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End of Silly Season (The Rally That Was)

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It is common for stocks to rally in the midst of a bear market. While this type of rally provides relief from the grind of daily volatility, it is generally based upon modest and possibly fleeting good news rather than enduring fundamentals and is therefore, temporary. During the eight-week period from mid-June through mid-August, the S&P 500 moved from 3650 to nearly 4300 on better than expected (but uninspiring) earnings, falling long-term bond yields and encouraging inflation data. Some of the strongest performances during the relief rally came from the most beat-up, speculative companies.

Bed Bath & Beyond

We rarely write about individual investments, let alone one that does not appear in our portfolios. We defy convention in this instance because the recent experience of Bed, Bath & Beyond (BBBY) is emblematic of a larger theme. Most readers are familiar with the home goods retailer if for no other reason than the 20% off coupons frequently in your mailbox. In August, BBBY was the focus of retail traders who loosely organize online to magnify the impact of their collective investment decisions. Targets of the "retail mob" tend to move straight up on zero fundamental reasoning. BBBY is case and point of positive investor sentiment exceeding reality. Consider recent business performance:

- Sales down 25% in one year
- Operating loss of $340 million in three months
- Gross profits down 45% in one year
- Gross margins down 26% in one year
- Cash on hand has dropped from $500 million to $107 million in three months

The company is selling fewer goods for a smaller profit and burning cash to keep the doors open and the lights on. This could be an attractive investment opportunity if BBBY was developing a new product or service that needed time and money to show results. They are not. The operating loss is not due to investing in the business; it is due to poor inventory management and changing consumer preferences. In other words, management bought a lot of home goods thinking pandemic-era consumer trends would continue. They haven't, and BBBY is left holding the bill for products consumers don't want or can get elsewhere for less.

In such a scenario you would expect BBBY bonds to be trading at pennies on the dollar (BBBY two-year bonds are yielding 68%, which implies default), their suppliers to demand payment before shipping new inventory, and the stock to be in free fall. All of this was true until August when the stock suddenly went from $5 to $26 in two weeks as the retail trading army took to the trenches. Today the stock is trading

at a little over $8, and the viability of the firm remains in question. Without access to credit from the bond market and wholesale suppliers, bankruptcy is a distinct possibility.

The Summer Rally

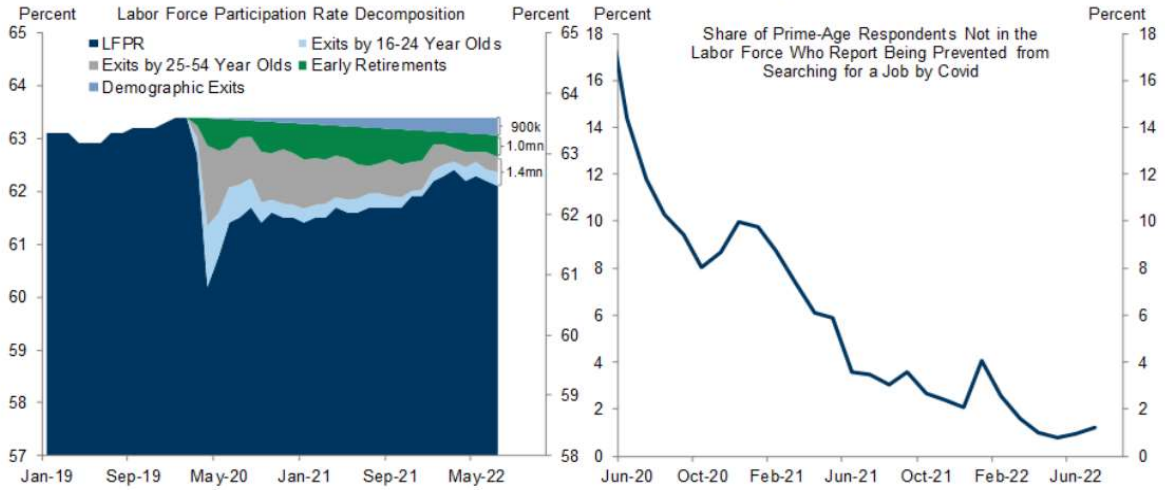
The BBBY story is not dissimilar to the June-August rally in the S&P 500. The fundamentals of the equity market became disconnected from reality. The US consumer is clearly facing hard times, as wages fail to keep pace with inflation, and has been forced to reassess household spending patterns. The rapid increases in borrowing costs have depressed demand for housing, a classic leading indicator of economic growth. Overseas, an energy crisis in Europe and a property bubble in China slowed demand for US exports. Slower economic growth is inevitable in this scenario.

The BBBY case is symbolic of the extent to which, during the summer rally, the market and the Fed were out of synch. Speculators drove BBBY stock up five-fold, in days, then back down to approaching the starting price. Over an 8-week period, the S&P 500 jumped over 17% on mildly encouraging but generally flimsy data. This was unwarranted and seems to have been based upon the assumption that short-term progress on inflation would moderate the Fed's approach to interest rate increases. To quell such misperceptions, Chairman Powell felt the need to deliver an 8-minute speech at the Jackson Hole conference on August 26th, making clear the Fed's commitment to bring inflation down via an aggressive interest rate hiking strategy. On that day, the S&P 500 was down by 3.38%. The S&P 500 is off almost 9% from the August 16th peak through the end of the month.

The Labor Market

A primary focus of Chairman Powell's speech on that date was the labor market. Analysts believed that the overall labor force participation rate (percentage of people working or seeking work relative to the overall population) would return to pre-pandemic levels as COVID-related concerns ebbed. If more people were looking for work, wage growth and staffing issues should ease. A balanced labor market would help bring down inflationary pressures. August's employment report did show advancement in this area. The participation rate is now at a post-pandemic high, but progress has been slow, and the labor market remains historically tight.

Exhibit 5: The Recovery of Labor Supply Has Stagnated This Year and Seems to Be Running Out of Steam



Source: Goldman Sachs Global Investment Research, Department of Labor

Expectations for easy money to fund speculative excess, such as BBBY, are completely unfounded in this environment. The underlying pressures from the labor market (the largest factor of inflation) strongly suggest that interest rates will need to move higher than was expected just a few months ago.

Conclusion

The data of the past few months is clear in our view. Inflationary pressures are easing in certain areas, but the labor market is not following along. 2.4 million people that were employed in 2019 are no longer working, even after adjusting for demographic retirements.

The data suggests continued volatility with a downwards bias. In July we wrote that our portfolios would remain conservative, as the odds of recession appeared elevated. That positioning, and the reasoning for it, have not changed. The "relief rally" of July and August were a welcome respite, but the less than terrible corporate earnings and economic data that drove that rally are far from enough to slow down the Fed. Our best advice is to stay patient. We aren't out of the woods yet, but we'll get there eventually. We always do.