July 2022

Economic Update

A Review of Second Quarter 2022

The stock market continued to struggle during the second quarter. Combined with the first three months, that makes this the worst first-half-of-the-year performance since 1970. Unrelenting inflation has been the biggest economic headwind so far, as the Federal Reserve's original estimation that inflation would be "transitory" turned out to be a mistake. Through May, inflation over the last 12 months now stands at 8.6%, which is the highest reading for that statistic since the 1980s.

This inflation shock has roiled both bond and stock markets, not to mention other risk assets like cryptocurrency which is also down significantly. In retrospect, perhaps the Fed should have started raising rates sooner as they now appear to be trying to make up for lost ground. They have raised the Fed rate by one-quarter, one-half, and three-quarter percent respectively over their last three meetings, with still more increases to come. We now stand at a target range of 1.5 to 1.75% while their target rate for year end is 3.4%.

U.S. Economy

Inflation was specifically called out as a key concern in the most recent Consumer Sentiment Survey conducted by the University of Michigan. The final reading for May was a dismal 50.0, the lowest result since the survey was first introduced in 1952. Survey respondents were not optimistic about business growth, with 79% of consumers expecting bad times in the year ahead for business conditions.

Poor consumer sentiment is echoed by the Atlanta Federal Reserve, which currently predicts that GDP contracted by 1.9% annualized net of inflation during the second quarter. This is consistent with the 1.6% annualized GDP decline that we saw in the first quarter.

Existing home sales have been trending down for each of the last four months as interest rates have risen. Per the National Association of Realtors, 5,410,000 homes were sold during May as compared to 6,490,000 sold during January of this year.

Despite these headwinds, not all economic indicators are negative, however. Institute for Supply Management manufacturing PMI registered 55.0 in June. This has been trending down in recent months, but it is still positive. A reading above 50.0 is indicative of economic expansion. Survey respondents remain optimistic regarding consumer demand but continue to note supply chain and pricing issues as their biggest concerns.

On another positive note, jobs growth remains consistently strong. Per the Bureau of Labor Statistics, the U.S. economy added 368,000 jobs during April, 384,000 in May and 372,000 in June. The total number of unemployed persons is now down to 5.9 million and the unemployment rate is 3.6%. Both values stand slightly behind pre-pandemic levels of 5.7 million and 3.5% respectively.

Jobs growth would likely be even higher if we weren't seeing such a significant labor shortage. Per the Bureau of Labor Statistics, current job openings are still 11.3 million nationally, nearly double the total number of unemployed persons.

International Economy

Hopes for a quick end to the conflict in Ukraine appear to have been unrealistic. While Russian advances have generally been halted, the prospect of them calling off their invasion any time soon is unlikely at this point. The net result is a relative stalemate which will continue to cost both money and lives for the foreseeable future. A diplomatic solution could still be on the table, but both sides seem very far apart.

PMI data is slightly optimistic in the Eurozone, much like business sentiment in the United States. Markit survey manufacturing PMI registered 52.0 in June, which is a 22-month low but still represents some economic expansion. German manufacturing is called out as a particularly weak spot which will likely continue to keep the European Central Bank from the rapid rate tightening that we are currently seeing from the U.S. Fed.

China is mired in another Covid-19 outbreak, with roughly 200-300 new cases in the last several days as of this writing. Beijing and Shanghai had finally reopened in June after being locked down for much of April and May. The Chinese government continues to take a much stronger stance on quarantining than most other governments do. Currently, there are a total of 11 Chinese cities with some sort of restricted movement. Per Ting Lu, chief China economist at Nomura, the impacted regions comprise approximately 14.9% of the country's GDP.

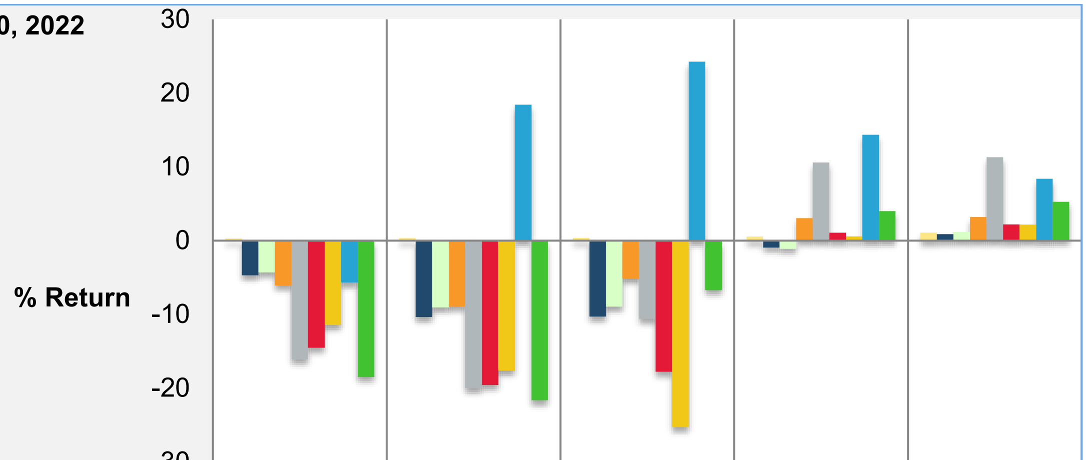
Markets

Developed equity markets experienced a very poor quarter for returns due to the economic uncertainty throughout the world today. U.S. large-cap equities, as represented by the S&P 500 Index, lost 16.10% during the quarter. Developed international equity markets, as represented by the MSCI EAFE Index, lost a little less. That index finished the quarter down 14.51%. Real estate also continued to struggle as well. The Wilshire REIT Index lost 18.48% during the quarter.

Bond indexes had another quarter of relatively large losses, given what is typical for the category. Interest rates, which heavily influence bond prices, continued to climb during the quarter. The Barclays U.S. Aggregate Bond Index and the Barclays Global Aggregate Bond Index lost 4.69% and 4.30% respectively during the quarter. Even the Barclays U.S. Inflation-Linked Bond Index was not immune, also losing 6.08% for the period.

Emerging markets lost a little less than developed markets. The MSCI Emerging Markets Index finished the quarter down 11.45%. Commodities were also not immune to losses this quarter. The Dow Jones UBS Commodity Index lost 5.66% during the second quarter of 2022.

Through June 30, 2022



	Quarter-to-Date	Year-to-Date	1-Year	3-Year	5-Year
T-Bills	0.27	0.35	0.37	0.56	1.08
Bloomberg US Agg Bond Index	-4.69	-10.35	-10.29	-0.93	0.88
Bloomberg Global Agg Bond Index	-4.30	-9.06	-8.94	-1.13	1.16
Bloomberg US Infl Linked Bond Index	-6.08	-8.92	-5.14	3.04	3.21
S&P 500 Index	-16.10	-19.96	-10.62	10.60	11.31
MSCI EAFE Index	-14.51	-19.57	-17.77	1.07	2.20
MSCI Emerging Markets Index	-11.45	-17.63	-25.28	0.57	2.18
Bloomberg Commodity Index	-5.66	18.44	24.27	14.34	8.39
Wilshire REIT Index	-18.48	-21.64	-6.70	4.01	5.26

Outlook

Recession is defined as two consecutive negative quarters of growth. We might have already started one given that we appear to be on course for negative GDP in both Q1 and Q2. Even if the second quarter does surprise with a positive GDP number, that might just be forestalling the inevitable as the Fed seems committed to continuing to raise rates regardless. Given all the economic uncertainty, Nomura economists now think a mild recession before the end of the year is “more likely than not.”

Regardless of whether this period is officially labeled a recession or not, our economy clearly is slowing down. There is an old market saying, “don’t fight the Fed,” meaning that the Fed has substantial impact on stock market valuations and can often exert more influence on them in the short term then company-specific results do.

Still, one wonders how much of the current economic headwinds have already been priced in. As always, we recommend a diversified portfolio containing a reasonable amount of equity exposure for any investor with a long enough time horizon. There is another old market saying that the “market climbs a wall of worry.” Assuming inflation moderates during the next few months, it would not be shocking to see a market rebound from these levels despite the headwinds. It certainly has happened before. The last time that the market declined by this much in the first half of the year was 1970. For the record, it went back up by 26.5% in the second half of that year to finish with a positive gain overall.

Bloomberg US Aggregate Bond Index: The Aggregate Bond Index is a broad-based benchmark that measures the investment grade, dollar-denominated, fixed-rate taxable-bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS. The Aggregate rolls up into other Bloomberg flagship indices such as the multi-currency Global Aggregate Index and the Universal Index, which includes high-yield and emerging markets debt. The Aggregate Index was created in 1986, with index history backfilled to Jan. 1, 1976.

Bloomberg Global Aggregate Bond Index: The Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the Aggregate (USD 300mn), the Pan-European Aggregate (EUR 300mn) and the Asian-Pacific Aggregate Index (JPY 35bn). In addition to securities from these three benchmarks (94.0% of the overall Global Aggregate market value as of Dec. 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300mn), Euro-Yen (JPY 25bn), Canadian (USD 300mn equivalent) and Investment Grade 144A (USD 300mn) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized sub-indices by liquidity constraint, sector, quality and maturity. A component of the Multiverse Index, the Global Aggregate Index was created in 1999, with index history backfilled to Jan. 1, 1990.

Bloomberg Global Inflation-Linked Index: The Global Inflation-Linked Index (Series-L) includes securities that offer the potential for protection against inflation as their cash flows are linked to an underlying inflation index. All securities included in the index have to be issued by an investment-grade-rated sovereign in its local currency. The list of eligible currencies is the same set of currencies eligible for inclusion in the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) represents a stand-alone multi-currency index exposed to the real yield curve for each relevant currency. As such, the index does not contribute to the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) was created on Oct. 31, 1997.

S&P 500® Index: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard & Poor's chooses the member companies for the 500 based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. The returns presented for the S&P 500 are total returns, including the reinvestment of dividends each month.

MSCI EAFE Index: The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed-market equity performance, excluding the U.S. and Canada. As of April 2002, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index: The MSCI EMF (Emerging Markets Free) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of April 2002, the MSCI EMF Index consisted of the following 26 emerging-market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

Bloomberg Commodity Index: Bloomberg Commodity Index℠ and Bloomberg Commodity Index Total Return℠ the DJ-UBSCI℠ family includes both the BSCI℠, which is calculated on an excess-return basis, and the BSCITR℠, a total return index based on the BSCI℠. The former reflects the return of underlying commodity futures price movements only, while the latter reflects the return on fully collateralized positions in the underlying commodity futures.

Wilshire US REIT Index: Introduced in 1991, the Wilshire REIT index is intended as a broad measure of the performance of publicly traded real estate equity securities. The index is market-capitalization weighted of publicly traded real estate securities, such as Real Estate Investment Trusts (REIT), Real Estate Operating Companies (REOC) and partnerships. The index is composed of companies whose charters are the equity ownership and operation of commercial real estate.

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