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ECONOMIC UPDATE

Among the most notable pieces of economic data we came across over the past month was the Labor Department's July nonfarm payroll report which detailed a surprising leap in jobs, twice the median consensus forecast, defying expectations of an economic slowdown and highlighting the resilience of the economy. The report, showing the US economy expanding broadly, not only debunks the idea advanced by a fair number of Wall Street economists that we are already in a recession, but also supports the view the Federal Reserve is unlikely to dial back the pace of its rate increases at its September meeting. In fact, the outsized employment gain raises the possibility Fed officials will conclude they need to tighten monetary policy even more aggressively than they have and keep rates elevated longer than is now generally expected to cool the economy.

Since the July Fed meeting, labor market data suggest wages have been stronger than earlier reported, while hiring has been brisk. Employers added 528,000 jobs last month, recouping all the jobs lost since the February 2020 onset of COVID-19, while the unemployment rate fell to 3.5%, the lowest in over half-century, from 3.6% during the prior four months. Meanwhile, wage growth was more robust than economists anticipated in July, with average hourly earnings rising 0.5% from June and 5.2% from June 2021. Wage growth in June was also revised higher, indicating earlier data overstated the magnitude of a recent deceleration in the rapid pace of wage growth. The behavior of wages is of concern to the Fed currently because of worries companies are raising wages since they can pass higher labor costs on to consumers in the current inflationary environment. Together, red hot job growth and rapid wage gains could fuel fears of such a wage-price spiral.

Recently Fed officials, trying to manage financial market expectations, have been jawboning that another 75-basis point increase in the Fed's reference rate in September is not off the table despite the unusually uncertain outlook. Overall, the strong July jobs report should dampen recession fears but, at the same time, boost concerns the Fed has more work to do to quell inflation than previously thought.

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INFLATION

Elevated inflation is currently a global phenomenon. In the US, it is evidenced by the rising prices of both goods and services, driven by a confluence of factors including the massive fiscal stimulus applied in response to COVID-19, highly accommodative monetary policy including a huge increase in the M2 money supply in 2021, rising commodity prices related to the war in Ukraine, supply pressures stemming from the reopening of the economy as pandemic fears subside, and supply-chain bottlenecks, to name a few. There is already clear evidence goods inflation, ignited by the pandemic, has peaked as commodity prices, notably gasoline, have rolled over. Services inflation remains more intractable, awaiting further policy responses from the Fed, which pivoted to an increasingly hawkish stance in the past few quarters by signaling its intention to increase interest rates and shrink its balance sheet. The Fed is expected to keep credit conditions tight at least through yearend. Recall that the central bank raised its target federal funds rate by a quarter percentage point from near zero in March, beginning a tightening cycle. In May, the Fed raised the rate by half percentage point. It hiked the rate by three-quarters of a percentage point in June and again in July, the most aggressive series of rate increases since 1994. Whether the Fed raises its reference rate 50 or 75 basis points in September, a hot debate topic for Fed watchers, is likely to depend upon data received between now and when the Fed next meets in late September.

Meanwhile, the highly anticipated July inflation report released by the Bureau of Labor Statistics (BLS) Wednesday, delivered some very good news to the Fed. It showed July CPI inflation to be weaker than expected supporting the view consumer inflation may have peaked. Surprisingly, the report showed the headline index essentially flat between June and July and the core rising only 0.3%, still a firm pace by pre-pandemic standards. It also showed year-over-year inflation at 8.5%, down from the previous month's four-decade high rate of 9.1%, but still elevated. The June CPI reading of 9.1% had marked the largest 12-month increase in that measure since the period ending November 1981. The weakness in the headline index was largely attributable to a sharp decline in energy prices, which fell 4.6% over the month but were nevertheless 32.9% higher than a year ago.

Beyond its battle to reign in current inflation, the Fed is also attempting to manage inflation *expectations* as these may prove more difficult to control if high inflation expectations become imbedded in consumer behavior. The Fed's recent aggressiveness is meant to assure consumers and businesses that it is serious in its efforts to anchor these expectations. On that score, the Fed has recently received some other good news: The New York Fed's latest monthly Survey of Consumer Expectations showed respondents believe the inflation rate, 9.1% as measured by the

CPI in June, will decline to at about 6.2% for the next year and then fall further to a 3.2% rate over the next three years. While these expectations remain high, they have now decreased significantly over the past few months as the price of gasoline and mortgage rates slipped from recent peaks.

INDICATORS

Other economic data released during the past month has been mixed, showing the economy still expanding but at a more moderate rate. The Bureau of Economic Analysis reported that real US GDP growth for the second quarter came in at -0.9% on an annualized basis. Real GDP growth was -1.6% in the prior quarter. While two consecutive quarters of negative growth fits the standard definition of a recession, the strong labor market, with unemployment at 3.5%, does not reflect a recessionary climate. Semantics aside, the sharp plunge in the yield of the 10-year US Treasury Note, from a high of 3.48% on June 14 to 2.80% currently, does suggest investors are concerned about the state of the economy. Consider the following sampling of data we have reviewed and comments on each.

- **ISM Non-Manufacturing Index** increased to 56.7 in July easily exceeding the consensus expected 53.5 (Levels above 50 signal expansion; levels below signal contraction.) The major measures of activity moved mostly higher in July, and nearly all stand above 50, signaling growth. The service sector accelerated last month leading the economy higher, as consumers shifted their spending habits away from goods to the still-reopening services sector. Business activity and new orders, the two most forward-looking components of the report, both rose to 59.9. Supplier deliveries, a measure of supply chain bottlenecks, dropped over four percentage points and is now at the lowest level since the beginning of 2021. Meanwhile, the employment index rose to 49.1 in July from 47.4 in June. Despite remaining in contractionary territory, the principal issue for the labor market remains a lack of supply. Finally, the highest reading for any category remains the price index which posted the largest monthly decline in more than five years.

- **ISM Manufacturing Index** declined to 52.8 in July, exceeding the consensus expected 52.0 (Levels higher than 50 signal expansion; levels below 50 signal contraction.) The major measures were mixed in July. The production index fell to 53.5 from 54.9 in June, while the new orders index fell to 48.0 from 49.2 in June. Manufacturing continued to expand in July, though at a slightly slower pace, with eleven of eighteen industries reporting growth. The slowdown in manufacturing is being driven by supply-chain issues and a weakening in demand due to the ongoing shift in consumer preferences away from goods toward services. Respondents’ comments in July highlighted shortages of key inputs, but also a decline in new orders due to recession fears and customers’ high inventories which resulted in a decline in new orders to 48.0. While the softening

in new orders is a negative sign for future manufacturing activity, it will allow US factories time to catch up on unfilled orders in their pipelines. The best news in the report came from the prices index, which posted the largest monthly drop since 2010, another signal that inflation pressures might have peaked.

- **North American Freight Rail Traffic** turned positive after weekly declines for most of the year. For the last week in July, traffic edged up 0.6%. Carloads rose 1.9% on 12 reporting US, Canadian and Mexican railroads. This follows a 3.1% decline for the first 30 weeks of the year.

- **Senior Loan Officer Opinion Survey on Bank Lending Practices** addresses changes in the standards and terms of, and demand for, bank loans during the second quarter of 2022. The survey is conducted by the Federal Reserve. The survey found on balance, tighter standards and stronger demand for commercial and industrial loans, an indicator usually associated with a coming slowdown in business activity.

Also worth mentioning is the sharp slowdown in the rate of growth of M2 money supply reported by the Federal Reserve. So far this year, the annual rate of increase in M2 is only a 1.7% , after climbing at an 18.4% annual rate in 2020-21. By contrast, M2 grew at a 6.2% annual rate in the ten years leading up to COVID. Slow growth in M2 is welcome news as it removes one of the props under inflation, allowing fewer dollars to chase goods and services during a time when there is a mismatch between the demand for goods and their supply.

Finally, the July reading of our firm's proprietary Economic Model, designed to signal a change in the direction of the economy, came in below-trend for the second consecutive month pointing to the increased possibility of a recession six to nine months in the future.

OUTLOOK

The aim of tighter monetary policy is to slow the economy by dampening demand. Slower business growth helps control inflation as demand and supply are brought into balance. Moderating growth cools the labor market, calming inflation. A controlled slowdown (aka soft landing) is the Fed's goal. As the process plays out, unemployment should trend moderately higher. Under current circumstances, with record low unemployment, consumer and corporate balance sheets stronger than they have been for decades, unprecedented global liquidity, the US banking system passing stringent stress tests with flying colors and credit quality excellent, and few, if any, signals from the credit markets of trouble ahead, the probability of anything more than

a mild pullback over the intermediate term appears slim. However, the below trend-reading of our Economic Model is a warning sign not to be ignored.

EQUITY INVESTMENT POLICY

Following the first half rout in equities, stocks have staged a broad and significant, almost uninterrupted, rally, recouping nearly half of their earlier losses in less than two months. This rebound appears to have been driven by the spreading belief among investors that the Federal Reserve's more aggressive monetary policy will quell inflation more quickly than previously assumed, avoiding tipping the economy into a serious recession, allowing it to pivot from tightening next year. Whether this view of the fundamentals will be validated remains to be seen, but there are some very recent signs inflation may have peaked, giving new impetus to market's rally. Interestingly, from a technical viewpoint, we have seen in just the past few days several previously bearish market technicians "throw in the towel" on their warnings of yet another down-leg to the market decline before a sustainable bottom is reached, revising upward their yearend targets for the S&P 500.

Given the significant first half market pullback, market analysts have been wrestling with the issue of equity valuation and how it compares with prior market cycles. At its low point in mid-June, the S&P 500 had experienced its second sharpest P/E valuation de-rating of 6.7x (compared with an average of a 4.5x compression experienced during prior recessions). While the current equity multiple of 17.5x is slightly higher than the historical median of 16x, we and other analysts believe the market is currently close to being fairly valued given the shift in industry mix to higher quality companies over the past two decades; companies are now less cyclical, have structurally higher pricing power and better profitability, boast robust balance sheets and have less credit risk exposure.

Beyond market valuation, which appears to be fair currently, and despite the near-term concerns and caution warranted by the uncertain outlook, the longer-term case for maintaining clients' equity positions, having added selectively to them during the recent downturn, remains unchanged. US economic fundamentals are sound. The global economy is flush with cash amounting to over $9 trillion. As noted earlier, households and corporate balance sheets are in better shape than they have been for decades. Recent stress tests conducted by the Federal Reserve 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 dislocations in the credit markets that would be cause for concern. The price of gold, a supposed haven in troubled times, has declined this year. And over time, despite their inherent market risks, returns from

a well-diversified portfolio of high-quality equities with strong financials and growing cash flows should exceed those likely to be earned from fixed income investments.

Clients' equity portfolios under our supervision are well diversified, balanced between high quality, large cap *growth* and *value* shares, slightly tilted toward *value*. *Value* has outperformed *growth* this year although its margin of outperformance has narrowed recently. Our equity investment platform allows for small cap domestic equities and equities domiciled abroad in both developed and emerging markets.

FIXED INCOME INVESTMENT POLICY

The trend higher in bond yields, evident through most of the first half of the year, has reversed as investors have had second thoughts about how much further the Fed will have to tighten monetary conditions to control inflation and as recession risks have been priced into the market. For example, the yield on the 10-year US Treasury Note has fallen to 2.80% from 3.48% on June 14. In our view, the Fed's tightening is far from complete and interest rates are headed higher, 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 high quality, very liquid corporate obligations with a target duration of 1. Over the past few months, during which time short-term rates have moved up sharply due to Fed policy, we have reinvested the proceeds of bond maturities in obligations with slightly longer maturities with yields above 3.0%.

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