

ECONOMIC OUTLOOK

Summary

Data from the past few quarters has shown the U.S. economy is slowing from its torrid pace following the pandemic. As the benefits of government stimulus and economic reopenings have faded, inflation-adjusted consumer spending has normalized toward pre-Covid averages. Knowing this, along with the ongoing war in Ukraine, a “zero-Covid” policy in China and 40-year high inflation, the headline GDP number for the first quarter still managed to surprise to the downside. Expectations were for 1.0% real growth, and yet preliminary data showed a decline of -1.4%. While that may be alarming, especially as the Fed is embarking on a rate-hiking cycle, when digging into the data, it appears much less concerning.

First, the positive – even with high inflation, the U.S. consumer appears resilient. While we certainly wouldn’t categorize personal consumption in the first quarter as robust, it contributed positively to growth by adding 1.8% to GDP, which was its highest contribution rate in the past three quarters. Additionally, domestic business investment added another 0.4%. Still, those increases were more than offset by a detraction from defense spending, inventories and net exports.

The slower growth in certain areas was anticipated. For example, after seeing a massive boost in 4Q21 GDP due to inventory buildup, we wrote about how it was likely to be a drag on growth in the first quarter. That’s exactly what happened as it detracted 0.83% from growth after adding 5.32% in the prior quarter.

Other areas of slower growth in the economy were less expected and in a bizarre way some are attributable to the overall strength of the U.S. economy relative to other countries. Continued demand from U.S. consumers caused an increase in imports during the quarter, and other countries were happy to

ship their goods stateside. Conversely, demand for U.S. goods slowed in other countries. In Europe, for example, consumers are having a tougher time with the effects of higher energy prices compounding already high inflation. This has created a trade imbalance, which led net exports to detract 3.2% from GDP. This data point notwithstanding, growth in the first quarter would have exceeded expectations.

We do not expect last quarter’s contraction in GDP to alter the path of rate increases by the Fed, since we do not anticipate further contractions in the short term. But as the Fed attempts to increase the overnight rate beyond a neutral rate to quell inflation, they will need to carefully monitor their impact on economic growth.

Positives

The labor market remains hot, adding another 428K jobs

Personal consumption increased 2.7% quarter-over-quarter

Personal income is accelerating, but not at an alarming rate

Negatives

Core PCE year-over-year remains elevated at 5.2%

ISM Manufacturing and ISM Services both decreased month-over-month

Pending home sales declined for the fifth straight month

EQUITY OUTLOOK

Summary

As we indicated last month, the March rally seemed a bit premature given the uncertainty that remains. With the benefit of hindsight, the performance of equity markets in April confirms that belief. The S&P 500 fell 8.7% for the month hitting a fresh year-to-date closing low. Upward pressure on bond yields in April again led to outsized pressure on growth stocks. The Russell 1000 Growth index dropped 12.1% versus the Russell 1000 Value which declined 5.6%. This is an acceleration of a trend that has dominated much of 2022.

With well over half of the S&P 500 companies having reported earnings for the quarter, results have largely been mediocre as expected. The average company has exceeded their expected earnings by 4%, a rate far lower than the averages experienced in recent years. Forward guidance has expectedly been soft given the uncertain environment many companies face.

Equity markets are likely to remain volatile and challenged as we barrel into summer. Visibility remains quite cloudy on a number of fronts. The war in Ukraine has no obvious or immediate resolution. Covid lockdowns in China continue to pressure supply chains. The Fed has only begun their policy steps to fight inflation with an elevated risk of overshooting their objective.

We believe the clouds should begin to part as we head into the closing months of 2022. The sun will again shine on equity markets but we may have to dodge a few raindrops in the meantime. Keep an umbrella handy.

Positives

Stocks are oversold in the short term

Corporate balance sheets

Negatives

Fed policy uncertainty

Supply chain and labor shortages

Unknowns

Ukraine war escalation possibility

FIXED INCOME OUTLOOK

Summary

At the press conference following the early May meeting of the Fed's Open Market Committee (FOMC), Chairman Powell made the comment that clearly the labor market is too strong and inflation is too high. Thanks for the update. The continued strong job gains and upside surprises on inflation have been ringing alarm bells for months upon months. Many economists, forecasters, analysts and even Fed officials, current and past, have been commenting the Fed is significantly "behind the curve" and they need to become more aggressive to combat inflationary pressures before they become imbedded in consumer and labor market psychology. Some Fed officials floated the idea of 75 basis point (bp) rate hikes with the hopes of getting to a neutral rate, or even higher, by the fall.

The calls for more aggressive action fueled a move higher across the yield curve. The 2-year Treasury note increased another 38 bps to end the month at 2.72%. The 10-year rose by about 60 bps to end at 2.93%. Recall these rates were just 0.73% and 1.51% to start the year, respectively. As indicated by the front end yields, the market was pricing for three 50 bps rate increases by the July FOMC meeting with a 50% probability that one of those could be a 75 bps hike. To add insult to injury for bond investors, credit spreads increased sharply as well. The result was that investment-grade bonds delivered one of their worst monthly returns in the past 30 years. This follows their absolute worst quarterly return and a rare negative calendar year return last year. All told, the broad bond market indices are down over 13% during the past 16 months with the intermediate segment down more than 10%.

We were hoping to see some moderation in the year-over-year rate of inflation, but Russia's invasion into Ukraine dashed those thoughts for months to come. With some moderation we felt the Fed was unlikely to achieve all of the rate increases that were expected by the market, especially as stimulus benefits faded and growth slowed. It now appears that inflation will remain stickier and more persistent. Even with this, we still question the Fed's ability to increase the funds rate as much as implied by the forward curve. One thought is that they know

it will be difficult in the face of slowing economic activity, so they had better get on it sooner than later. In the end, we really wonder whether increasing the overnight rate is really going to do much to curtail inflation. It appears reducing the balance sheet will have a bigger impact. We are encouraged by the fairly aggressive plan to ramp up to \$95 billion per month reductions.

No one knows exactly where the top in yields will be for this move higher, but somewhere around 3.25% on the 10-year Treasury note looks to have good support on the technical basis. We also believe the front-end of the curve already reflects the very most we are likely to see from the Fed rate increases. With investment-grade credit spreads about 50 bps wider than they were six-months ago, it is easy to find value there as well. All-in-all, we see brighter skies ahead for bond investors.

Positives

Yields are higher than the projected long-run level of inflation

Demand for safety investments should increase as global economic uncertainties rise

Short maturity yields already reflect multiple 50 bp Fed rate increases

Negatives

Inflationary pressures will persist

Balance sheet reductions could force longer yields higher

Unknowns

Russia/Ukraine war
