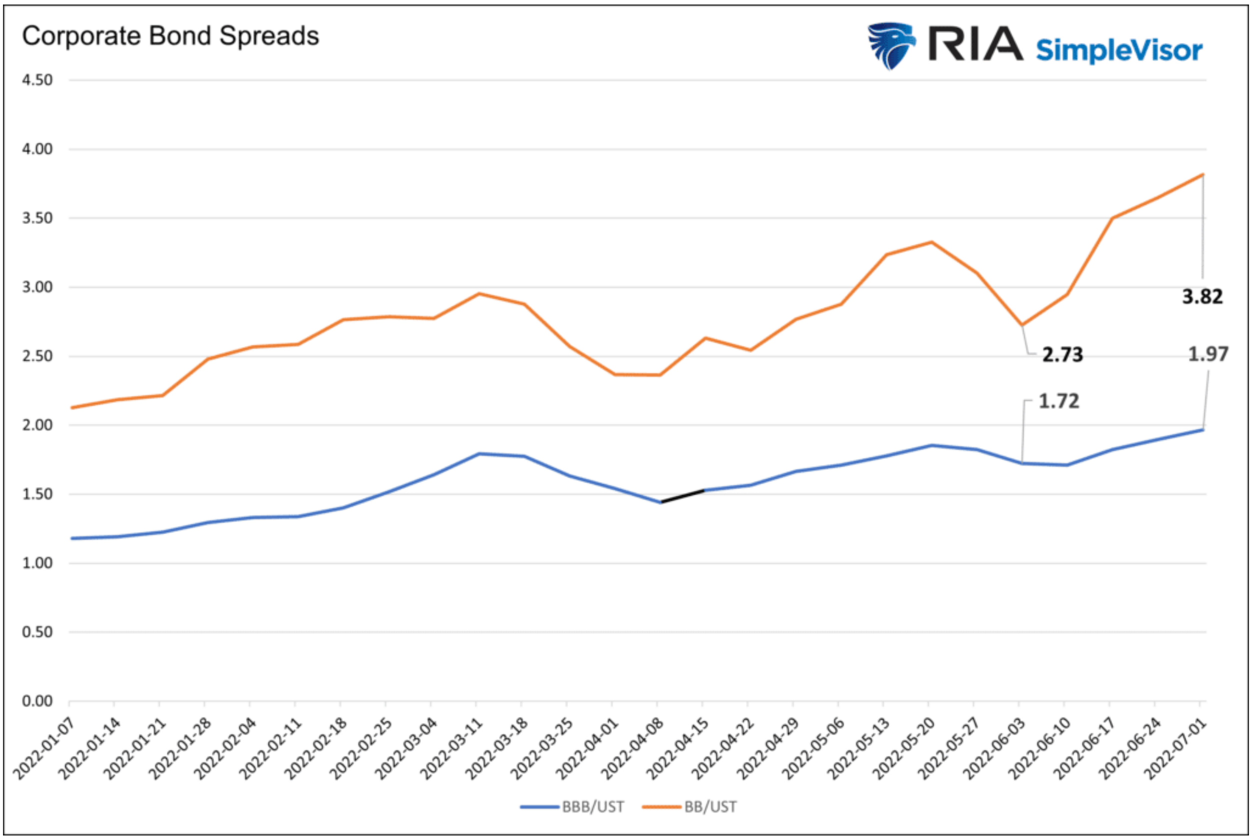
Corporate Bond Spreads Raise Concerns

During June, the BBB-rated investment-grade corporate bond index rose 25bps more than similar-maturity U.S. Treasury bonds. At the same time, the BB-rated junk-grade corporate bond index rose by over 1% more than Treasury bonds. Simply, bond spreads are rising versus Treasuries and within the corporate bond market rating structure. Prior to June, and despite economic weakening and higher interest rates, corporate bond yields, both junk and investment grade, were not rising in yield versus U.S. Treasury yields at a concerning rate. In June, that started to change. Higher corporate bond yield spreads are a warning of potential financial instability. If spreads continue to widen, the Fed will take notice. In mid-June, we wrote Are Financial and Market Instability The Last Hopes For Stocks?. The article raises the point that higher corporate bond yield spreads may at some point force the Fed to pull back on its tightening campaign.



What To Watch Today

Economic Calendar

- 7:00 a.m. ET: **MBA Mortgage Applications**, week ended July 1 (0.7% during prior week)

- 9:45 a.m. ET: **S&P Global U.S. Services PMI**, June final (51.6 expected, 51.6 during prior month
- 9:45 a.m. ET: **S&P Global U.S. Composite PMI**, June final (51.2 expected, 51.6 during prior month)
- 10:00 a.m. ET: **ISM Services Index**, June (54.0 expected, 55.9 during prior month)
- 10:00 a.m. ET: **JOLTS job openings**, May (10.9 million expected, 11.4 million during prior month)
- 2:00 p.m. ET: **FOMC Meeting Minutes**

?**Earnings**

- *No notable reports are scheduled for release.*

Market Trading Update - A July Rally?

After a weak opening yesterday, the markets rallied back into positive territory as deflationary pressures led to a rally in growth stocks and bonds. Inflationary trades were under a lot of pressure with oil prices falling below $100/bbl yesterday. We are close to getting stopped out of our small oversold energy trades we picked up last week. We are giving them a little from for an oversold bounce.

The market is not yet back to overbought, so this early July rally may still have a little more to go. Today's action was encouraging but lately, rallies have consistently failed. We will continue to watch this one closely.

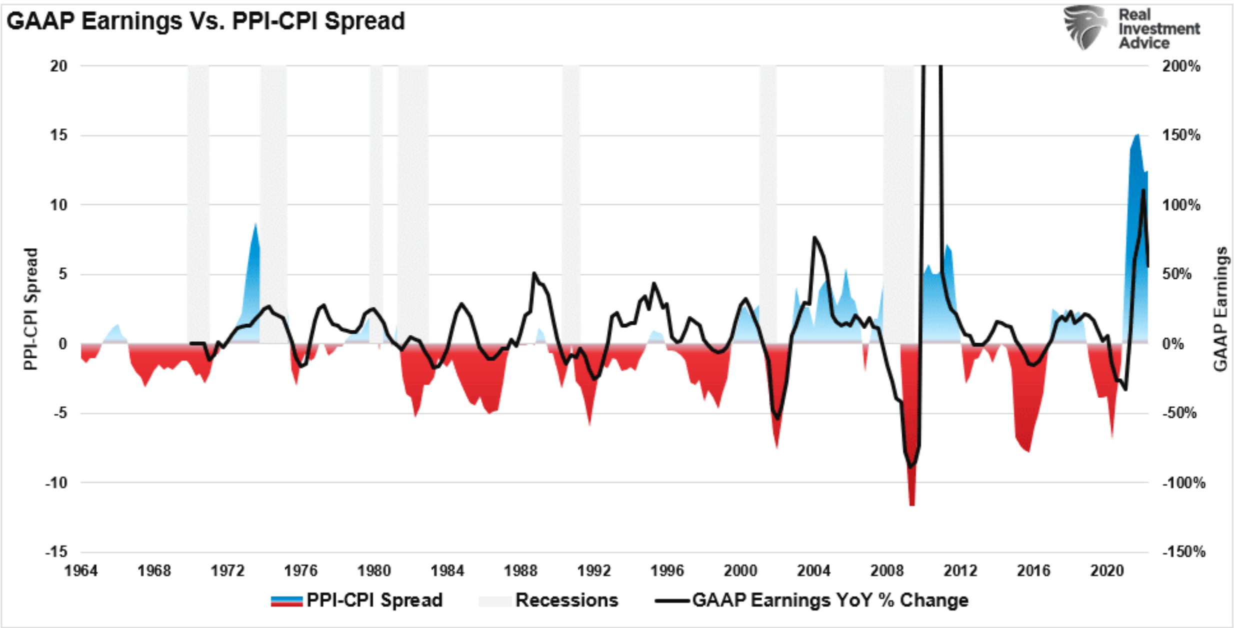
Apparently, Those "Greedy" Corporations Aren't So Greedy

Stop me if you have heard this one.

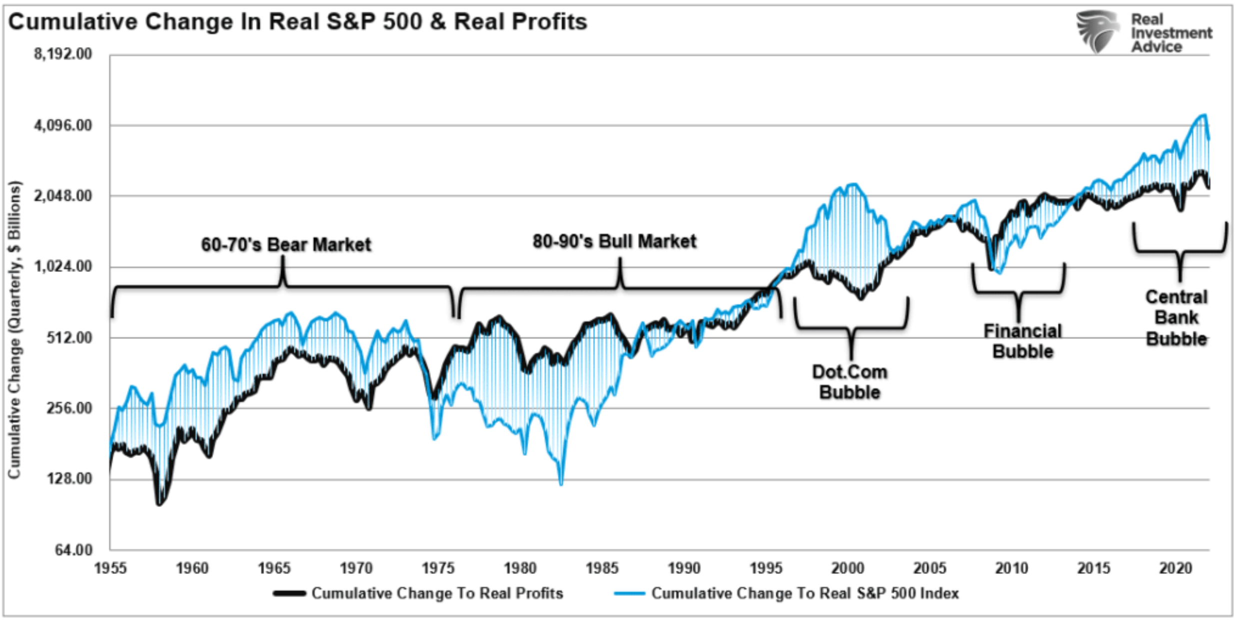
> *"Greedy corporations are causing inflation by taking advantage of consumers and charging more for goods and services." - Progressive Left & Mainstream Media*

The problem is that it isn't true.

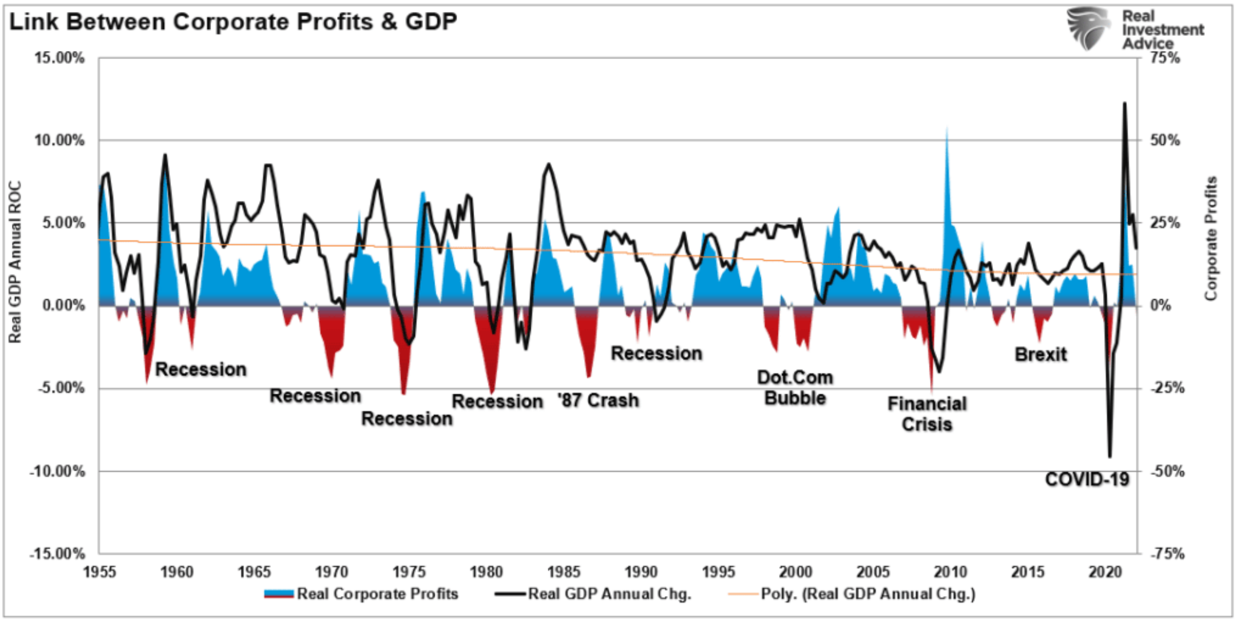
When input costs rise, corporations try to pass on some of those higher costs to consumers. However, in situations where there are spiking prices or slower economic growth, such is not always the case. As we noted previously, the spread between producer prices and consumer prices suggested that corporations were having to retain a good bit of the higher input costs. We noted that those costs would weigh on earnings.



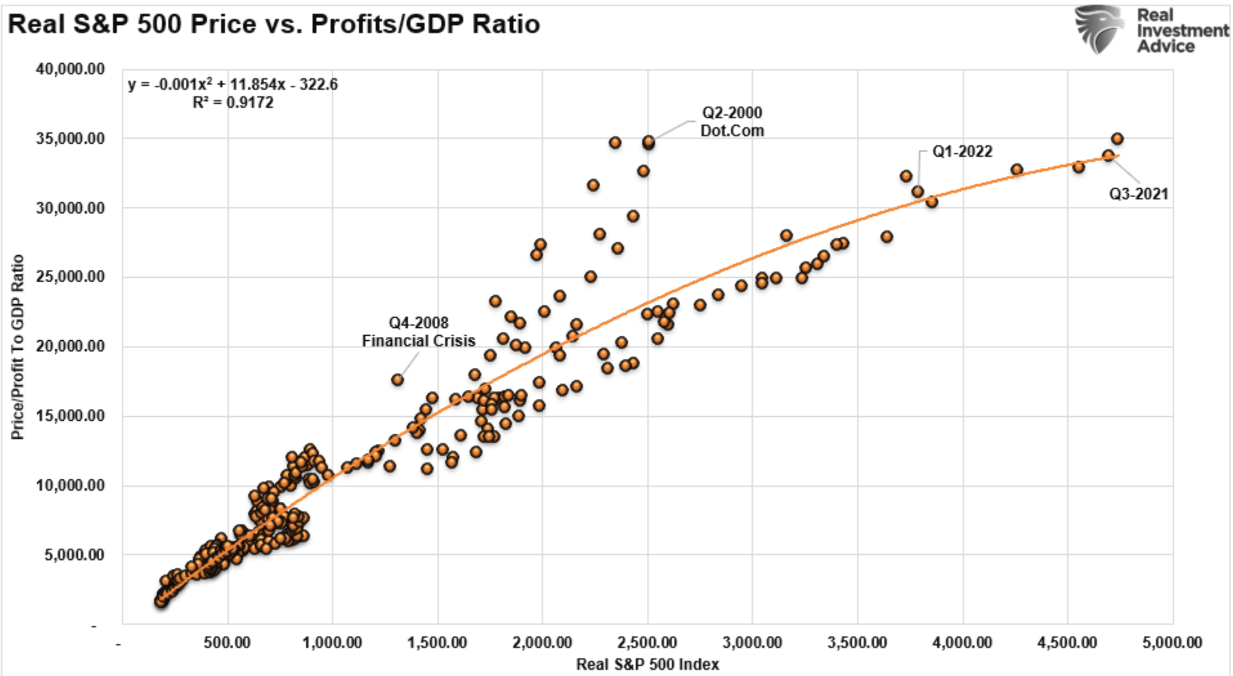
With the latest GDP report for the first quarter, we also received the latest data on corporate profits for the first quarter. As we guessed, corporate profits shank in Q1 and are not running a negative growth rate on an annual basis which is also what the financial markets have been sniffing out all year.



With slower economic growth ahead, corporate profits will likely fall further in the year ahead as a recession becomes a higher probability event due to tighter monetary policy.



There is a very high correlation between economic growth and corporate profits, which should be of no surprise since economic activity creates revenues for companies. Therefore, as noted recently, the risk of overly optimistic corporate earnings remains very high.



Sentimentrader Opines on Bond Yields

Sentimentrader uses a recession indicator based on corporate bond yields. Per its model, recession odds increase if the BBB-corporate bond yield closes at an 18-month high in five of the last 12 months. As of the June 2022 month-end, the indicator triggered a recession warning.

> Per Sentimentrader: *"The Baa bond yield signal has triggered before or during a recession in 11 out of 15 instances since 1929. Most alerts occur before a recession."*

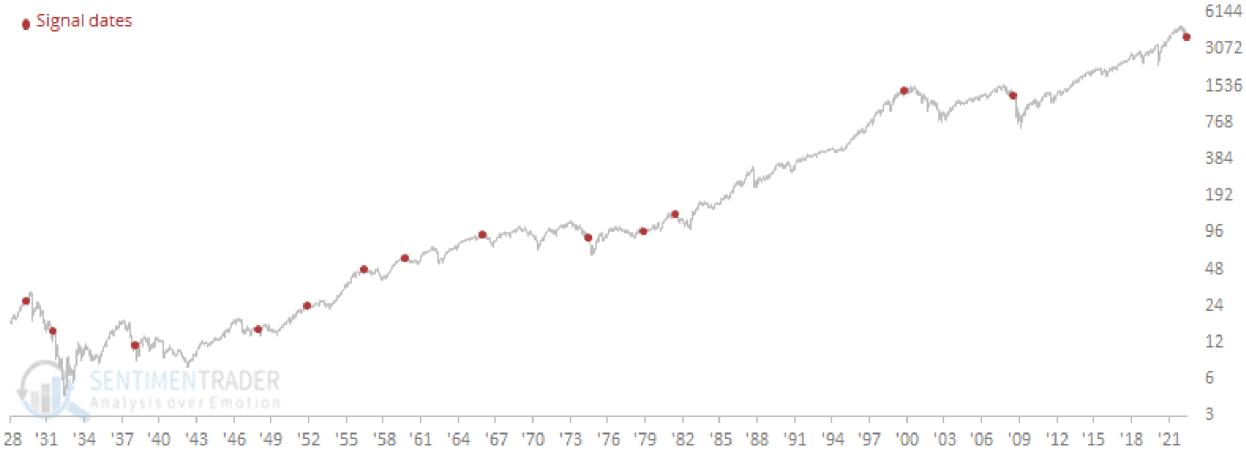
Baa Yield Signal & Recessions

Recession Start	Recession End	Signal Status
1929-08-01	1933-03-31	prior to recession
1937-05-01	1938-06-30	coincide with recession
1945-02-01	1945-10-31	no signal
1948-11-01	1949-10-31	prior to recession
1953-06-01	1954-05-31	no signal
1957-08-01	1958-04-30	prior to recession
1960-04-01	1961-02-28	prior to recession
1969-12-01	1970-11-30	prior to recession
1973-11-01	1975-03-31	coincide with recession
1980-01-01	1980-07-31	prior to recession
1981-07-01	1982-11-30	prior to recession
1990-07-01	1991-03-31	no signal
2001-03-01	2001-11-30	prior to recession
2007-12-01	2009-06-30	coincide with recession
2020-02-01	2020-04-30	no signal

Equally concerning are the implications for stock returns.

Per Sentimentrader: *"This model generated a signal 13 other times over the past 93 years. After the others, S&P 500 future returns, win rates, and risk/reward profiles were unfavorable across medium and long-term time frames. Returns were negative at some point in the first 6 months in 11 out of 13 instances. The 1999 signal was a bit early. However, we all know what happened after that one."*

S&P 500 after a BAA Corporate Bond Yield Sell Signal



Signals (13)	1 Week	2 Weeks	1 Month	2 Months	3 Months	6 Months	1 Year
1929-04-30	1.5	1.2	-3.2	1.5	9.7	17.3	-8.6
1931-06-30	-2.2	-4.0	-6.1	-4.7	-19.2	-36.7	-61.8
1938-02-28	-1.9	-6.7	-12.8	-10.8	-9.5	10.1	15.8
1947-12-31	0.1	-2.3	-6.3	-8.7	-8.3	9.3	-0.7
1951-12-31	0.6	1.2	3.3	-2.9	0.6	0.1	8.2
1956-06-29	2.7	4.6	5.2	0.8	-3.4	-1.6	2.0
1959-10-30	0.0	-2.3	1.9	4.2	-1.2	-4.7	-7.2
1965-12-31	0.8	1.2	0.5	-3.5	-3.5	-8.3	-13.1
1974-06-28	-5.7	-2.6	-6.4	-17.7	-24.5	-21.9	10.2
1978-12-29	2.8	4.8	5.1	0.8	5.7	7.1	12.2
1981-05-29	-0.3	0.7	-0.5	-2.6	-6.8	-6.4	-15.0
1999-10-29	0.5	2.4	1.9	7.5	2.3	7.7	1.2
2008-07-31	-0.1	2.0	1.2	-8.0	-26.6	-34.8	-22.1
2022-06-30							
Median	**0.1**	**1.2**	**0.5**	**-2.9**	**-3.5**	**-1.6**	**-0.7**
% Positive	**54%**	**62%**	**54%**	**38%**	**31%**	**46%**	**46%**
Avg Risk	-1.0	-1.4	-1.5	-4.1	-6.7	-9.5	-19.0
Avg Reward	0.8	1.2	2.1	2.9	3.0	5.0	8.3
% Big Drop	15	23	31	38	38	38	54
% Big Rise	23	15	15	0	8	8	0
Z-Score	-0.1	1.0	0.0	-2.1	-1.6	-1.0	-1.3

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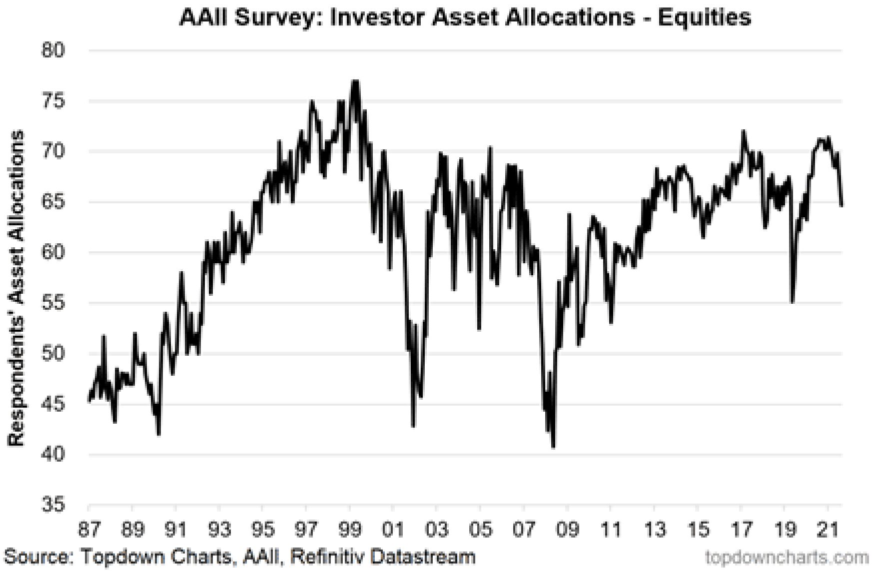
Investor Sentiment vs. Action

The graph below should be concerning to stock investors. Most levels of investor sentiment show extremely bearish attitudes among individual and institutional investors. Typically such washed-out sentiment is a bullish contra indicator. If everyone is bearish, who is left to sell? Unfortunately, the bearish opinions are not aligning with investor actions. Based on the graph below, there is some selling but not to the degree we would expect given the 20%+ market drawdown and sentiment. So while sentiment is poor, things could get worse for markets if investors start putting their money where their minds are.



Euro Heads Toward Parity With the Dollar

The Federal Reserve aggressively fights inflation with once-unthinkable 75bps rate hikes and aggressive QT. Europe is witnessing equally crippling inflation, yet its central bank, the ECB, is taking baby steps to arrest it. Partially as a result, the graph below shows that the euro has fallen 10% versus the dollar in 2022. It is nearing parity with the dollar for the first time in 20 years. Is parity with the dollar coming soon? At this point, with technical support from 2015-2017 giving way, that is a distinct possibility

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