on services is below trend (**Chart 1**).

CHART 1
Total US Consumer Spending Is Almost Exactly At Its Pre-Pandemic Trend, But The Composition Of Spending Remains Skewed



NOTE: ALL SERIES REBASED TO JAN. 2015 = 0%.

Services prices tend to be stickier than goods prices. Thus, the shift in spending patterns caused goods inflation to rise markedly with little offsetting decline in services inflation. ...

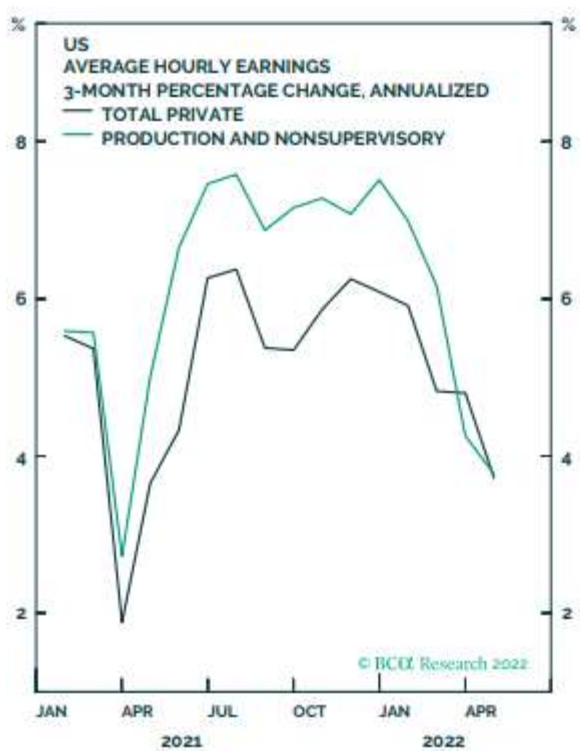
As goods demand normalizes, goods inflation will come down. Meanwhile, the supply of goods should increase as the pandemic winds down, and hopefully, a detente is reached in Ukraine (again, not what we expect). There are already indications that some supply-chain bottlenecks have eased.

Q: Even if supply shocks abate, which seems like a BIG IF to me, wouldn’t the shift in spending towards services supercharge what has been only a modest acceleration in services inflation so far?

A: Wages are the most important driver of services inflation. Although the evidence is still tentative, it does appear as though wage inflation is peaking.

The 3-month annualized growth rate in average hourly earnings for production and nonsupervisory workers slowed from 7.2% in the second half of 2021 to 3.8% in April (**Chart 4**). Assuming productivity growth of 1.5%, this is consistent with unit labor cost inflation of only slightly more than 2%, which is broadly consistent with the Fed’s CPI inflation target.

CHART 4
Wage Pressures May Be Starting To Ease



Moreover, a smaller proportion of firms expect to raise wages over the next six months than was the case late last year according to a variety of regional Fed surveys. The same message is echoed by the NFIB small business survey. Consistent with all this, the US Citi Inflation Surprise Index has rolled over (**Chart 7**).

Q: What about the “too cold” risk to your Goldilocks scenario? The risks of recession seem to be rising.

A: The market is certainly worried about this outcome, and that has been the main reason stocks have fallen of late. However, we do not think this fear is justified, certainly not in the US (**Chart 8**).

CHART 7
The US Inflation Surprise Index Has Rolled Over

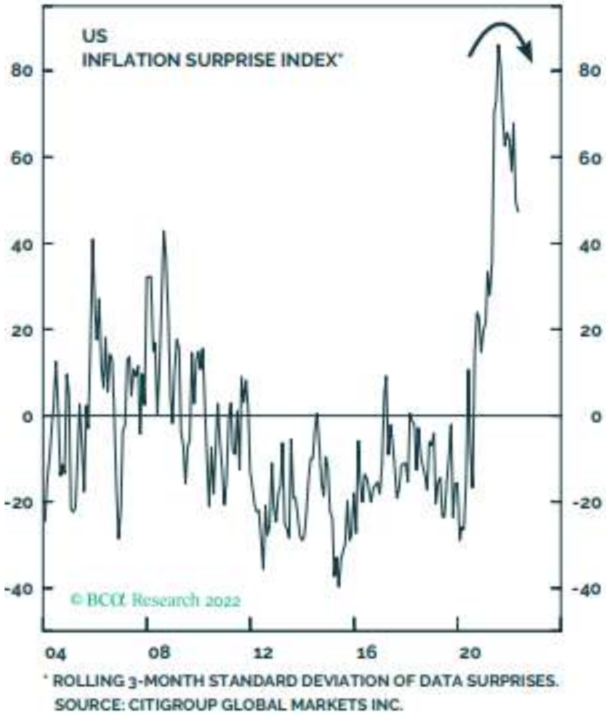
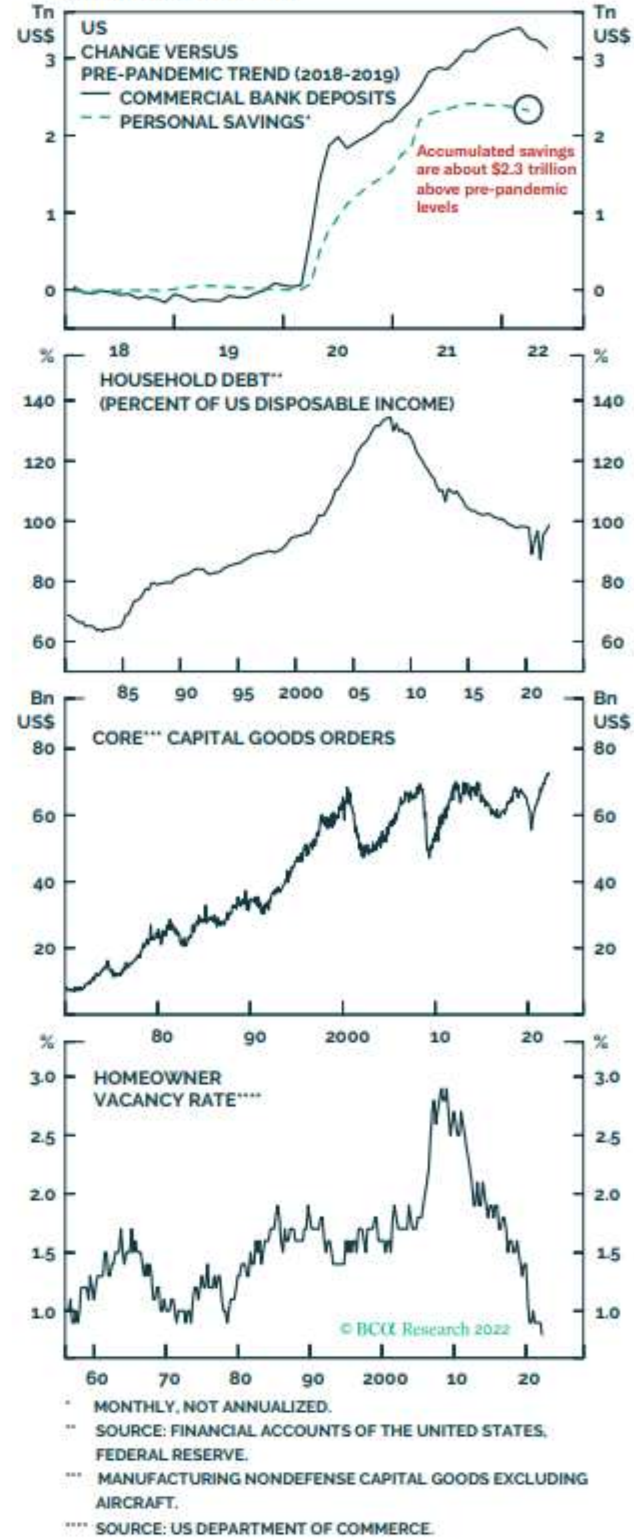


CHART 8
The US Economy Will Benefit From Plenty Of Pent-Up Demand



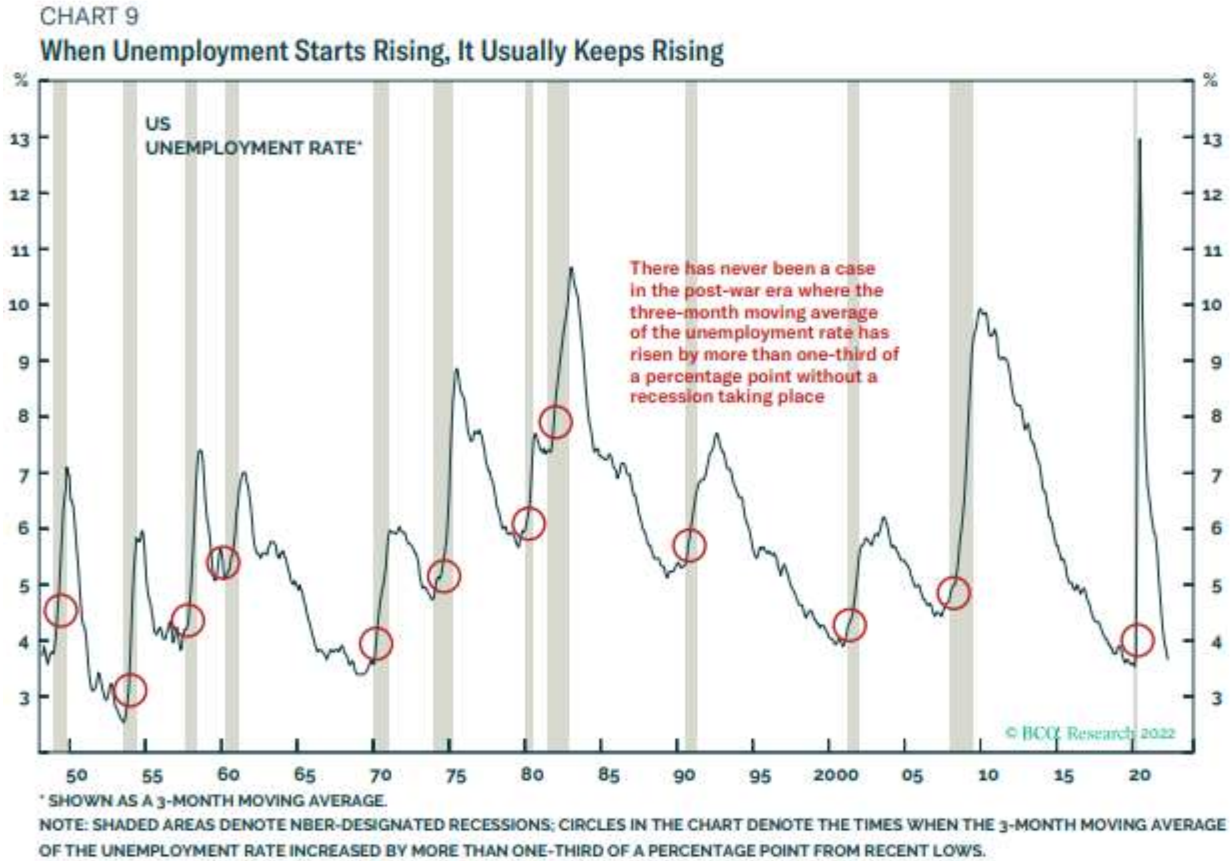
US households are sitting on $2.3 trillion excess savings, equal to about 14% of annual consumption. The ratio of household debt-to-disposable income is down 36 percentage points from its highs in early 2008, giving households the wherewithal to spend more.

Core capital goods orders, a good leading indicator for capex, have surged. The homeowner vacancy rate is at a record low, suggesting that homebuilding will be fairly resilient in the face of higher mortgage rates.

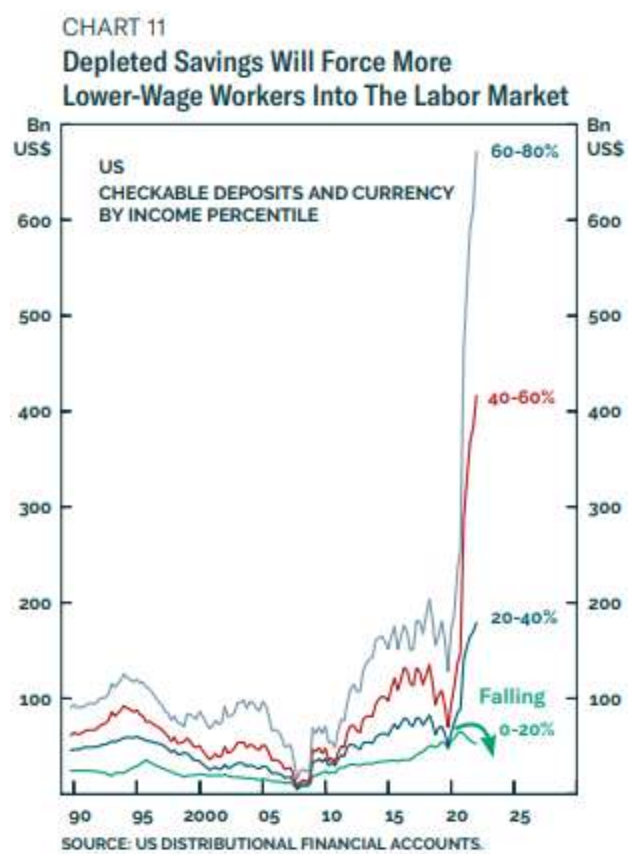
Q: It seems like the Fed has a nearly impossible task on its hands: Increase labor market slack by enough to cool the economy but not so much as to trigger a recession. You yourself have pointed out that the Fed has never achieved this in its history.

A: It is correct that the unemployment rate has never risen by more than one-third of a percentage point in the US without a recession occurring (**Chart 9**). That said, there are three reasons to think that a soft landing can be achieved this time.

First, increasing labor market slack is easier if one can raise labor supply rather than reducing labor demand. Right now, the participation rate is nearly a percentage point below where it was in 2019, even if one adjusts for increased early retirement during the pandemic.



Wages have risen relatively more at the bottom end of the income distribution. This should draw more low-wage workers into the labor force. Furthermore, according to the Federal Reserve, accumulated bank savings for the lowest-paid 20% of workers have been shrinking since last summer, which should incentivize job seeking (**Chart 11**).



Second, long-term inflation expectations remain well contained, which makes a soft landing more likely. Median expected inflation 5-to-10 years out in the University of Michigan survey stood at 3% in May, roughly where it was between 2005 and 2013. Median expected earnings growth in the New York Fed Survey of Consumer Expectations was only slightly higher in April than it was prior to the pandemic.

A third reason for thinking that a soft landing may be easier to achieve this time around is that the US private-sector financial balance – the difference between what the private sector earns and spends – is still in surplus (**Chart 14**). This stands in contrast to the lead-up to both the 2001 and 2008-09 recessions, when the private sector was living beyond its means.

Q: You have spoken a lot about the US, but the situation seems dire elsewhere. Europe may already be in recession as we speak!

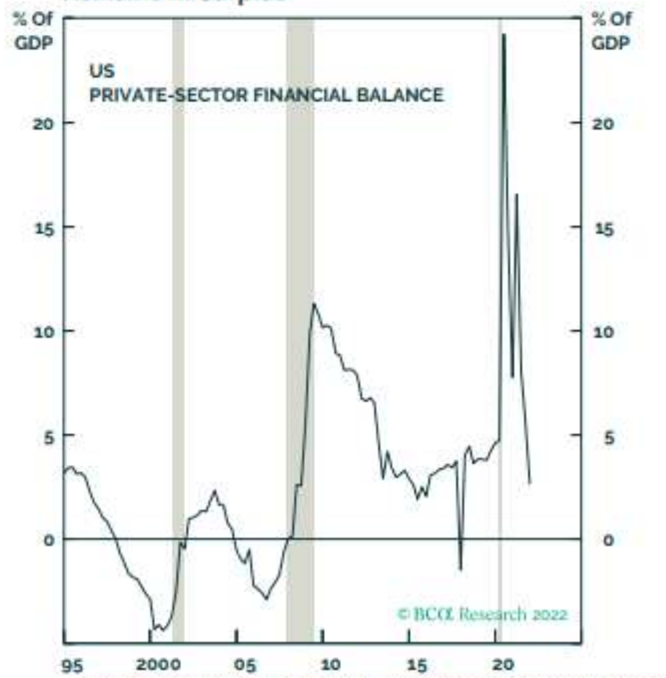
A: The near-term outlook for Europe is indeed challenging. The euro area economy grew by only 0.8% annualized in the first quarter. Mathieu Savary, BCA's Chief European Strategist, expects an outright decline in output in Q2.

To no one's surprise, the war in Ukraine is weighing on European growth. The Bundesbank estimates that a full embargo of Russian oil and gas would reduce German real GDP by an additional 5% on top of the damage already inflicted by the war.

While such a full embargo is possible, it is not our base case. In a remarkable aboutface, Putin now says he has "no problems" with Finland and Sweden joining NATO, provided that they do not place military infrastructure in their countries. He had previous threatened a military response at the mere suggestion of NATO membership.

In any case, there are few signs that Putin's increasingly insular and dictatorial regime would respond to an oil embargo or other economic incentives. The wealthy oligarchs who were supposed to rein him in are cowering in fear. It is also not clear if Europe would gain any political leverage over Russia by adopting policies that push its own economy into a recession.

CHART 14
The US Private-Sector Financial Balance Remains In Surplus



SOURCE: FEDERAL RESERVE (FINANCIAL ACCOUNTS OF THE UNITED STATES).
NOTE: SHADED AREAS REPRESENT NBER-DESIGNATED RECESSIONS.

It is worth noting that the price of the December 2022 European natural gas futures contract is down 39% from its peak at the start of the war (**Chart 16**). It is also noteworthy that European EPS estimates have been trending higher this year even as GDP growth estimates have been cut. This suggests that the analyst earnings projections were too conservative going into the year.

Q: What about China? The lockdowns are crippling growth and the property market is in shambles.

A: There is truth to both those claims. The government has all but said that it will not abandon its zero-Covid policy anytime soon, even going as far as to withdraw from hosting the 2023 AFC Asian Cup. While the number of new cases has declined sharply in Shanghai, future outbreaks are probable.

On the bright side, China is likely to ramp up domestic production of Pfizer's Paxlovid drug. Increased availability of the drug will reduce the burden of the disease once social distancing restrictions are relaxed.

As far as the property market is concerned, sales, starts, completions, as well as home prices are all contracting (**Chart 18**). BCA's China Investment Strategy expects accelerated policy easing to put the housing sector on a recovery path in the second half of this year. Nevertheless, they expect the ... rebound in housing activity will be more muted than in past recoveries.

CHART 16
European Natural Gas Futures Are High But Below Their Peak

Ironically, the slowdown in the Chinese housing market may not be such a bad thing for the rest of the world. Remember, the main problem these days is inflation. To the extent that a sluggish Chinese housing market curbs the demand for commodities, this could provide some relief on the inflation front.

Q: So bad news is good news. Interesting take. Let's turn to markets. You mentioned earlier that equity sentiment was very bearish. Fair enough, but I would note the very same American Association of Individual Investors survey that you cited also shows that investors' allocation to stocks is near record highs. Shouldn't we look at what investors are doing rather than what they're saying?

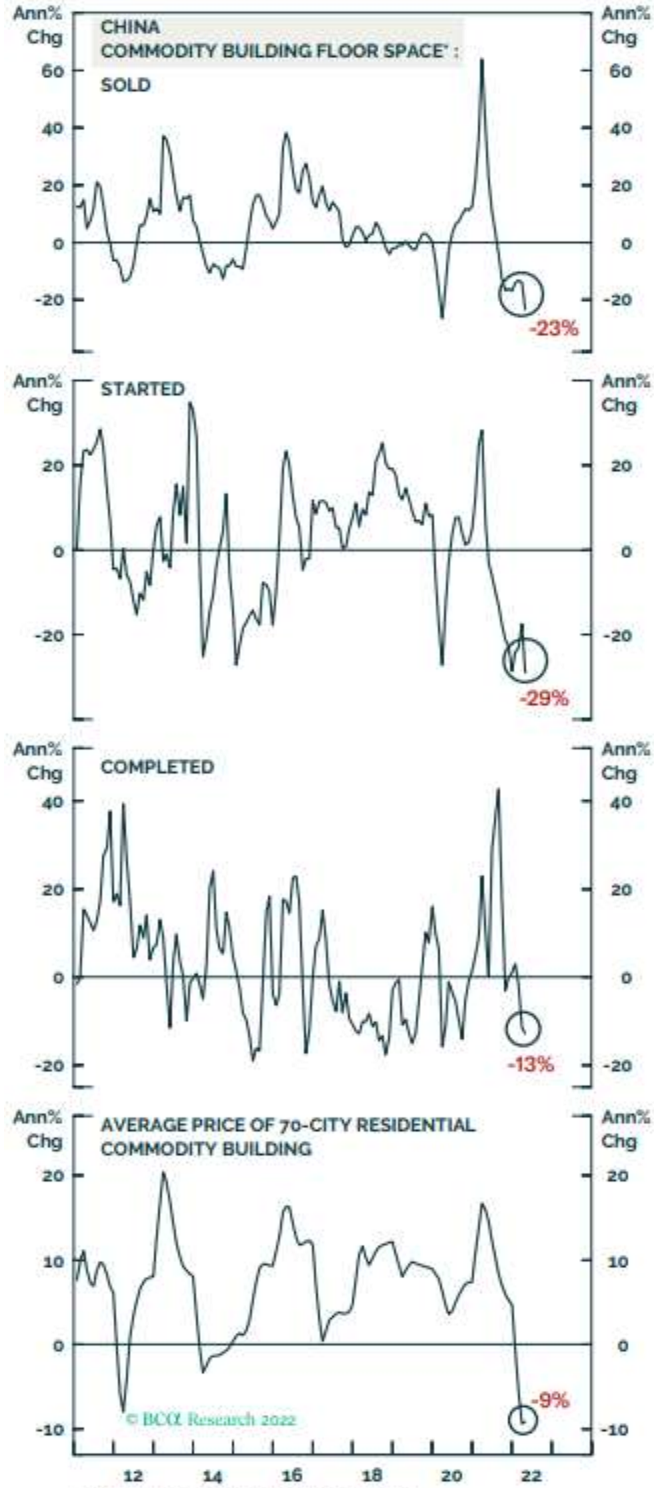
A: The discrepancy may not be as large as it seems. As ... investors may not like stocks, but they like bonds even less.

Global equities currently trade at 15.3-times forward earnings; a mere 12.5-times outside the US. The global forward earnings yield is 6.7 percentage points higher than the global real bond yield. In 2000, the spread between the earnings yield and the real bond yield was close to zero.

It should also be mentioned that institutional data already show a sharp shift out of equities. The latest Bank of America survey revealed that fund managers cut equity allocations to a net 13% underweight in May from a 6% overweight in April and a net 55% overweight in January. Strikingly, fund managers were even more underweight bonds than stocks. Cash registered the biggest overweight in two decades.

Q: Your bullish equity bias notwithstanding, you were negative on tech stocks last year, arguing that the NASDAQ would turn into the NASDOG. Given that the NASDAQ Composite is down 29% from its highs, is it time to increase exposure to some beaten down tech names?

CHART 18
Chinese Property Sector: Signs Of Contraction



* SHOWN AS A 3-MONTH MOVING AVERAGE

A: Both the cyclical and structural headwinds facing tech stocks that we discussed in These Three High-Flying Equity Sectors Could Come Crashing Back Down To Earth and The Disruptor Delusion remain in place. Nevertheless, with the NASDAQ Composite now trading at 22.6-times forward earnings, down from 32.9 at its peak last year, an underweight in tech is no longer appropriate (**Chart 22**). ...

Q: I guess if bond yields come down a bit more, that would help tech stocks?

A: Yes. Tech stocks tend to be growth oriented. Falling bond yields raise the present value of expected cash flows more for growth companies than for other firms.

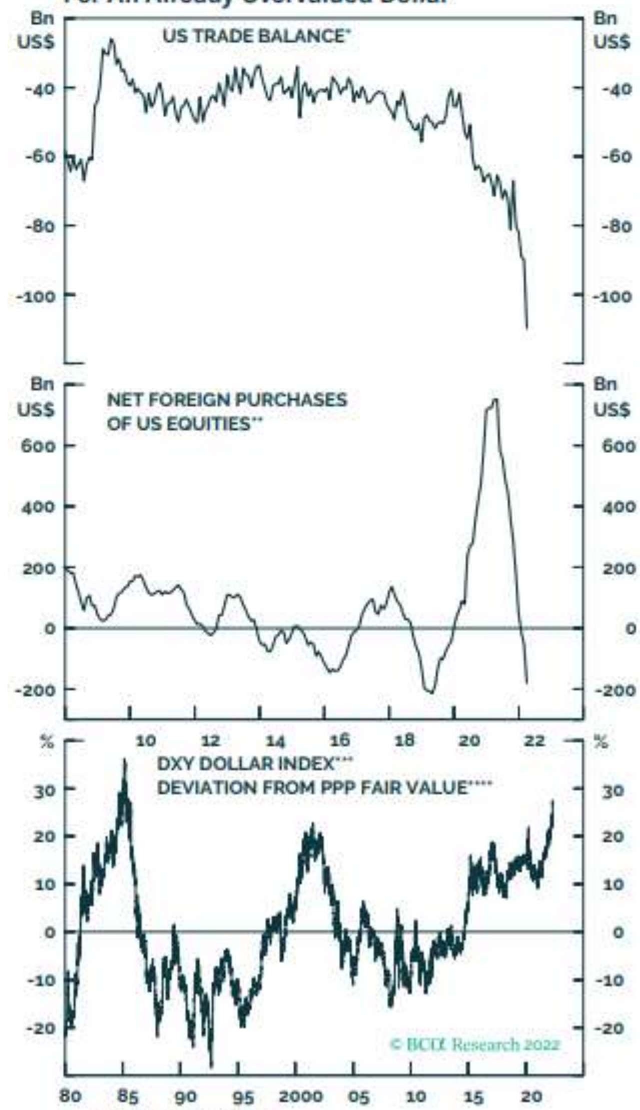
CHART 22
Tech Stock Valuations Have Returned To Earth

While we do expect global bond yields to eventually rise above current levels, yields are likely to decline modestly over the next 12 months as inflation temporarily falls. We expect the US 10-year yield to end the year at around 2.5%.

Q: A decline in US bond yields would undermine the high-flying dollar, would it not?

A: It depends on how bond yields abroad evolve. US Treasuries tend to be relatively high beta, implying that US yields usually fall more when global yields are declining. Thus, it would not surprise us if interest rate differentials moved against the dollar later this year.

CHART 25
Widening Trade Deficit Is A Headwind For An Already Overvalued Dollar



* GOODS AND SERVICES.
** SHOWN AS 12-MONTH MOVING TOTALS. SOURCE: UNITED STATES DEPARTMENT OF TREASURY.
*** SOURCE: BLOOMBERG FINANCE L.P.
**** BCA PURCHASING POWER PARITY MODEL BASED ON ADJUSTED CPI.

It is also important to remember that the US dollar is a countercyclical currency. If global growth picks up as pandemic dislocations fade and the Ukraine war winds down (we expect the fighting to intensify over the summer), the dollar is likely to weaken.

A wider trade deficit could also imperil the greenback. The US trade deficit has increased from US$45 billion in December 2019 to US$110 billion. Equity inflows have helped finance the trade deficit, but net flows have turned negative of late (**Chart 25**). Finally, the dollar is quite expensive – 27% overvalued based on Purchasing Power Parity exchange rates.

Q: Let's sum up. Please review your asset allocation recommendations both for the next 12 months and beyond.

A: To summarize, global inflation has peaked. Growth should pick up later this year as supply-chain bottlenecks abate. The combination of falling inflation and supply-side led growth will provide a springboard for equities. We expect global stocks to rise 15%-to-20% over the next 12 months.

Historically, non-US stocks have outperformed their US peers when the dollar has been weakening. ...

Our guess is that this Goldilocks environment will end towards the end of next year. As inflation comes down, real wage growth will turn positive. Consumer confidence, which is now quite depressed, will improve. Stronger demand will cause inflation to reaccelerate in 2024, setting the stage for another round of central bank rate hikes.

Positions

AFCG - We added 2% positions in this Cannabis REIT yielding over 12% for 6 clients on 5/16 @ 16.95.

Insider Buying:

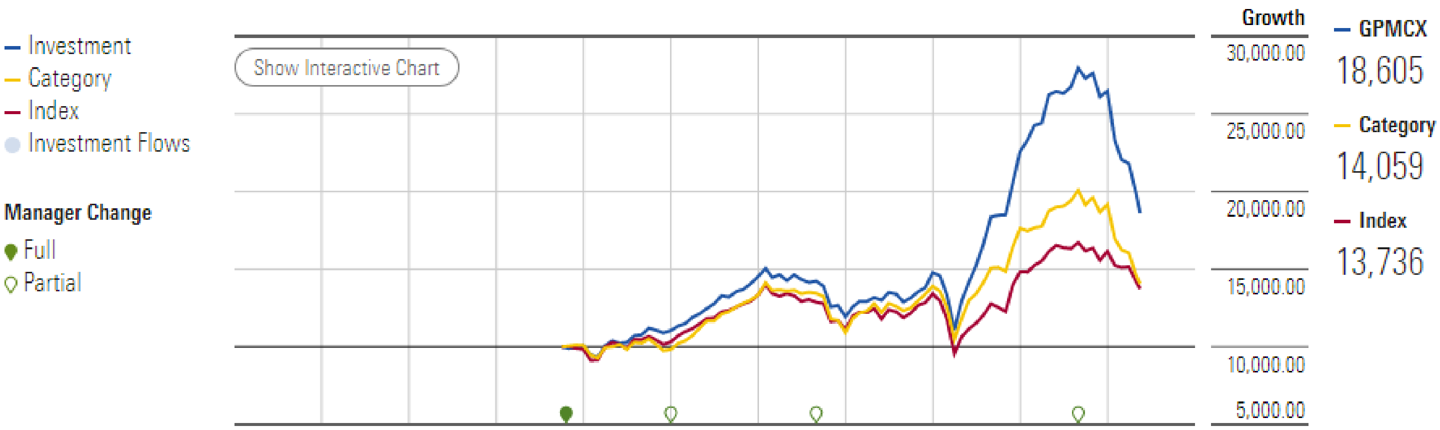
Trade Date	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
05/12/2022	2	GAMMA LENDING HOLDCO LL...		24,900
05/11/2022	4	Tannenbaum Leonard, Tan...		62,366

GPMCX - We added 5% positions in this OEF for 4 clients, and 7% for a 5th on 5/17 @ 12.63.

Grandeur Peak Global Micro Cap Instl GPMCX ★★★★★

NAV / 1-Day Return	Total Assets	Adj. Expense Ratio	Expense Ratio	Fee Level	Longest Manager Tenure
12.63 / ↑ 1.77 %	49.4 Mil	2.000%	2.000%	High	6.58 years
Category	**Investment Style**	**Min. Initial Investment**	**Status**	**TTM Yield**	**Turnover**
Foreign Small/Mid Growth	Small Growth	2,000	Closed	0.00%	36%

Growth of 10,000



Total Return %	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	YTD
Investment	—	—	—	—	9.76	31.48	-17.77	23.78	52.85	17.19	-29.72
Category	22.20	26.61	-5.40	7.05	-2.98	36.19	-18.34	27.78	28.40	8.79	-26.47
Index	18.81	16.82	-3.70	-0.40	4.84	29.28	-16.70	20.79	10.54	8.88	-14.97
Quartile Rank	—	—	—	—							
Percentile Rank	—	—	—	—	37	21	70	69	10	12	71
# of Invest. in Cat.	148	144	140	142	118	134	136	132	134	135	135
Category Name	—	—	—	SW	SW	SW	SW	SW	SW	FR	FR

USD | YTD Investment as of May 17, 2022 | Category: Foreign Small/Mid Growth as of May 17, 2022 | Index: Morningstar Gbl Mkts xUS SMID NR USD as of May 17, 2022 | Italics indicate Extended Performance. Extended performance is an estimate based on the performance of the investment's oldest share class, adjusted for fees.

With under 15% of its portfolio in U.S. stocks, Morningstar's Category is now Foreign Small/Mid Growth (FR), rather than Global (SW), as shown above. Grandeur Peak caps GPMCX at 50 Mil in Total Assets. From its Fact Sheet:

"One of a handful of funds focused specifically on micro-cap companies globally. We believe our global view and experience gives us an advantage to better understand the competitive landscape and opportunity of each company and in finding the most interesting investment opportunities throughout the world."