

ECONOMIC OUTLOOK

Summary

Economic data during the past month has done little to define the direction of the economy in the face of an aggressive rate-hiking cycle by the Federal Reserve. On one hand, there is hope that we may have seen the peak of inflation in March since April's data provided the first year-over-year decrease in 10 months. Additionally, the labor market remains very strong and manufacturing PMIs continue to be in expansionary territory. Personal consumption has also increased and remains at elevated levels, which is an indication that the consumer remains well-positioned. However, the first revision to GDP decreased the economic growth rate for the first quarter to -1.5%, consumer confidence is near historical lows and the housing market is quickly declining in the face of the highest mortgage rates in 14 years. The juxtaposition continues as we've seen personal incomes continue to increase but a consumer with less overall purchasing power.

All else aside, inflation has been the primary focus of Federal Reserve officials since the start of the year as they increase rates "expeditiously toward neutral." So far, the overnight rate has been lifted by 75 basis points (bps) through the end of May, and another 100 bps in hikes are nearly guaranteed to occur by July 27. This would mark the fastest 2.0% increase to the Fed Funds rate since 1981. Additionally, 50 bp hikes in September and beyond could still be in play. The Fed is taking these actions to slow the economy and economic demand, which should hopefully drive prices lower.

But the Fed is walking a fine line, and though they are attempting a "soft landing" - or a reduction in inflation toward their target while not materially damaging the economy - their own comments of late seem to acknowledge the difficult path ahead. For example, Chairman Jay Powell has referred to a "softish landing" and acknowledges that it depends on factors the Fed cannot control (think China lockdowns, Russia/Ukraine).

It is unlikely to have a recession without weakness in the labor market, and we have seen continued increases in non-farm payrolls, the labor force participation rate and average hourly earnings month-over-month. That gives the Fed plenty of cushion to move further with hikes, but even though the consumer seems well-positioned, we've seen the savings rate decrease substantially over the past few months. If that trend continues, and the consumer continues to dip further into savings to keep up with inflation, the runway for a soft landing may get even shorter.

Positives

Non-farm payrolls beat expectations by 72k (390k vs 318k est.)

Second consecutive month of declining year-over-year Core PCE data

ISM Manufacturing remains elevated (56.1 vs 54.5 est.)

Negatives

First quarter GDP was revised further negative due to declining corporate profits

University of Michigan consumer confidence is approaching it's all time low

Double digit decreases in pending and new home sales

EQUITY OUTLOOK

Summary

Volatility continued throughout the month of May. The S&P 500 nearly roamed into bear market territory mid-month closing down 18.7% from the early January high of 4,796.56. Equities rallied late in the month and the S&P 500 finished flat on a price basis, up .22 points. This was particularly impressive considering the index had fallen 5.6% at its low point on May 19. Growth stocks continue to be challenged more than value. The Russell 1000 Growth Index fell 2.4% while the Russell 1000 Value Index rose 1.9%, on a total return basis.

The recent selloff in equities began with weakness in higher valuation and high momentum stocks. In recent weeks, selling spread to include higher quality, more traditionally resilient companies. With earnings season mostly in the books, any sign of weakness or uncertain guidance has largely been punished by investors, regardless of style.

While the strength in late May was welcome and may signal a market bottom was established, volatility will still quite likely persist throughout the summer. Many of the factors contributing to the market weakness remain problematic but there is some evidence of progress. The battle in Ukraine has shifted but the ultimate resolution remains unclear. Covid lockdowns in China have further stressed supply chains but the country is beginning to remove the lockdowns and open back up. Inflation in the U.S. may have officially peaked, with several prognosticators making this their new base case. The question

now becomes how long it will take for inflation to moderate to a comfortable level for both the Fed's Open Market Committee (FOMC) and the markets.

We believe the higher quality companies that have been unfairly discounted by the markets present an attractive opportunity for long-term investors. Capital market waters will eventually calm and those willing to invest in equities should be rewarded for their patience.

Positives

Peak inflation

Corporate balance sheets

Negatives

Consumer sentiment

Supply chain and labor shortages

Unknowns

Fed piloting challenges

FIXED INCOME OUTLOOK

Summary

After four horrible months for bond investors, yields peaked in early May around the time the Fed increased the overnight rate by 50 basis points (bps), which was the first increase of that size in more than 20 years. When the prospect of 75 bp rate increases were dashed by Chairman Powell, yields began to move steadily lower. From the peak close of 2.78%, the 2-year Treasury note declined about 30 bps before rising a bit to end the month at 2.56%. This was 16 bps lower than the end of April level. The 10-year followed the same pattern and declined about 40 bps from a closing peak level of 3.13% before ending May at 2.84%. This was a 9 bp drop for the month. The 30-year bond spiked early but then did not decline as much, as it ended May 5 bps higher at 3.05%. With this modest rise, long Treasury bonds are now down about 20% in value. With the decline across the yield curve from the 2-year to the 10-year, intermediate Treasuries delivered a positive return for the first time this year. Importantly, bonds finally reasserted their role within a balanced portfolio by moving in lock-step with equity markets. When stocks sold off, Treasury notes rallied and vice versa.

Credit spreads also seemed to move in a fairly lock-step fashion with riskier markets. As the stock market dropped, credit spreads increased by about 16 bps, then as the stock market rebounded in the last third of the month spreads dropped by 21 bps. Overall credit spreads ended the month about 5 bps tighter than at the end of April. Combining a higher starting yield with a modest level of price appreciation due to lower credit spreads, corporate bonds delivered superior returns relative to Treasury bonds. This was only the second month of the year in which corporate bonds outperformed. Overall, May brought a sign of relief to bond investors battered by the worst start of the year in decades.

No one knows exactly how far the Fed will go with the overnight rate increases in their effort to combat inflationary pressures. Even they don't know. Investors and the Fed also do not know how the run-off of the balance sheet will impact the economy, inflation and market liquidity. On the other hand, through years of observation we do have a pretty

good idea how sharply higher interest rates will eventually impact consumer and corporate behavior. The hope is that when combined with a declining balance sheet, the Fed can precisely deliver an overnight rate that eases inflationary pressures without collapsing the economy and the labor market. Whether they can achieve this unicorn-like rate or they push until things break, we believe 10-year yields around 3.25% seems like a reasonable target. There is good support at that level and there was already a sharp intra-day move that got close but was unable to reach it. We understand the Fed is looking for "clear and convincing evidence" that inflation is slowing before they ease back from their hawkish stance. If they push too much, rates could move beyond this target, but the subsequent economic gloom would cause rates to move back below this level within a few quarters.

Positives

Long-run inflation expectations remain fairly anchored

Demand for safety investments should increase as global economic uncertainties rise

Short maturity yields already reflect multiple 50 bp Fed rate increases

Negatives

Technical support levels are somewhat higher than current yields

Inflationary pressures will persist due to Russia's invasion of Ukraine

Unknowns

Impact on markets as balance sheet run-off ramps higher

Russia/Ukraine war