



Dave Hutchison, CERTIFIED FINANCIAL PLANNER™

1720 E Calle Santa Cruz

Phoenix Arizona 85022

HUTCHISON INVESTMENT ADVISORS

Registered Investment Advisor

Founded on a CPA Firm Background

(602) 955-7500

E-mail: dave@HutchisonRIA.com

website: www.HutchisonRIA.com

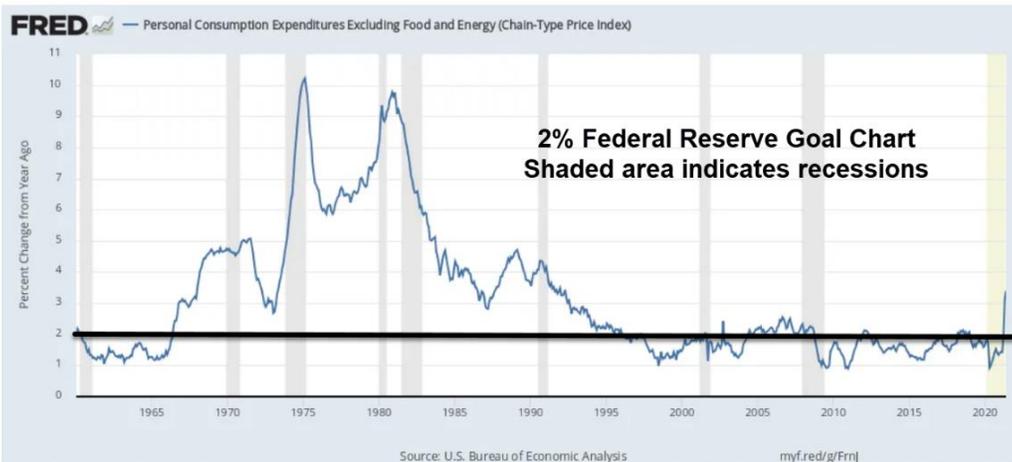
Fax (602) 955-1458

Late August 2022: Is the Market Recovery Real?

Short answer: Maybe, but don't get too excited yet.

Market Recommendations

Higher interest rates are generally viewed as preferable to high inflation. The primary tools to reduce inflation are: 1) The Fed funds rate; 2) The Fed sells bonds to provide less liquidity in the financial system (reverse quantitative easing - QE), although it has never been done before. The Fed began using QE to combat the 2008 Great Recession, and many believe the Fed should have reversed QE sooner.



The Federal Open Market Committee (FOMC) judges that inflation of 2 percent over the longer run, as measured by the annual change in the price index for personal consumption expenditures, is most consistent with the Federal Reserve's mandate for maximum employment and price stability. federalreserve.gov

The year-over-year core inflation rate, from 1960 to the present. Gray areas represent recessions. | Federal Reserve Bank of St. Louis

If inflation continues to be a significant problem, demands for an even more aggressive Volcker-style response will grow. The Fed, then led by Paul Volcker, raised the federal funds rate, which peaked at 20% in June 1981, which helped lead to the 1980–1982 recession. Wikipedia

Today we have a much stronger economy, a long period of record low-interest rates, and below 2% inflation for over a decade.

As cited by the Fed, while various inflation and economic indicators softened in July, job gains have been robust, and unemployment remains low. Inflation remains elevated, reflecting supply and demand imbalances related to the post-pandemic surge in demand, supply change issues, soaring food and energy costs globally due to the Ukraine war, global droughts, record heat waves, and flooding.

In the view of many analysts, the strong rebound in the market since late June results from unwarranted expectations that the Fed will not have to be as aggressive as some think. However, in August, many Fed officials reinforced the stated policy to do whatever is needed to reach its 2% goal. For example, St. Louis Fed President James Bullard says, "We've still got some ways to go here to get to restrictive monetary policy. We should get to 3.75 to 4% (Fed Funds) this year." Interview CNBC.

Thomas Barkin, Richmond Fed President, said: "We're committed to returning inflation to our 2% target, and we'll do what it takes to get there." He said that this could be achieved without a "tremendous decline in activity" but acknowledged that there were risks. Bloomberg 8/19/2022

Arguments that the rebound will continue or at least not have a significant decline

Corporate profits: The S&P 500 index earnings for the second quarter were better than expected. With 95.2% of S&P 500 companies reporting 2nd quarter earnings, the aggregate blended EPS growth

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was 6.3%. However, the greatest growth was from the energy sector. Although 73% of retailers beat EPS expectations, EPS growth for the group was negative 6.4%. Despite the earnings weakness in the retailers sector, driven by actions to get rid of excess inventory and by changing consumer spending habits due to historically high inflation, revenue for the group rose 9.1%. For the third quarter, aggregate S&P 500 EPS is expected to increase by 3.9%. Marketwatch 8/19/2022

Gasoline prices: The national average gas price was \$3.89 on 8/22/2022, according to AAA. That's higher than \$3.17 a year ago but well below the record of \$5.02 in mid-June. However, Diesel used by barges and trucks to deliver goods to ports, warehouses, and retailers is at \$4.98 vs. \$3.29 a year ago. Higher diesel costs increase retail prices, as transportation costs are passed on to the consumer or manufacturer.

Global fuel demand has been declining because of the high prices and the strong US dollar, making oil more expensive elsewhere (since oil is priced globally in \$US). US gasoline prices have followed a drop in the futures market for crude oil and gasoline. Those markets are down because investors are worried interest-rate hikes will slow the economy as central banks aggressively combat inflation. Reuters

Consumer spending continues to be robust from their considerable savings during the pandemic. On the other hand, lower-income workers and those living on social security are increasingly feeling inflation's pain.

"If you're looking for recession, you won't find it here," wrote Ian Shepherdson of Pantheon Macroeconomics. "The July retail sales report made it clear that the US consumer is rather more willing to spend than you might expect if you spend much time wallowing in the misery of the recession-obsessed media," he said. That recession obsession has faded a bit amid continued signs of labor market strength, falling gas prices, and hints that runaway inflation may be peaking.

"Summertime and the living is easy for consumers where most are fully employed with the lowest unemployment rate in the nation's history," wrote economist Chris Rupkey of FWDBONDS. CNN Business 8/18/2022

Risk Concerns

A lot of trading is now done by algorithms; algorithmic trading by computers, often based on momentum, can be good or bad for investors, depending on whether it is directing higher or lower prices for stocks. This may be why the market may have overcorrected on the downside, and now the momentum is reversing.

In the US stock market and many other developed financial markets, about 60-75 percent of overall trading volume is generated through algorithmic trading according to Select USA The Robust Trader 7/25/2022

Food prices often priced by global markets are rising far faster than overall inflation. American farmers are killing their crops and selling cows because of extreme drought. 8/17/2022 cnn.com

Gasoline prices have been falling for weeks, but diesel and natural gas prices remain much higher. This raises costs for the nation's fuel-intensive agricultural industry, leading to expectations that food prices will remain high. Kent Vander Lugt, a farmer in Minnesota, says his fuel costs are 60% higher than a year ago. Barron's 8/19/2022

Globally extreme heat waves and droughts are disrupting food production. In July 2022, inflation was 10.1% in the UK, the fastest pace since 1982. Food prices rose 2.3 percent from June to July, the most rapid monthly increase in 21 years. Office for National Statistics

The extreme heat in China has resulted in crop failures in many parts of the country. Affected by the continuous high temperature, the price of fresh vegetables rose by 12.9% year on year, said Fu Linghui, a spokesperson for the National Bureau of Statistics. He pointed out that the extreme heat has caused droughts in some agricultural areas in the south. In the north, rainfall and flooding also resulted in some crop failures. CNN business 8/17/2022

Global Natural Gas Prices Surging: Oil prices are down, bringing down gasoline prices too, but natural-gas prices are still soaring. Some analysts expect gas to break above \$10/mcf, which was last seen in July 2008.

In Germany and England, wholesale power prices hit new records - more than quintupled in the past year. Natural-gas futures in Europe are more than ten times as high as they were a year ago! The problem is that Russia has ratcheted down the gas it's sending to Europe through its Nord Stream pipeline to about 20% of pre-war levels, adding to already-short supplies.

In the US, power prices are considerably lower than in Europe, but they're still rising. The wholesale price of power in the US ranges from \$62 per megawatt-hour (MWh) to \$95 per MWh. In Germany, the price is now over \$450 per MWh. The US produces more natural gas than Europe and can't export most of it, so US residents benefit from lower prices. Barron's 8/16/2022

Mortgage rates have soared. Bankrate 8/19/2022 reports the average 30-year fixed mortgage rate is 5.66%. I did a cash-out refinancing for 30 years in December 2021 at 2.9%, since the last place I want equity tied up is in my home, which I plan never to sell and I can afford the reasonable payments.

Surging rent prices. Instead of gas, rents are now hitting consumers, according to Bank of America Institute data. The report said that middle-income and younger Americans saw the largest increases. USA Today 8/9/2022

Foreign risks more than in the US but could affect trade and prices.

Rhine River closed to barges: Low water levels resulting from a lengthy heatwave across Europe have forced the closure of barge traffic on the Rhine and other vital rivers globally. Barge operator Contargo told customers: "We regretfully have to point out we can no longer guarantee to meet all deadlines" Contargo had earlier imposed low water surcharges. The river's closure couldn't come at a worse time for European supply chains, which are already contending with severe port congestion and the repercussions of the war in Ukraine. TheLoadStar 8/15/2022

China's worst heatwave in 60 years is forcing factories to close: China's Sichuan province has ordered factories to shut down to ease a power shortage in the region as a scorching heat wave sweeps across the country. Sichuan is a key manufacturing location for the semiconductor, car battery, and solar panel industries. The power shutdowns will hit factories for the world's biggest electronics companies, including Apple supplier Foxconn, Texas Instruments, and Intel. Financial Times

UK Inflation projected to hit 18.6% as gas prices surge. The Financial Times 8/22/2022

\$4.1 trillion could be good for the economy & jobs but may be bad for inflation

March 2021 **\$1.9 trillion American Rescue Plan:** To fight massive job losses with the Covid-19 pandemic, it provided direct payments to lower income folks (basically under \$75k income), provided extended unemployment benefits for those under \$150k of income, and extended the Payroll Protection Program to provide an incentive for small businesses to keep their workers on their payroll. Proponents argue that it helped supercharge the historic economic recovery of 2021, when the economy grew faster than in any year since 1984 and unemployment fell faster than ever. NPR.org

Inflation concern The most recent stimulus programs below will pump lots of money into the economy, but most of it will not be immediate but will span 5-10 years. Hopefully inflation will be normalized before many programs affect the economy, since they could lead to higher inflation. Another concern is where will all the workers come from for all the new jobs that will be created? We desperately need more foreign workers but do not have a workable immigration policy.

November 2021 **\$1.2 Trillion Bipartisan Infrastructure Investment and Jobs Act**, including \$550 billion newly authorized above what Congress was already planning to authorize. It includes provisions related to highways, transit, research, hazardous materials, and rail programs. It also funds broadband access, clean water, and electric grid renewal.

July 2022, **\$280 billion CHIPS Act** to strengthen domestic semiconductor manufacturing, design, and research, fortify the economy and national security, and reinforce America's chip supply chains. The

Act had bipartisan support. Stanford Law Professor Alan Sykes has a detailed analysis at <https://law.stanford.edu/2022/08/02/stanfords-al-sykes-on-the-280-billion-chips-and-science-act-government-intervention-and-trade/>

August 2022 **\$737 Billion Inflation Reduction Act of 2022:** The Act authorizes \$369 billion in spending on energy and climate change, \$300 billion in deficit reduction, three years of extended Affordable Care Act subsidies, prescription drug reform to lower prices, and tax reform.

The Act represents the most significant investment in addressing climate change in United States history, plus transition funding for the oil and gas industry. It includes funds for an extensive expansion and modernization of the Internal Revenue Service and a 15% minimum tax on the largest corporations, who often pay little or no tax.

IRS enforcement will be increased to go after high-income folks who hide money in shell corporations, Cryptocurrency tax evasion, and tax cheats like Allen Weisselberg. Weisselberg pled guilty on 15 charges of evading taxes on income from the Trump Organization and will pay the IRS nearly \$2 million and face five years of probation. Funds will also be used to modernize the old IRS computer system and increase customer support and other items that have been underfunded for many years.

The Act extends the solar investment tax credit for ten years as part of the investment into clean energy. The Act contains provisions that cap insulin costs at \$35/month and will cap out-of-pocket drug costs at \$2,000 for people on Medicare. It also funds drought relief for western states. Dave notes that all Congressional Republicans voted against the measure.

Conclusion The US has one of the strongest global markets. Treasury yields have recently declined again, and the US Dollar has become stronger, since we are seen as a safer haven. The key is how fast inflation can be tamed.

Market Recommendations

Small Cap Value Opportunities - Jill Carey Hall BofA Head of US SMID-Cap Securities August 2022

Small caps are extremely cheap now. The risk of recession already seems priced into smaller companies more than large companies. The forward P/E ratio is at similar levels as in prior recession lows - trading at about 12 times forward earnings for small caps vs. the S&P500. The relative discount of small caps vs. large is almost as large as we have ever seen. If recession gets more priced into the market, we think there is more downside risk to large caps than small caps. The last time small caps were so undervalued was after the tech boom in 2000, when small caps widely outperformed large caps until the 2008 financial crisis.

I continue to recommend from recent pdf reports on hutchisonria.com:

Reasons to Stay Invested in Volatile Times <https://dhutch.news/StayInvested2022>

Include Value and Growth in Portfolios: <https://dhutch.news/ValuevsGrowth2022>

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Small-cap funds may be subject to a higher degree of market risk than large-cap funds or more established companies' securities. Furthermore, the illiquidity of the small-cap market may adversely affect the value of an investment so that, when redeemed, shares may be worth more or less than their original cost.

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Investors cannot invest directly in indexes. The performance of any index is not indicative of the performance of any investment and does not take into account the effects of inflation and the fees and expenses associated with investing.

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