COMMENTARY

June 13, 2022

Friday's Economic Reports Hit Investors with Double Whammy

- S&P 500 suffers its ninth weekly loss in just 10 weeks.
- Investors worry that an aggressive Fed will lead to a recession.
- Our base case is a growth slowdown, not a recession.

A late sell-off sent domestic equities lower as the S&P 500 declined 5.1% last week, marking the index's ninth decline in the last 10 weeks. A stronger-than-expected Consumer Price Index (CPI) report led investors to conclude that the Federal Reserve (Fed) is still behind the inflation curve and needs to be more aggressive in raising the Federal Funds Rate, its primary tool to fight inflation. Further adding to concerns was a report that showed signs inflation may be dragging down consumer sentiment. While both reports increase the risks of a recession, we do not see a recession in 2022 as our base case scenario for numerous reasons such as a strong labor market, healthy consumer balance sheets, and improving supply chains. We are instead witnessing an economic growth scare where the economy is slowing to its long-run trend of growth after the sharp V-shaped recovery from late-2020 and 2021. We do acknowledge investors' concerns and the risks to markets and expect market reactions to swing back and forth daily to both favorable and unfavorable economic and earning reports.

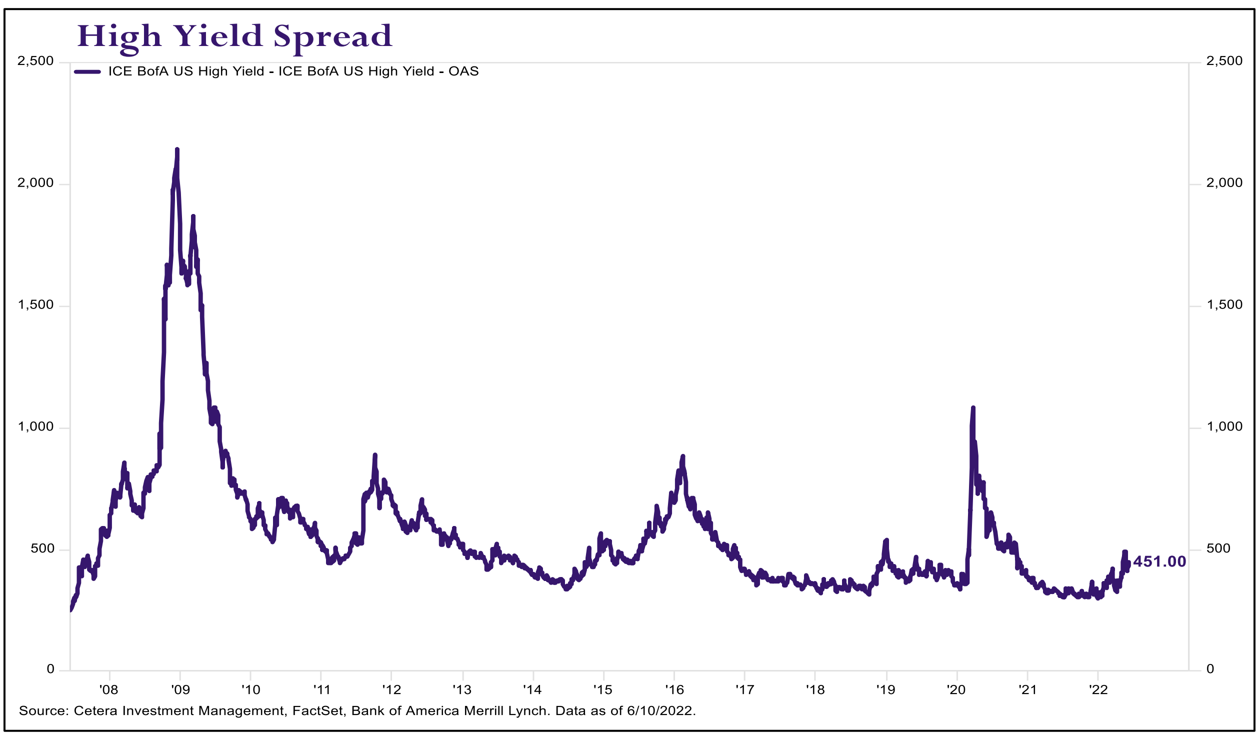
This past Friday, we saw two such reports that portrayed a gloomy picture for investors. The May CPI report showed broad-based price pressures with both goods and services inflation accelerating. The most concerning was seen in shelter prices with rent inflation climbing to its highest level since 1987. Rent inflation can lag home prices by a year and shelter prices represent about one-third of CPI and tends to be one of the biggest expenses for consumers. Investors worry that these rising costs will dampen consumer spending, which represents about 70% of the U.S. economy. These lingering inflation pressures may give the Fed the green light to be more aggressive in raising interest rates, as higher rates reduce the demand that drives inflation by increasing borrowing costs.

Investors were hit with a second whammy on Friday when the University of Michigan consumer sentiment survey was released for June. This signaled that inflation concerns were in fact impacting the consumers mindset. This report showed its lowest recorded value, comparable to the trough of the 1980 recession. As a testament to inflation concerns, consumer assessment of their personal financial outlook worsened with 46% pointing to negative inflation views, a number only exceeded once since 1981. Five-year inflation expectations also rose to the highest level since mid-2008.

Combined, these two reports caused even more investor angst. The CPI report put doubts into investor hopes that inflation has peaked. Secondly, the consumer sentiment report raised concerns that the U.S. economy is already in a recession. Bond investors acted accordingly to these reports and narrowed the two- to 10-year U.S. Treasury yield curve. In other words, the yield difference between two-year and 10-year bonds was reduced. The reason for this is because the two-year Treasury is a good proxy of where the Fed Funds Rate will be one year from now and the 10-year Treasury is good proxy for economic growth. With the prospects of the Fed needing to raise rates at a greater pace to slow inflation and the subsequent impact of these higher rates on economic growth, this squeezed the 2-10 U.S. Treasury spread. The bond market is basically saying that the Fed is unlikely to engineer a so-called "soft landing." A soft landing is when the Fed raises interest rates to slow inflation but does not trigger a recession. However, we are optimistic that the Fed could still slow its pace of rate hikes later this year as inflation may slow later this year, supply chains are improving, the U.S. dollar is rallying, and the economy is already feeling the effects of the Fed's rate hikes.

Even if the Fed does not raise rates to the level that the financial markets expect, there is a clear danger that any Fed response to high inflation will throw our economy into a recession this year. Though economic uncertainty naturally rises as time progresses, at this time, our base case is not for a recession in 2022. We feel the economy can withstand higher interest rates for a variety of reasons. First, the labor market is extremely strong with unemployment well below 4% and around 5.3 million more jobs available than people looking for jobs. Yes, higher interest rates will slow hiring, however, the labor foundation is unprecedently strong. Second, consumer balance sheets are still very strong. The combination of low debt and the fact that owners' equity in homes averages is approaching levels not seen this high since the 1950's at close to 70%. Third, improving supply chains should continue to alleviate economic pressures and benefit corporate profit margins. Lastly, historically, the Leading Economic Index (LEI) trends lower and declines year-over-year ahead of a recession, but the most recent reading, though slowing, is not flashing any dire recession signals.

Usually, a recession is caused by excesses in the economy, such as inventories or housing, or a weak credit market. The combination of supply chain improvement and slowing demand has increased inventory levels, but not to a level pointing to a recession. On the housing front, higher rates and economic uncertainty have had their impact. However, low inventories and the high owners' equity should limit some of the downside. A good proxy for the health of credit markets are yields in below investment grade bonds (high yield bonds) relative to comparable U.S. Treasury bonds. Because high yield bonds have a higher risk than U.S. Treasury bonds, they have a higher yield as compensation for the extra risk. Given the weakness in the equity markets, this spread has widened from 3.08% to 4.51%. As seen in the chart below, past recessions or recession scares have seen much bigger surges: 10.8% (2020 recession), 8.45% (early 2016 recession scare), 8.83% (2011 U.S. debt concerns), and 21.5% (2008 Great Financial Crisis). Currently there are not any significant warnings coming from credit markets.



On the other hand, the area where we have seen an excess is in the equity markets. Late last year, we warned that the S&P 500 was trading at a high valuation with a price-earnings ratio on forward earnings of 22. While not a record high, this valuation was pretty close to levels not seen since the tech bubble in the late 1990s. Today, valuations are much more reasonable with this same ratio trading in the mid-16s. Mid and small cap indices are trading at an even steeper discount relative to projected earnings and their historical averages. Yes, there is the possibility that high inflation and/or Fed rate hikes could put downward pressure on earnings. However, we are optimistic that valuations are more attractive today than at the end of last year and earnings and revenue growth are expected to both rise over 10% this year according to Factset.

The already jittery market was shocked by the double whammy of a hot CPI report and a weak consumer sentiment survey. Investors fearing an imminent recession caused by too high inflation or a too aggressive Fed helped to drive the ensuing sell-off. On the other hand, we are a bit more optimistic that the economy is not headed for a recession this year and the Fed may even raise rates to a slower degree than markets anticipate. We acknowledge economic growth has slowed down, but in our opinion, it is a growth scare. After the sharp V-shaped recovery in 2020 and 2021, the economy was likely to come back to its long-term normal trend. Even if the economy slows exactly as we anticipate, there is plenty of uncertainty for the near-term and we expect markets to react favorably or unfavorably to daily macro events.

We are in uncertain times and markets are facing less confidence as headwinds continue to surface. It is important to work with your financial advisor to help navigate through periods of volatility. We continue to recommend a diversified allocation to help dampen volatility risk.

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

The Bloomberg US Aggregate Bond Index is a broad based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. Eligible bonds must have at least one year until final maturity, but the index holdings have a fluctuating average life of around 8.25 years. This total return index is unhedged and rebalances monthly.

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Nasdaq Composite Index is a large, broad-based, market-cap-weighted index of more than 2,500 common equities listed on the Nasdaq stock exchange. It is often seen as a stand-in for the technology sector and its performance.

The ICE BofA US High Yield Index tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the U.S. domestic market. Securities must have a below investment grade rating (average of Moody's, S&P, and Fitch) and an investment grade rated country of risk (average of Moody's, S&P, and Fitch foreign currency long term sovereign debt ratings). Each security must have greater than 1 year of remaining maturity, a fixed coupon schedule, and a minimum amount outstanding of $100 million.