Argent Capital Management LLC

Market Overview – May 2022

May saw the tail end of a seven-week losing streak for the S&P 500® Index. Continuing concerns over inflation and what actions the Federal Reserve may take weighed on the markets. Throughout the evolving discussion around the longevity and rate of inflation, investors drew comfort in the belief that the consumer, representing 70% of the economy, was strong and was spending.

Retail results posted in May dented that belief, at least in part. On May 17, 2022, Walmart released its earnings. The following day, Target did the same. Both retailers reported sales that were above guidance, a positive for consumer strength, but both badly missed expectations for profits. As a result, investors reacted forcefully, driving down Walmart's stock 10% the day it reported its earnings and Target down 25% the following day, erasing literally billions of dollars of market capitalization from both companies.

If sales were better for both companies, what happened to profits? Part of the explanation was less of a surprise to investors. With continued supply chain issues logistic costs have risen, eating into profits for retailers. In addition, with a very strong employment picture in the United States, wages have risen, another source of earnings erosion.

The big surprise, however, was the change in consumer behavior. To put it succinctly, consumers traded down. Instead of buying big ticket items, like bicycles and furniture, consumers bought staples, like food and cleaning products. Not only do big ticket items bring big dollar sales to retailers like Walmart and Target, they come with higher profit margins. Those two retailers had expected that we consumers would walk out of their stores with shiny bicycles and a brand-new couch and love seat, but that didn't happen. To add insult to injury, consumers shunned brand names that generally sell at higher price points, for private label products which are less expensive.

This mix shift to lower profit, less expensive goods came as a big surprise to retailers and generated a strong negative reaction by investors. In addition to the unexpectedly low profits retailers posted, their inventories grew because the inventory they had purchased was not what consumers bought. Investors concluded that the hold-over inventory would be sold in future periods, likely at a discount, implying another negative for retailers' profits.

The explanation for the sudden change in consumer behavior is tied into what is going on in the economy. Put simply, consumers are faced with higher prices, the impact most easily seen at the gas pump, and are reacting by changing their purchasing habits. This change makes it all the more critical for the Federal Reserve to take action to decrease inflation in the country. The problem with that is that Fed actions may slow the economy. Fed Chairman Powell has said the Fed will try to execute a 'softish' landing. The recent results from retailers may portend a bumpier ride. Stay tuned.

As a reminder, we are 100% employee-owned and we thank you for your business and your interest. In addition, if you like our market letters, videos by Ward Brown and my podcasts, 'Conversations with Ken,' we hope you will share them with friends. For information on our five successful equity strategies–Large Cap U.S., Dividend Select, Mid Cap U.S, Small Cap U.S. and SMID Cap U.S., please contact clientservices@argentcapital.com.

Sincerely,

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