Investment Management of Virginia

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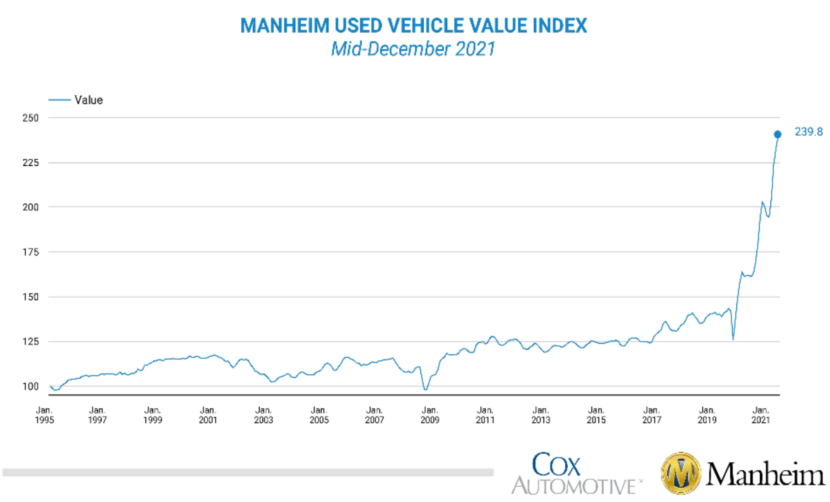
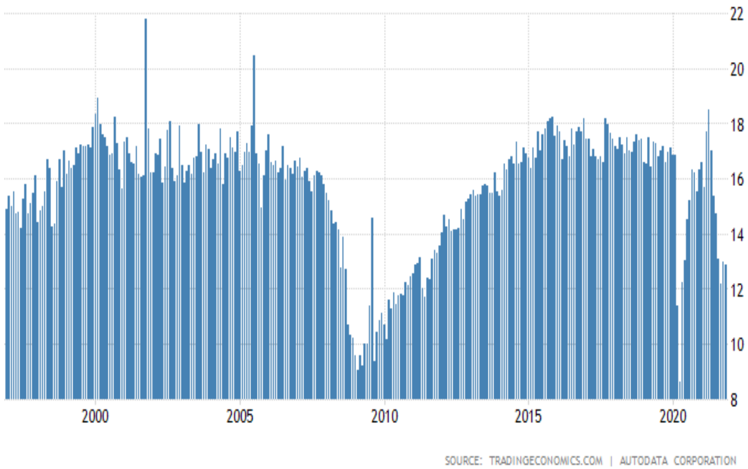
Interesting Charts and Commentary

A Puzzling Puzzle

Multiple, unprecedented forces are affecting markets, making economic and market forecasting even more difficult than usual. Nowhere is this puzzle more apparent than in the auto market. Driven by strong employment and government stimulus, vehicle demand remains strong. However, the lack of new car production due to an ongoing semiconductor shortage in the auto industry has led to a never-before-seen dynamic where some used cars cost more than new cars. To be sure, this is vehicle-specific and not widespread, but the point remains. Anyone claiming to fully understand the dynamics affecting the current economy is probably fooling themselves.



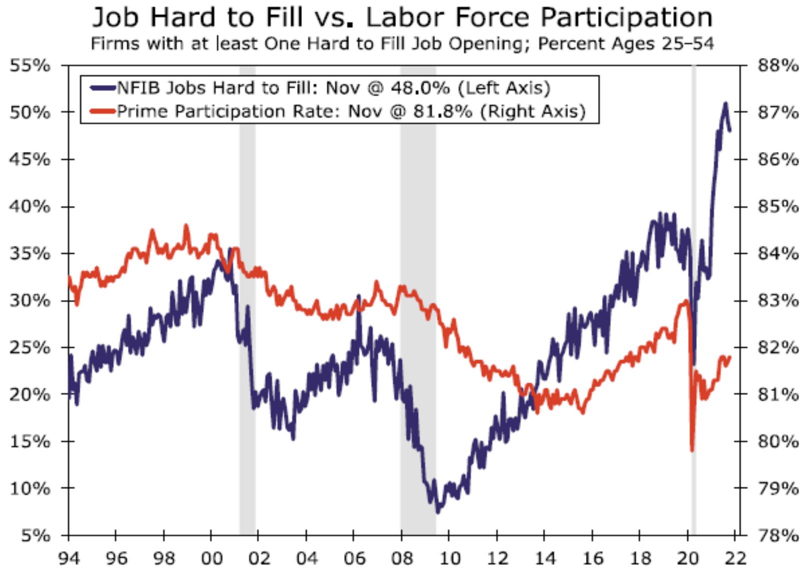
Total Vehicle Sales



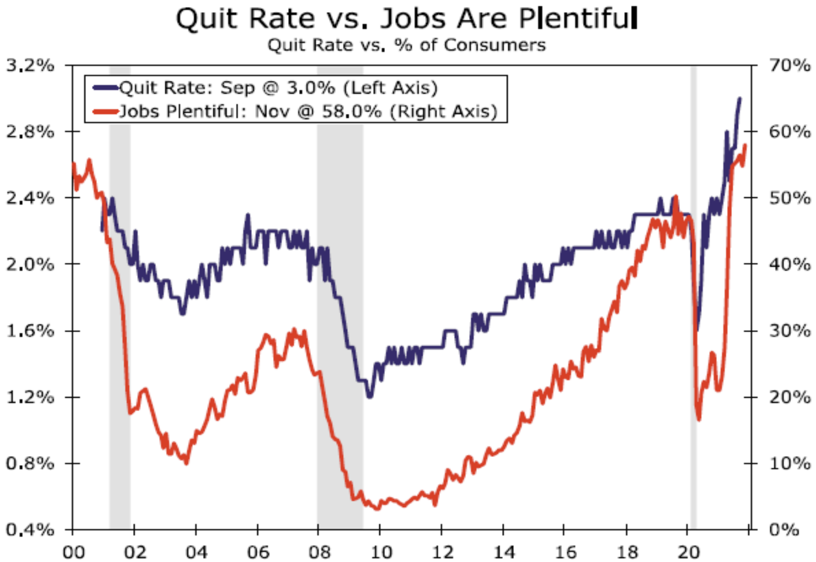
Source: Trading Economics, Cox Automotive, Manheim

The Great Resignation Continues

Jobs are plentiful for anyone seeking employment. The tight labor market has been exacerbated by continued variants of COVID, government subsidies, and a strong equity market encouraging early retirement. It will be interesting to see how the quit rate and fill rate change as subsidies and tax breaks wind down, and if a market pullback would drive early retirees back into the workforce.



Source: U.S. Department of Labor, NFIB and Wells Fargo Securities

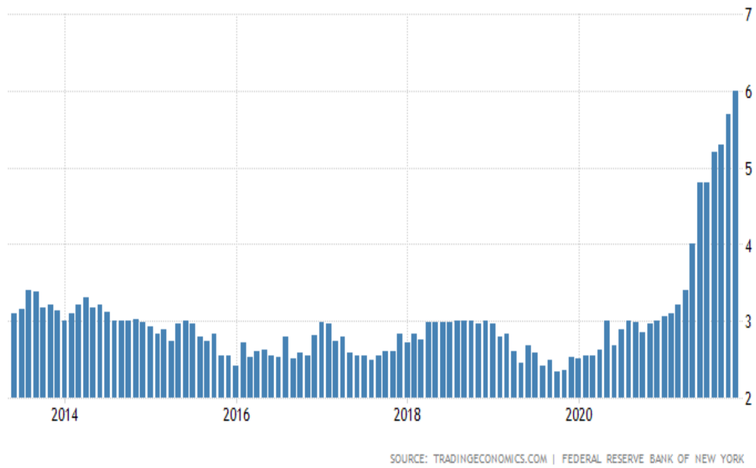


Source: U.S. Department of Labor, the Conference Board and Wells Fargo Securities

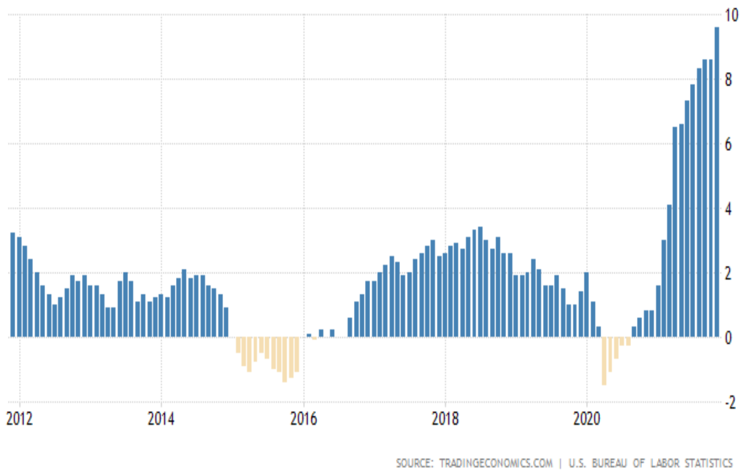
Inflation Gets Fed's Attention

The strong employment numbers and persistent rise in inflation got the attention of the Federal Reserve which announced a faster taper of asset purchases. The market now expects the Fed to increase rates three times in 2022. Ironically, the next 3-6 months will likely show a deceleration in prices growth (inflation) on increasingly difficult year-over-year comparisons. The latter half of 2022 will be key to see if inflation is more transitory in nature or here to stay.

Inflation Expectations



Producer Price Change YoY

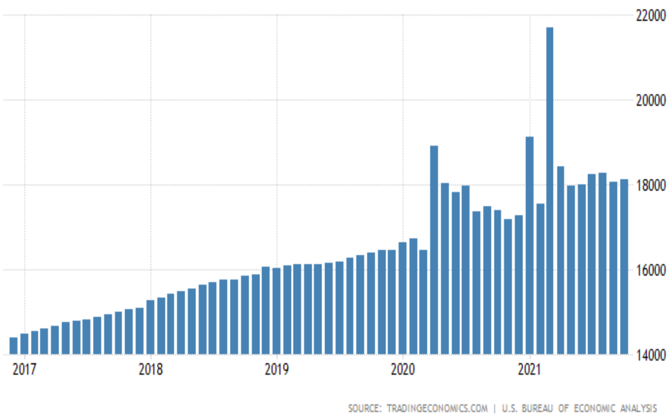


Source: Trading Economics

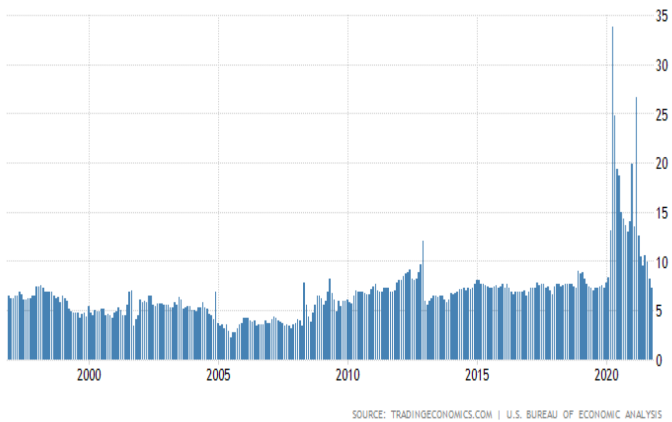
Consumer Remains in Great Shape

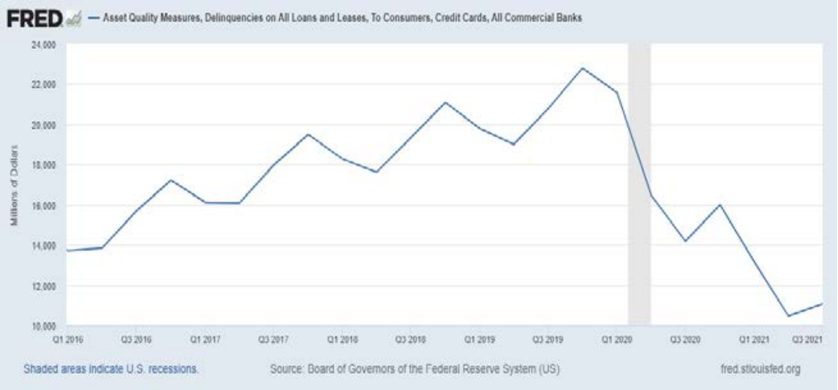
The consumer remains strong and willing to spend. Rising wages, strong employment numbers, and, ironically, supply chain constraints should keep consumer demand elevated. Both consumers and businesses remain in excellent shape from a credit/delinquency standpoint.

Personal Disposable Income



Personal Savings Rate



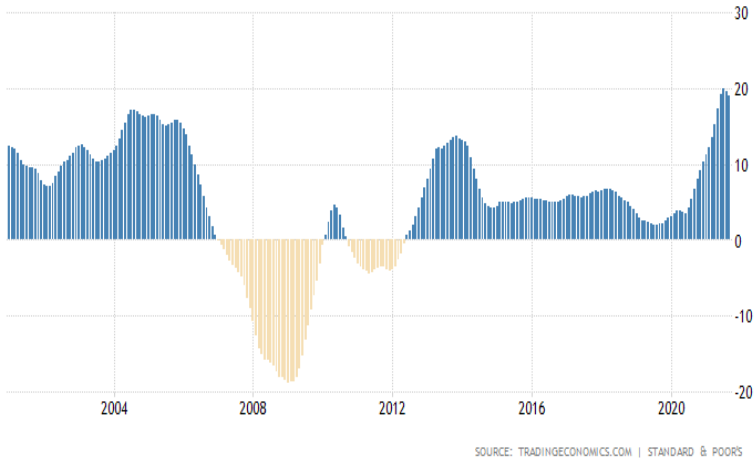


Source: Trading Economics, St. Louis Federal Reserve Bank

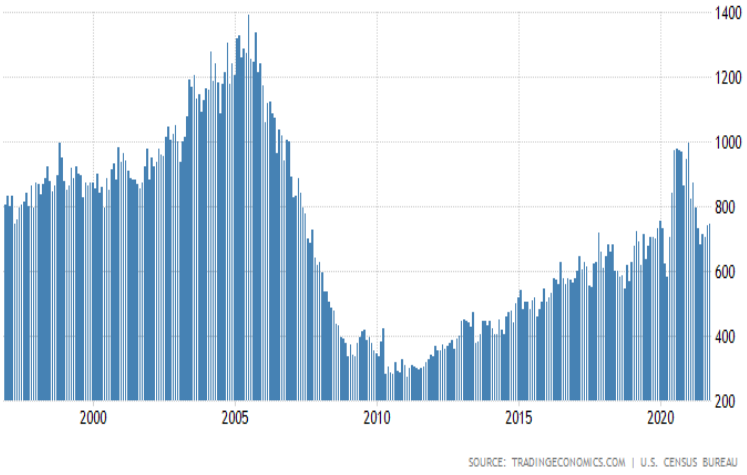
Housing Remains Strong

Home prices may be peaking, but the market still has room to run from a volume perspective as we continue to catch up from the lack of sales and new home construction in the 2009-2011 timeframe. The transition of Millennials into their peak earning years should also boost demand over the next decade.

Case Shiller Home Price Index YoY



New Home Sales



Source: Trading Economics

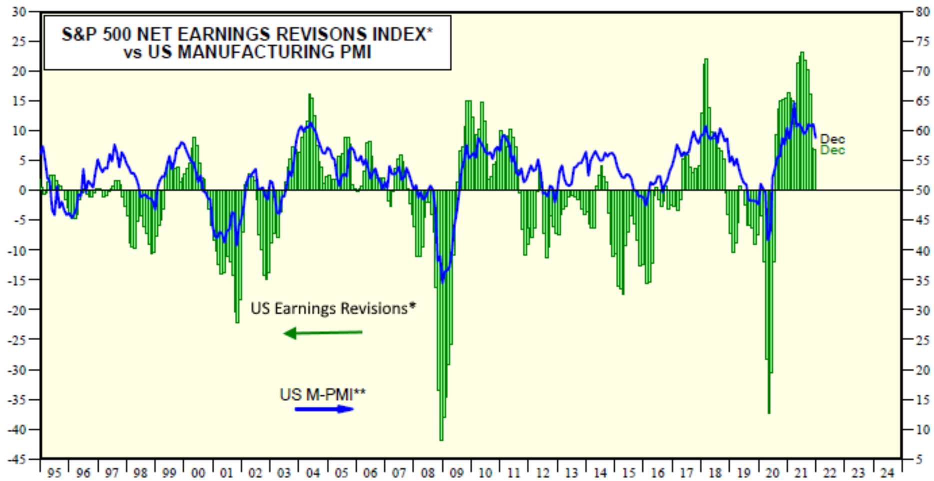
Manufacturing Remains Robust

Manufacturing remains strong but growth is slowing. December's Purchasing Managers Index (PMI) slowed to 58.7% from over 60% for most of 2021. We track this measure closely because the PMI is highly correlated with earnings growth.

Manufacturing at a Glance

INDEX	Dec Index	Nov Index	% Point Change	Direction	Rate of Change	Trend* (months)
Manufacturing PMI®	58.7	61.1	-2.4	Growing	Slower	19
New Orders	60.4	61.5	-1.1	Growing	Slower	19
Production	59.2	61.5	-2.3	Growing	Slower	19
Employment	54.2	53.3	+0.9	Growing	Faster	4
Supplier Deliveries	64.9	72.2	-7.3	Slowing	Slower	70
Inventories	54.7	56.8	-2.1	Growing	Slower	5
Customers' Inventories	31.7	25.1	+6.6	Too Low	Slower	63
Prices	68.2	82.4	-14.2	Increasing	Slower	19
Backlog of Orders	62.8	61.9	+0.9	Growing	Faster	18
New Export Orders	53.6	54.0	-0.4	Growing	Slower	18
Imports	53.8	52.6	+1.2	Growing	Faster	2
Overall Economy				**Growing**	**Slower**	**19**
Manufacturing Sector				**Growing**	**Slower**	**19**

*Number of months moving in current direction.
Manufacturing ISM® *Report On Business®* data has been seasonally adjusted for the New Orders, Production, Employment and Inventories indexes.

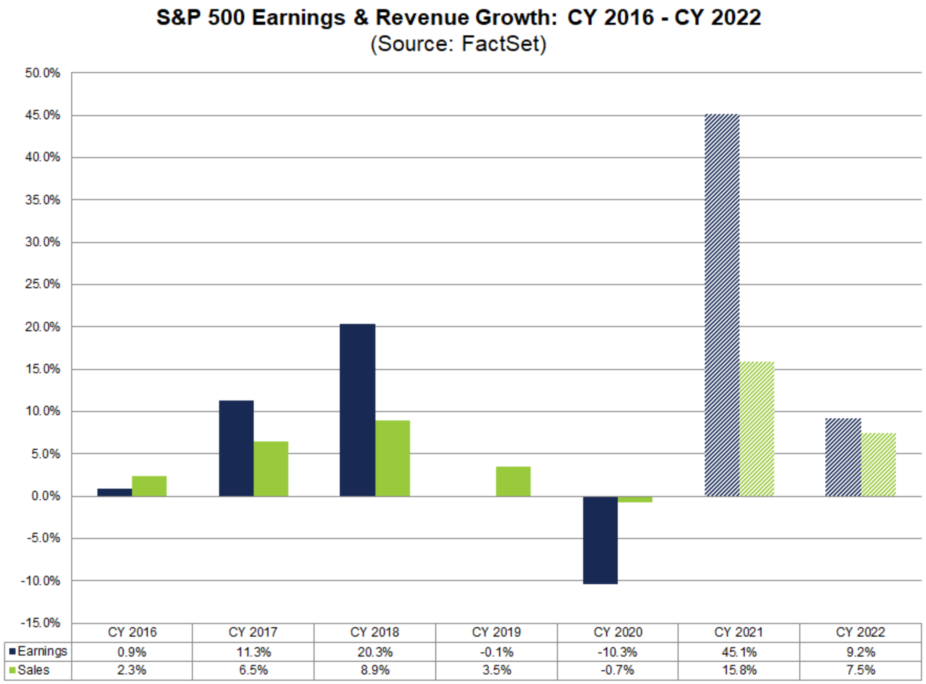


* Three-month moving average of the number of forward earnings estimates up less number of estimates down, expressed as a percentage of the total number of forward earnings estimates.
** An index above 50 indicates an increase in manufacturing activity. An index below 50 indicates a decrease in manufacturing activity.
Source: Institute for Supply Management, CIPS, Markit, Haver Analytics, and I/B/E/S data by Refinitiv.

Source: : ISM "Report on Business", Ed Yardeni.

Peak Earnings Growth

2021 will likely see the “peak earnings growth rate” for this cycle as the process of decelerating growth unfolds… a long process (hopefully). Real earnings growth and earnings revisions are currently projected in the right direction (UP). History demonstrates these factors and the market index price have the best correlation of any indicator, but correlation is never a guarantee.

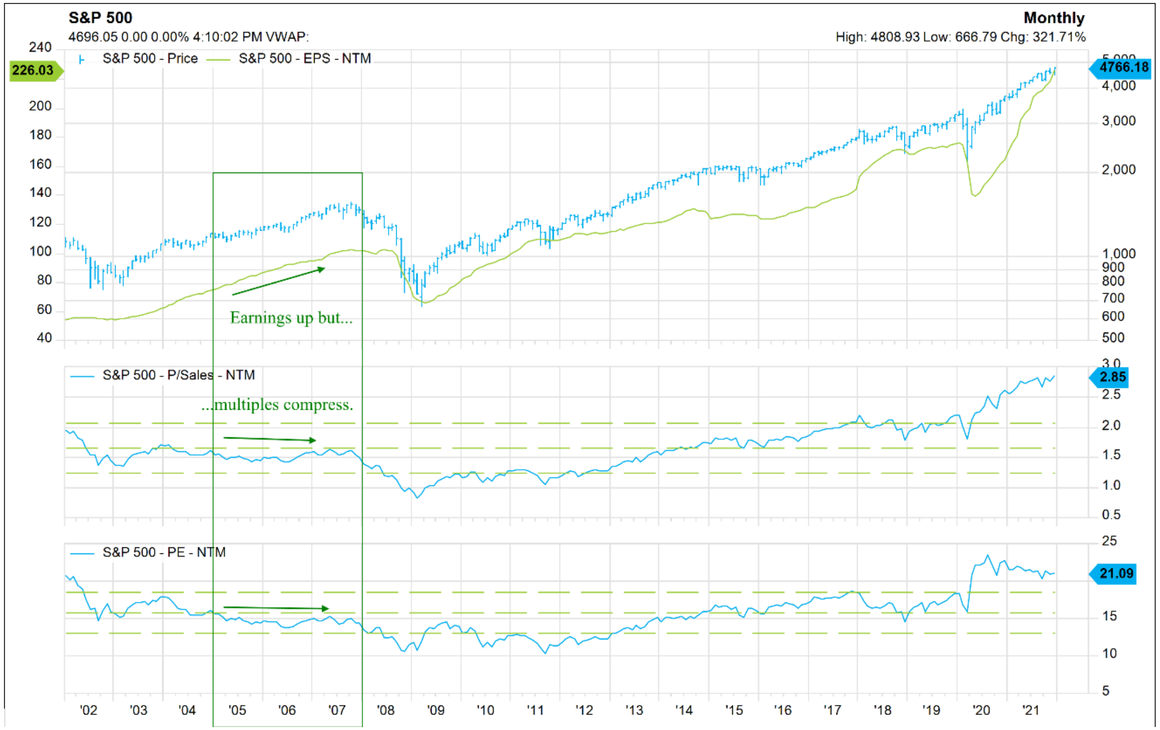


	CY 2016	CY 2017	CY 2018	CY 2019	CY 2020	CY 2021	CY 2022
Earnings	0.9%	11.3%	20.3%	-0.1%	-10.3%	45.1%	9.2%
Sales	2.3%	6.5%	8.9%	3.5%	-0.7%	15.8%	7.5%

Source: FactSet, as of December 17, 2021

Multiple Compression in A Rate Hike Cycle

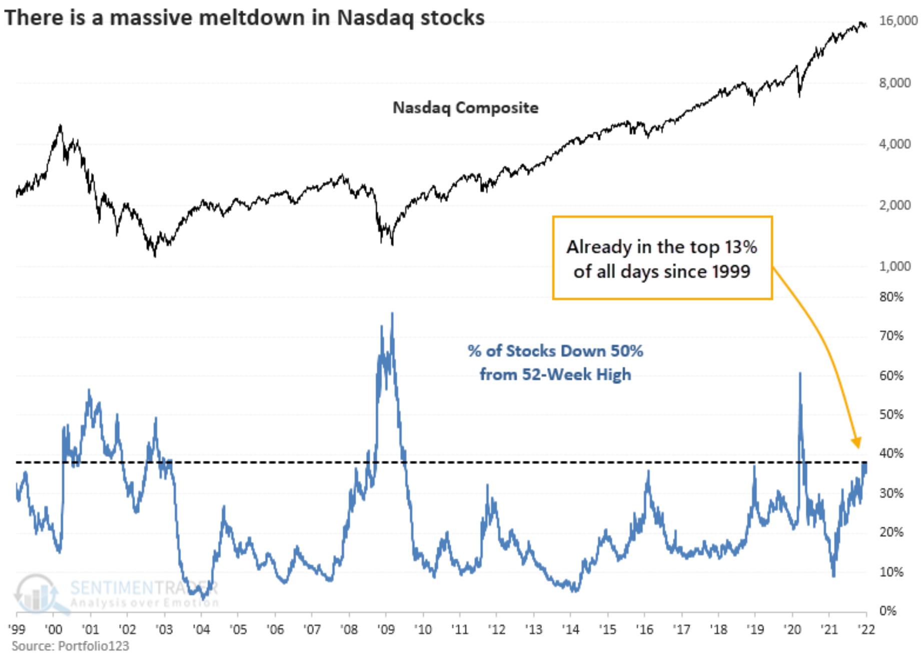
Valuation is high relative to any historic range; however, adjusted for interest rates, equity valuations appear more reasonable. And, the yield on high-quality, dividend-paying stocks remains relatively attractive for income-focused investors. However, during a Fed rate hike cycle, P/E multiples typically contract, often over a period of years, e.g. 2005-2007. Even as multiples compressed during that timeframe, the market went to new highs on rising revenue and earnings. This multiple compression is true of all Post-WWII rate increase cycles.



Source: FactSet, IMVA

A Stealth Correction with Indexes at Highs

The multiple compression theme has already started playing out in the most highly valued NASDAQ stocks. Almost 40% of NASDAQ-listed stocks are now down 50% from their 52-week highs. Only 13% of days since 1999 have seen more stocks cut in half. It is difficult to tell what this divergence means from a historical perspective, but it does reinforce our forecast for increased market volatility.



Source: Sentimentrader.com

Conclusion:

- Multiple, unprecedented forces are affecting markets, making economic and market forecasting even more difficult than usual.

- Jobs are plentiful for anyone seeking employment. The tight labor market has been exacerbated by continued variants of COVID, government subsidies, and a strong equity market encouraging early retirement. The U.S. consumer is in good shape. Personal consumption has moderated, but delinquencies continue to trend downward.

- The strong employment numbers and persistent rise in inflation got the attention of the Federal Reserve which announced a faster taper of asset purchases. The market now expects the Fed to increase rates three times in 2022.

- Home prices may be peaking, but the market still has room to run from a volume perspective as we continue to catch up from the lack of sales and new home construction in the 2009-2011 timeframe. The transition of Millennials into their peak earning years should also boost demand over the next decade.

- Manufacturing remains strong but growth is slowing. December's Purchasing Managers Index (PMI) slowed to 58.7% from over 60% for most of 2021. We track this measure closely because the PMI is highly correlated with earnings growth.

- 2021 will likely see the "peak earnings growth rate" for this cycle as the process of decelerating growth unfolds… a long process (hopefully). Real earnings growth and earnings revisions are currently projected in the right direction (UP). History demonstrates these factors and the market index price have the best correlation of any indicator, but correlation is never a guarantee.

- Valuation is high relative to any historic range; however, adjusted for interest rates, equity valuations appear reasonable. During a Fed rate hike cycle, P/E multiples typically compress, often over a period of years.

Disclosure:

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