Level Four Capital Management

# WEEKLY INSIGHT

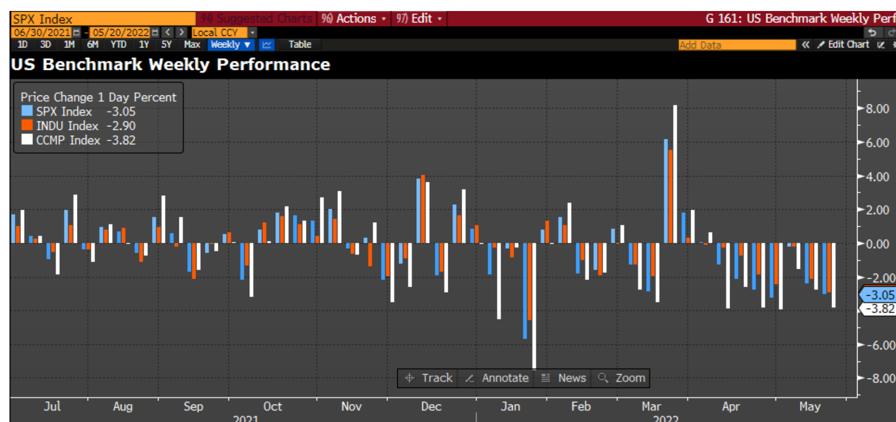
## Highlights

- U.S. equities came under pressure again with both the S&P 500 (3.05%) and NASDAQ (3.82%), closing lower for the seventh straight weekly decline, the longest such decline since 2001 and 2011.
- Consumer Staples (8.63%), Consumer Discretionary (7.44%), and Technology (3.77%), were the worst performing sectors on the week.
- The Federal Reserve continued to re-iterate the need and likelihood of a 50bp hike at the upcoming two meetings.
- $550 billion in market value was erased from consumer stocks over the past five days, as retailers came under pressure following earnings releases that showed inventory build, a shift of consumer spending, and margin pressure.
- In Europe, Christine Lagarde announced that net bond buying should end at the beginning of the third quarter.
- In China, the People's Bank of China cut the Loan Prime Rate by 25bps to 4.45% to support housing demand.
- In India, the government announced tax cuts and plans to boost subsidies on fertilizers by $14.2B to fight inflation.

## Market Commentary

### U.S.

Last week the story remained the same as U.S. equities came under pressure again with both the S&P 500 and NASDAQ closing lower for the seventh straight weekly decline, the longest such decline for the S&P since 2001 (2011 for the NASDAQ). The Dow also dropped for an eighth straight weekly decline, the lengthiest streak in 99 years. Treasuries were mostly stronger across the curve, with the 10Y yield dropping back below 2.8% after hitting a recent high above 3.13% on May 6th. The Dollar index was down 1.5%, its sharpest weekly drop since February following six straight weeks of gains while oil pulled back slightly to finish largely unchanged.




*Source: Bloomberg as of 05.24.22*

The S&P managed to avoid closing in bear market territory (a decline of +20%) following a big afternoon rally on Friday, in what was a very volatile session with no significant incremental developments. Earlier in the week, investors saw the S&P 500 post its largest 1-day decline since June of 2020, declining 4.04%. The index now stands 16.66% below its January 3rd all-time closing high.

There were few places to hide in the sell-off, with Consumer and Technology stocks coming under the most pressure. With the most recent decline in Technology stocks, investors have seen the relative valuation premium versus Consumer Staples completely dissipate. The MSCI World Information Technology Index is now trading at 20 times forward earnings, a similar level to its consumer staples peers, which is in stark contrast to the premium previously seen. According to Bank of America's May fund manager survey, Consumer Staples relative to Technology have been the most overweight since December 2008, given the current landscape.

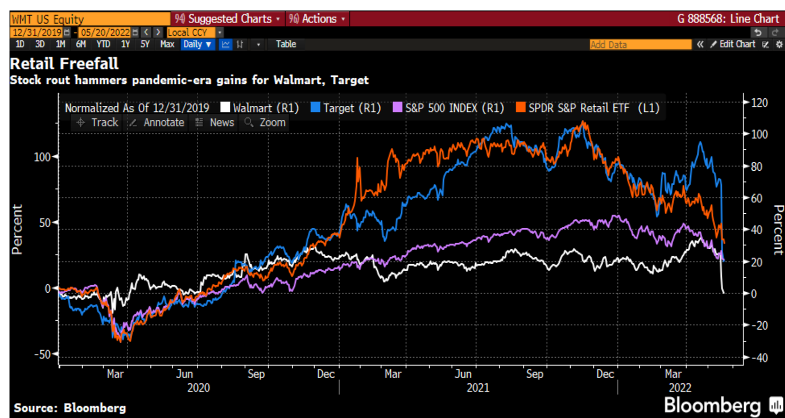
*Source: Bloomberg as of 05.24.22*

While the week lacked a catalyst, many of the bearish themes remained in focus dominating headlines, as strategists remain convicted and continue to call for additional downside pressure. The spotlight continued to highlight:

- Fed continuing their tighter monetary policy path
- Continued inflationary pressures
- China's COVID lockdowns
- Potential for a soft landing versus the probability of a recession
- Retail spending as highlighted by earnings releases from retailers

## RETAIL EARNINGS

One of the primary drivers behind the week's price action was retailers who reported lackluster earnings, margins, and future outlook, while raising questions about consumer spending and company margins. When all was said and done, since Friday, some $550B in market value was erased from consumer stocks over the past five days, with Consumer Staples being the worst underperformer on the week, closing lower by 8.60%.




*Source: Bloomberg as of 05.24.22*

The week was a bloodbath for retailers in general, as many point to consumer spending habits changing, higher material costs, and rising inventories as a reason for the weakness. Consumers seem to be pivoting away from higher margin goods to cheaper ones as the cost of everyday life increases.

Both Walmart and Target gave comments, saying they are seeing customers trade down for cheaper "more bargain" goods, avoiding more expensive name brands, as the consumer channels spending more in basic need categories versus other discretionary purchases. Amazon and Walmart, who collectively employ over 3 million workers, have both stated they are freezing hiring effective immediately with similar retail brands likely to take comparable measures.

Exacerbating the problem are stores that were once undersupplied with inventories, but are now oversupplied with products. Shipping delays and backlogs were so bad that some companies chartered cargo ships to keep their shelves stocked, and although that worked for a while, inventories have now started to get out of hand. As a result, retailers are marking down products, eroding profit as they seek new "in demand" goods to fill their shelves.

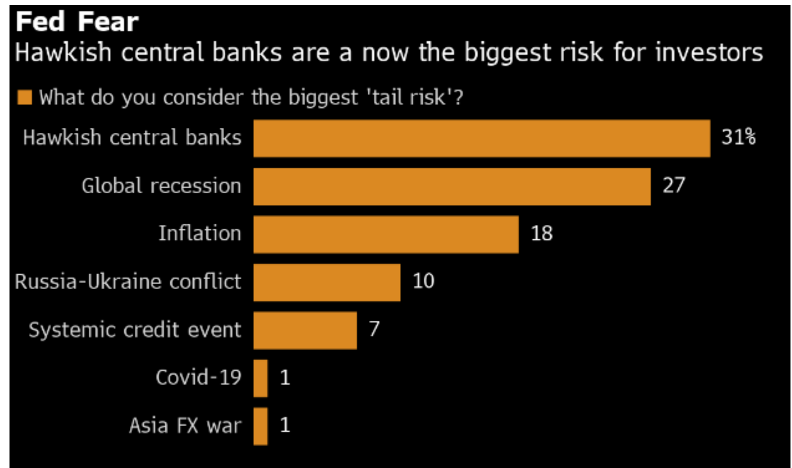
Among those contributing to the negative sentiment in the retail space were:

- Walmart (-19.5%) flagged higher supply chain costs, general merchandise markdowns, and higher wage costs for the weaker numbers.
- Target (-29.3%) echoed the same sentiment with higher input costs and excess inventory.
- Ross (-21.9%) cut their forward guidance and reported declines year-over-year in both their revenue growth and earnings citing headwinds on spending of their lower-end consumer demographic.
- Lowe's (-4.8%) missed 1Q comps, but were impacted by unseasonably cold temperatures in April.
- Home Depot (-3.0%) was lower despite reporting their highest 1Q sales in company history as they warned we would see a slow-down in the housing market potentially lasting five years, as well as noted a decline in transactions due to inflation and interest rates.

## FEDERAL RESERVE NARRATIVE

There was no meaningful change in the Fed's narrative. Chairman Jerome Powell and others largely stuck to existing expectations that the Central Bank is committed to bringing inflation lower. Members of the Fed continued to re-iterate the need and likelihood of 50bp hikes at the upcoming two meetings, but also said they could move past the neutral rate if inflation persisted.

Given the Feds hawkish stance, aggressive monetary tightening by Central Banks is the biggest tail risk for markets, according to this month's Bank of America global fund manager survey. Fears that the Fed will need to hike more aggressively than expected to combat inflation has taken growth optimism near all-time lows, with 72% of surveyed investors expecting a weaker economy in the next 12 months. Current cash exposure is the highest it has been since September 2001, while equity holding exposure has been slashed.




*Source: Bank of American Global Fund Manager Survey, Bloomberg as of 05.24.22*

It is worth noting that investors will be looking at the minutes from the Fed's May meeting. While there are likely no surprises given Fed members have been on the same page and have echoed the same commentary for weeks, we view the release as largely a non-event, with many of the risks already priced in.

# INTERNATIONAL

The Bloomberg World index decreased 1.08% last week, with growth down 1.78% and value down 0.54%. Oil posted its fourth consecutive week of gains with Brent oil up 0.90% to $112 per barrel amid the war in Ukraine and supply shortage. The dollar index softened from $104 to $103 despite a rally in U.S. Treasuries. In the United Kingdom (UK), retail sales jumped 1.4% in April, contrasting with all-time low consumer confidence reading. The UK economy also added more jobs than expected in April, clearing the path for more rate hikes from Bank of England at the next policy meeting.

## EUROPE

European Central Bank (ECB) President Christine Lagarde gave an update on monetary policy in a blog post on Monday. She announced that net bond buying should end at the beginning of the third quarter, which would suppress negative rates. She added that this policy adjustment would allow the ECB to raise rates at the July meeting, in line with forward guidance. This announcement most likely ended speculations of a 50bp hike in July, as Lagarde stressed that policy normalization would be gradual. The Euro has weakened over 6% year-to-date against the U.S. dollar, amid longer-than-expected accommodative policy. The spread between the German 10-year yield and the Italian 10-year yield edged higher, as the bond market is assessing the risks of imminent monetary policy tightening.

The European Commission published a new forecast showing that Euro-area output would barely grow in case of significant disruption to gas imports from Russia. In its base-case scenario, the European Commission sees 2.7% GDP growth in 2022 and 2.3% in 2023. Under a severe scenario caused by the stoppage of Russian gas imports, the Euro-area would grow 0.2% this year and 1% in 2023 while inflation would climb to 9%. Last week, the EU unveiled its €300B package to reduce dependencies on Russian energy and phase out of Russian gas by 2027. The plan covers energy savings, energy supply diversification, push into renewables and emergency backstop in case of Russian gas supply interruption. The Euro STOXX index dropped 0.71% last week.

*Source: Fed, BOE, ECB, Bloomberg as of 05.24.22*

## APAC

*Source: BOJ, BIS, Bloomberg as of 05.24.22*

In China, the People's Bank of China (PBOC) cut the Loan Prime Rate (LPR) by 25bps to 4.45% to support housing demand. The Loan Prime Rate was introduced in 2019 by the PBOC as the new lending benchmark for bank loans to households and businesses. The announcement came as China's home sales declined faster in April under stringent COVID lockdowns.  The one-year LPR was maintained at 3.7% to avoid further narrowing spreads with the United States. On the fiscal front, the government plans over $21B of tax relief for companies to offset the impact of lockdowns. This tax cut is even higher than 2020's as well as those orchestrated the previous years at the peak of the trade war with the United States. The Shanghai Composite Index gained 2.02% last week.

In Japan, core inflation rose 2.1% year-over-year in April, slightly above the consensus of 2%. This is the first time since 2015 that core CPI hit the target set by Bank of Japan (BOJ). Bank of Japan Governor, Haruhiko Kuroda, said, "Prices are moving exactly as we have predicted." He added that 2% inflation in unlikely to last in Japan as it is mostly driven by commodity prices and worsening trade factors. According to data released by BOJ, the Yen's real effective exchange rate dropped to 60.9, the lowest purchasing power since August 1971. The government announced that Japan would allow small groups of tourists to visit Japan this month and gradually reopen borders. The Nikkei 225 index gained 1.18% last week.

## EMERGING MARKETS

In South Korea, early trade data show signs of slowdown amid China lockdowns. In the first 20 days of the month, exports to China only rose by a single digit, compared to 27.6% growth for exports to the United States. Semiconductor global shipments increased 13.5% year-over-year, the slowest increase since September 2021. Bank of Korea (BOK) chief said he would closely monitor July and August data to determine if a 50bp rate hike will be needed. Last month, headline CPI rose 4.8% year-over-year and core CPI rose 3.6%. The government has a different focus than BOK as it just proposed $46.3B extra budget to support COVID-hit businesses and foster economic expansion. The KOSPI index rose 1.35% last week.

In India, the government announced tax cuts and plans to boost subsidies on fertilizers by $14.2B to fight inflation. Indian Finance Minister said the government is committed to keep the price of essential items under control. India made a U-turn on its decision to ban wheat exports after facing backlash from G-7 countries. The initial decision was motivated by national food security as wheat prices soared to an all-time high following the Russian invasion of Ukraine. Indian farmers also lobbied against export restrictions as they claim the policy would hurt their competitiveness on global markets. The Nifty 50 index gained 3.07% last week.

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