

Review & Outlook

SECOND QUARTER 2022

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The first quarter of 2022 was alarming, with Russia invading Ukraine, and both stocks and bonds falling sharply. Unfortunately, the second quarter has been

just as unpleasant. The war in Ukraine continues. And while stocks had a short-lived rally in late March, they fell rather steadily over the second quarter. In June,

the Federal Reserve raised interest rates by 0.75%, a remarkable increase, with the intent to raise

them again. And now we are hearing more and more talk about a possible recession, due in part to rising interest rates, persistently high inflation, and consumer sentiment that has fallen to record lows.

Inflation was the big story for financial markets this quarter.

While it was once viewed as a temporary problem due to short-term supply and demand imbalances, inflation is now

seen as a bigger issue that may be hard to tame.

Lockdowns in port cities in

China (in keeping with their zero COVID policy) added to supply chain

problems, the war in Ukraine has resulted in higher prices for food and

energy, and the Federal Reserve has vowed to raise interest rates as

much as needed to control inflation. We think that core

inflation has peaked, but food and energy prices will remain a problem as long as the war in Ukraine continues.

Figure 1 shows the broad CRSP US Total Market and the Barclays Aggregate Bond indexes for 2022.² The two lines

illustrate the weak performance of both stocks and bonds so far. The stock market has not had a worse start to the year since 1970, and bond market declines are rivaled only by full

year declines in 1792, 1842, and 1980.^{3,4}

Looking forward invites a lot of speculation. One could see a positive forecast if there is a cease fire in Ukraine and inflation eases significantly. And if problems due to COVID continue to move to the

background this summer and fall, inflationary pressures in the supply chain should continue to ease. However, if these assumptions fail, inflationary pressure could endure.

Forecasts for the National Association for Business

Economics and the Blue Chip Consensus call for modest real growth for the rest of 2022. "Real growth" means growth after inflation has been subtracted. For example, if the economy

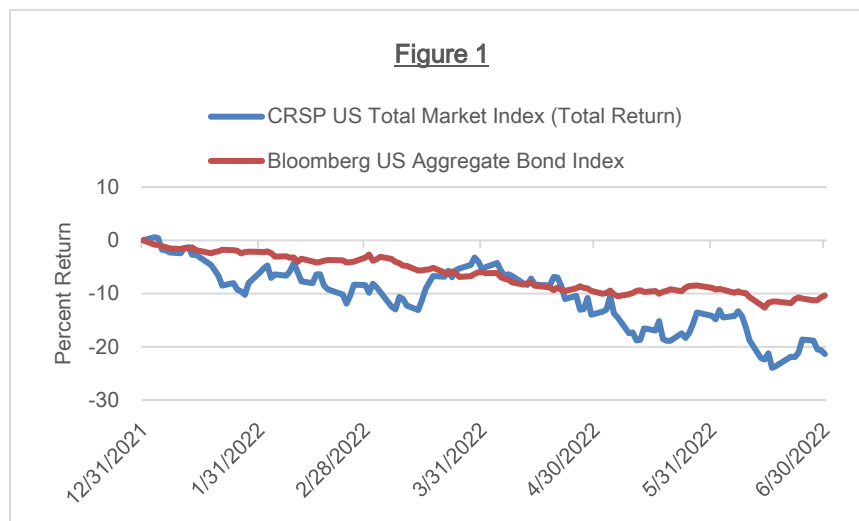
grows 5% and inflation is 3%, real growth is 2%. So, while real growth forecasts have been lowered, some real growth is still anticipated. Part of this forecast includes a view that inflation will start to diminish in the second part of the year.

Data now shows that the

impact of COVID stimulus funding is fading. That fact suggests that consumer spending will slow, which will slow inflation. Perhaps a bit faster than many forecasters are predicting. For example, retailers have much larger inventories than they had at this time last year, and consumer debt has increased noticeably in the first half of 2022. The

Index Performance Data
Total Return as of 6/30/2022

Indices ¹	Q2 2022	Trailing 12 Months
CRSP U.S. Total Stock Market Index	-16.85%	-14.22%
MSCI Global ex-U.S. Total Stock Market Index	-13.11%	-25.70%
Bloomberg Barclays U.S. Aggregate Bond Index	-4.69%	-10.29%



combination of reduced spending and retailers offering better deals to move inventories will help ease inflation, but some constraints, like the availability of chips for cars, will linger. Unfortunately, the war in Ukraine looks like it will linger as well. As such, we now do not expect inflation to return to the 2% range until late 2024.

Preliminary growth estimates from the Bureau of Economic Analysis for the second quarter of 2022 are not especially positive. The U.S. economy actually contracted in the first quarter, and may not have had much growth at all in the second. However, even if real Gross Domestic Product (GDP) drops in Q2 as well, we do not think that the National Bureau of Economic Research (the group that officially determines when recessions begin and end) will look back and say that the U.S. was in a recession in the first part of 2022, as the labor market was strong, and the drop in first quarter GDP was due to rising inventories, rather than broad weakness in the economy.

Regardless of whether or not we are flirting with a recession, inflation is a challenge. It is an obvious problem for

consumers, but also for investors evaluating their portfolios. As the Federal Reserve raises the Federal Funds Rate (the average rate banks pay for borrowing overnight) to fight inflation, other interest rates, like mortgage rates, are likely to increase, as well, but not

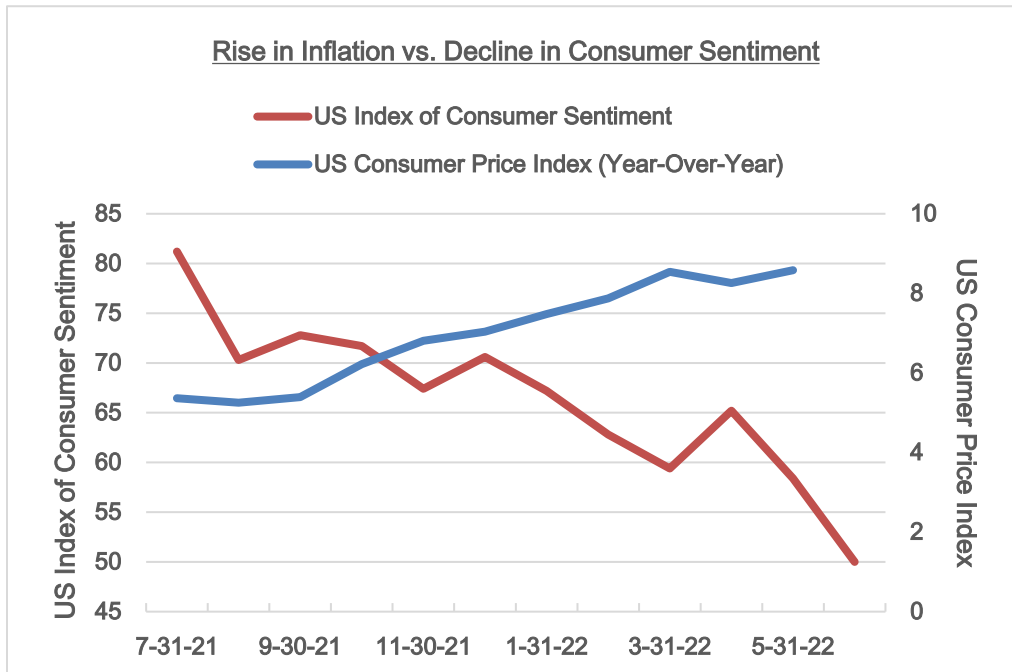
necessarily in lock-step. We expect the Fed will increase the Federal Funds rate by 0.75% later in July, and a further 0.5% towards the end of the third quarter. The year-end forecast according to the Fed's "Dot Plot" is for a Fed Funds rate of 3.4%. The Dot Plot is the combined estimates of future fed fund rates by Federal Reserve officials. As the Fed moves the

rate over 3%, they will likely then pause to assess inflation against a slowing economy.

In Focus

We typically see inflation when the economy is growing, and perhaps overheating. A typical policy response is to raise interest rates to cool the economy. The goal is to prevent a spiral where higher prices lead to a demand for higher wages, which in turn leads to even higher prices. But sometimes inflation happens when economic growth is very low, or the economy is stagnant. If unemployment rates are also starting to rise, we see the elements of "stagflation" taking hold. This presents challenges for policy makers, who have to wrestle with whether to risk a recession by doing what they can to reduce inflation when economic growth is weak, or weathering the problems caused by rising inflation.

The stock market rose the week of June 20th on news that inflation may be easing, and the Federal Reserve may not need to raise interest rates as much as anticipated. Some investors think the Federal Reserve may lower rates in early 2023 to try to stimulate the economy and prevent a recession.



And therein lies the challenge: deciding whether inflation has peaked and financial markets are likely to show strength in the coming months, or whether we are heading for a recession and financial markets are likely to drop.

One confounding

factor is that the data is difficult to interpret right now. The pandemic has caused dramatic swings in price indexes, employment, labor force participation, and other metrics, making it difficult to compare month-over-month or year-over-year changes. The U.S. Manufacturers Inventory-to-Sales ratio spiked in 2020, and has remained elevated ever since.

In April 2022, its value was similar to what it was at the time of the 2008 financial crisis and the 2001 dot com bubble. The worry is that retailers will have to take steps to reduce their inventory, and that doing so will put downward pressure on prices, while also negatively impacting industrial production. If consumers keep spending, the economy will be fine. But consumer sentiment is declining, meaning spending is likely to slow. The chart on Page 2 shows 12-month trends in consumer sentiment versus inflation. As year-over-year inflation has increased to over 8%, a number we have not seen in almost 40 years, consumer sentiment has steadily trended downwards. The consumer sentiment index is now at about 50, and it was at around 100 at the beginning of 2020.

Since 1952, consumer sentiment has been measured by the University of Michigan, and that index is at its lowest point ever. The only other time it was close was in 1980, another period of high inflation. Consumer sentiment took a huge plunge with the onset of COVID. It has recovered somewhat, but has been driven down relentlessly over the past year. Consumer spending will certainly appear to be slowing compared to the stimulus-driven period from mid-2020 to late-2021, but the question is whether it will slow relative to a longer-term trend.

The drop in financial markets this year also creates a type of wealth effect that can slow economic growth. Right now, data shows strong payroll growth, low unemployment, and companies with healthy balance sheets. But if consumers feel a little less wealthy and cut back on their spending accordingly, that data could weaken. Meanwhile, prices for gasoline and many food items are likely to stay elevated because of the war in Ukraine. This means that inflation could linger in a way that forces the Federal Reserve to raise interest rates when it would really rather not.

Last fall, the Fed Chair, Jerome Powell, spoke about how inflation was going to come down as supply constraints eased. He was trying to manage expectations about inflation without having to slow the economy by raising interest rates. A recent article in The Economist magazine notes that expectations about inflation have taken hold, despite Mr. Powell's best efforts.⁵ They foresee stubborn inflation, even as the flow of goods improves. And if inflation expectations are built into wage contracts and pricing habits, it becomes that much more challenging for the Fed. We expect the Fed will raise interest rates, making it clear they will wrestle inflation to the ground. One big question is how quickly the Fed will pull back from raising rates if the economy starts to noticeably slow. They have said dealing with inflation is their top priority, but if inflation expectations are embedded in contracts and habits, they cannot pivot as some are hoping.

We are continuing to position our clients' portfolios for a period of uncertainty and potentially weaker corporate earnings, giving extra weight to companies with good cash flow and strong profitability metrics. Nevertheless, despite all the gloom, we do not see the makings of a major recession. There will be a recovery, which traditionally happens while the economy is still on a downswing. We want to be cautious, but with a long-term investing perspective, we are looking for opportunities to work cash in client accounts back into invested positions. On the fixed income side, we do not anticipate that the Federal Reserve will lower interest rates soon, but we do think that the amount they will raise rates is limited. As such, we are considering longer-dated bond positions to take advantage of higher rates. Higher interest rates have put downward pressure on the price of many stocks, but there is a silver lining around this cloud of uncertainty: bond yields are finally high enough to generate meaningful income again.

1. Index performance data provided by ICE Data Services, and calculated by Black Diamond, an SS&C Advent company.

2. Index performance data provided by YCharts.

3. Backman, M. (2022, July 2). Stocks just had their worst first half-year run in 52 years. here's why you shouldn't worry. Nasdaq. Retrieved July 7, 2022, from <https://www.nasdaq.com/articles/stocks-just-had-their-worst-first-half-year-run-in-52-years.-heres-why-you-shouldnt-worry>

4. ETF Trends. (2022, July 8). A historic bond market decline, is an end in sight? Nasdaq. Retrieved July 11, 2022, from <https://www.nasdaq.com/articles/a-historic-bond-market-decline-is-an-end-in-sight>

5. "Free Exchange: Into a Void" (2022, June 25). The Economist, 76

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