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MID-YEAR ECONOMIC UPDATE

Investors have seen sharp declines in both stock and bond prices since the opening bell in January in what has been the worst first half for equities since 1970. Markets have reacted to the Fed's belated credit tightening geared to address rising inflation spurred by food and energy price spikes, COVID-induced supply-chain breakdowns and the war in Ukraine. Rising inflation is no surprise to us given the backdrop of outsized money supply growth and beyond-control fiscal policies when combined with the supply side shocks of the COVID era. The new aggressiveness of the Fed and the economic slowdown, evident in many of the economic indicators we have viewed this month, has given economists reason to lower their forecasts for real GDP growth and to increase the probability of a recession later this year or in 2023. Investors are thus left to ponder whether the Fed and other central banks will commit yet another policy blunder, compounding the damage produced by COVID-19 lockdowns and the war in Europe, or whether their policies will produce the elusive "soft landing" it has been seeking to achieve. While falling equities prices are an indication investors' recession fears are gaining the upper hand, keep in mind the old Wall Street adage: The stock market has discounted seven of the last three recessions.

While the probability of a recession in the US has risen significantly in the past few months, as confirmed by our June Economic Model, and the risks are skewed to the downside on growth, we fail to see signs of consumer distress, a deterioration in corporate balance sheets or the credit markets dislocations that would ordinarily signal the onset of a recession. We believe the rate of inflation crested in the second quarter, as previously forecast, and that it will recede in the second half, allowing the central bank to slow its tightening and avoid tipping the economy into a recession. Our reading of falling agricultural and industrial commodity prices and the topping-out of wage gains, supports this view.

Important and encouraging for the *intermediate term* inflation outlook is recently released data which shows M2 money supply growth slowing to just 0.1% in May, after falling in April. This is welcome news as the monetary surge propelling US inflation to a four decade high seems to be slowing. As a result, the 12-month change in M2 decelerated to 6.6%, the slowest growth rate since the pre-pandemic days of

2019. From a historical perspective, 6.0% growth in M2 would be considered "normal", so the May figures represent progress. Thus far in 2022, money supply has grown at a modest 3.1% annualized rate in contrast with the 18.0% annualized rate in 2020-21, roughly three times the "normal" rate.

ECONOMIC INDICATORS

Economic data we reviewed in June presents a picture of continued economic deceleration amidst the ongoing expansion which appears to have maintained decent momentum despite central bank tightening.

- **Nonfarm Payrolls** increased 390,000 in May, exceeding expectations, and the unemployment rate remained at 3.6% despite a healthy increase in the labor force. The details of the job report were also solid. Total hours worked rose 0.3% in May, are up 4.2% from a year ago, and are ahead 0.4% versus pre-COVID. The problem for workers is that wages are not keeping pace with inflation and are lagging by a substantial margin. In addition, the labor market has not fully recovered from COVID and its related lockdowns. Nonfarm payrolls remain 822,000 short of where they were in February 2020 and are not expected to exceed the pre-COVID peak until late Summer.

- **ISM Non-Manufacturing Index,** a widely-followed leading economic indicator, continued to expand last month although at a slower pace than in April, coming in at 55.9, falling short of the consensus expected 56.5. (Recall levels above 50 signal expansion; levels below 50 signal contraction.) The major measures of activity were mixed in May, but all stand above 50, portending growth. The new orders index rose to 57.6 from 54.6 in April while the business activity index fell to 54.5 from 59.1. The employment index increased to 50.2 from 49.5 while the supplier deliveries index declined to 61.3 from 65.1 the prior month. One comment in May's report described the current environment as "Exhausting…Continuous shortages, transportation delays and price increases all contribute to the destruction of historical lead times and firm commitments on delivery dates…It is relentless." That said, the services sector expanded at a healthy clip with fourteen of the eighteen industries reporting growth and should benefit this year as consumers shift their spending preferences away from expensive goods toward the still-recovering services sector. Evidence of this shift can be found in the 61,000 decline in retail payrolls in May, the steepest drop in this measure for any month since 2009 with the exception of the initial onset of COVID-related lockdowns in 2020.

- **ISM Manufacturing Index**, a widely-followed leading economic indicator increased in May, exceeding the consensus expected 54.5. (Recall levels above 50 signal expansion; levels below 50 signal contraction.) The major measures of activity were mixed in May, but nearly all remain above 50, portending growth.

The best news in the ISM report was that two of the most forward-looking indices, new orders and production, posted gains following two consecutive months of declines. Moreover, both indices are above 50 signaling growth. Respondent comments in May highlighted strong ongoing demand from customers while also reiterating supply-chain problems related to shortages of key inputs and transportation services. The ongoing COVID-19 shutdowns in China were explicitly mentioned in comments as well, with gridlock at ports exacerbating the issues. These problems have combined to keep manufacturing activity from rising quickly enough to meet an explosion of demand. The good news is that progress is being made, with the supplier delivery index falling in May, well below its recent high one year ago. However, delays are far from over, with fifteen of the eighteen industries reporting longer wait times for inputs.

- **Retail Sales** declined 0.3% in May versus a consensus expected gain of 0.1% and were revised lower for April, the first drop in five months. Moreover, the reported decline is calculated before inflation has been factored in. On an inflation adjusted basis, retail sales declined 1.3% in May. Although nominal sales are up 8.1% from a year ago, that pace lagged inflation as well, with the CPI up 8.6% over the same period. Six of the thirteen major sales categories declined in May, led by autos and non-store retailers. Supply-chain issues remain a major problem for the auto sector. Due to the massive increase in government transfer payments in response to COVID, retail sales were artificially lifted and are now trending down versus a year ago.

- **Consumer Price Index (CPI)** increased 1.0% in May, well above the consensus expected 0.7%, the largest increase in 40 years. The CPI is up 8.6% from a year ago. Core CPI prices rose 0.6%, up 6.0% from a year ago. Details of the report show energy prices led the index higher, rising 3.9%. Geo-political tensions and a reopening of China from strict COVID lockdowns enforced earlier this year mean energy prices will continue to impact the consumer for the foreseeable future. Food prices, another often volatile category, rose 1.2% driven by dairy products, which posted the largest monthly increase in thirteen years. Housing rents (for both actual tenants and the rental value of owner-occupied homes) accelerated in May, rising 0.6%. Expect rents to be a key driver of inflation this year and beyond as they make up more than 30% of the CPI and still have a long way to go to close the gap with home prices, which have skyrocketed 30% since the start of COVID.

- **Consumer Sentiment** fell in June to 50.2, its lowest level ever recorded according to a preliminary University of Michigan survey. The University of Michigan sentiment index has been trending downward for over a year. All components of the sentiment index fell driven by inflation fears, with the steepest decline in the year-ahead outlook for business conditions followed by consumers' assessment of their personal financial situation. Inflation expectations rose again in June as consumers see prices increasing 5.4% in the next year, up from 5.3% in May. Respondents expect annual inflation of 3.1% over the next five years. This

reading of consumers' future inflation expectations may have played a role in the Fed's decision to become more aggressive in its policy by raising rates 75 basis points at its most recent FOMC meeting. On June 24th the sentiment index was revised slightly lower to 50.0.

- **New Orders for Durable Goods** rose 0.7% in May, exceeding expectations with strength across all major categories. This surprisingly strong report issued this week should allay the concerns of some economists that the economy is already in or teetering on the brink of a recession. The underlying details of the durables report showed orders activity was largely positive, with primary metals and industrial machinery the standouts along with defense aircraft and autos. One of the most important pieces of the report, shipments of "core" non-defense capital goods ex-aircraft (a key input for business investment in the calculation of GDP) rose a healthy 0.8% in May following a 0.8% increase in April. If unchanged in June, these orders will be up at a 7.5% annualized rate in Q2 versus the Q1 average, providing a tailwind to second quarter GDP growth.

- **US Jobless Claims** last week plateaued near a five-month high, suggesting tightness in the labor market may be starting to ease. Initial claims for state unemployment benefits decreased by 2,000 to 229,000 in the week ended June 18. The jobless claims four-week moving average, a measure which smooths out some of the volatility in this series, increased to 223,000, the highest reading since late January. While the labor market remains strong and there are two job openings for every job seeker, there are some signs of softening as several major companies, including JPMorgan Chase, have announced layoffs or hiring pauses.

OUTLOOK

In summary, taking recently released data into account, we see the economy slowing but not entering recession this year. The peak in consumer inflation has probably passed but for the Fed to pivot away from its aggressive tightening it will need to see several months of cooling CPI readings. While new strains of the COVID virus are likely to emerge, we are "learning to live with it" and life is gradually returning to normal; future lockdowns are highly unlikely. Supply-chain bottlenecks are slowly easing. China's growth is expected to accelerate significantly in the second half as lockdowns there are lifted, providing support to Asian emerging market commerce and the global economy in general. And there is an outside chance economic constraints and geopolitical pressures will lead to progress towards a ceasefire in the grinding war in the Ukraine as the year progresses.

EQUITY INVESTMENT POLICY

US equities continued their decline in June as markets have become increasingly preoccupied with the growing possibility of a recession which some economists and investors now view as a near certainty. Market psychology has turned extremely negative and selling on some days has become indiscriminate, signs a market bottom may be in formation. Absent a recession, equities are attractively priced in our view. For example, US small cap stocks trade near their lowest valuations on record. Many of the astronomically priced small cap tech stocks without earnings or positive cash flows have crashed, declining as much as 90% from their mid-2021 highs. SPACS have cratered. The NASDAQ, home to many of the most widely held mega cap technology stocks, has declined over 28% year-to-date. The S&P 500 stock index is off 19%+ since year-end. S&P 500 stocks are reasonably priced, selling at about 15 times forward earnings, down from about 21 times at the end of 2021. Should the Fed push the economy into a mild recession, the broad stock market indices may for a time breach their earlier June lows as earnings estimates are cut and uncertainties linger, until the Fed pivots.

Recall that we are entering "earnings season" where companies will issue important guidance concerning their outlook for the back half of the year. Investors will be closely monitoring management's commentary and will be adjusting their views accordingly, adding to market volatility which is already elevated.

Despite the near-term concerns and caution warranted by the uncertain outlook, the longer-term case for maintaining clients' equity positions, and adding to them selectively during periods of weakness, remains unchanged. US economic fundamentals are sound. The global society is flush with cash amounting to over $9 trillion. Household and corporate balance sheets are in better shape than they have been for decades. Recent stress tests conducted by the Fed have found the US banking system to be more than sufficiently reserved to function in the event of a severe recession. There are few, if any, signs of widening yield spreads in the fixed income markets. The price of gold, a supposed safe haven in troubled times, has fallen this year. And, over time, returns from a well-diversified portfolio of high-quality equities with strong balance sheets and good cash flows should exceed those from fixed income alternatives.

Equity portfolios under our supervision are well-balanced, broadly diversified between domestic large cap *growth* and *value* shares, modestly tilted toward *value*. *Value* has significantly outperformed *growth* this year. (The S&P 500 *growth* index has declined over 27% compared with the 11% *value* index drawdown.) Our equity

investment platform also includes small cap domestic stocks and equities domiciled abroad in both developed and emerging markets.

FIXED INCOME INVESTMENT POLICY

The trend higher in bond yields this year has reversed as investors have had second thoughts about how aggressive the Fed will need to be to bring inflation down to its 2% target. The flight from equities has also put pressure on bond yields in recent days. For example, the yield on 10-year US Treasuries has fallen to 3.03% from over 3.48% on June 14, a remarkable decline in two weeks' time. In our view, rates will resume their secular rise as the Fed tightens credit conditions further making bonds with duration unattractive. Therefore, since preservation of principal and maintaining liquidity are primary objectives in managing our clients' bond portfolios, fixed income investments under our supervision are defensively invested in a short ladder of highly-liquid, investment grade corporate obligations with a target duration of 1. However, as short-term rates have risen sharply, we have begun to gradually extend maturities.

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