

ECONOMIC OUTLOOK

Summary

In July, the Federal Reserve increased the overnight rate by 75 basis points (bps) for the second consecutive meeting. Even though it pushed the upper bound of the Fed Funds rate to 2.50%, it was still on the low end of expectations after a 9.1% Consumer Price Index (CPI) reading just weeks prior raised the possibility of a full 100 bp hike. In contrast to prior meetings, Fed Chairman Jerome Powell indicated the committee would be more data-dependent in their rate hike decisions moving forward, as he believes we are now approaching a “neutral” rate.

The following day, we received news that GDP for the second quarter had contracted. Though it was a known possibility for several weeks prior to the release, it officially marked the second consecutive quarter of declining GDP. That would signal a recession in many other countries, but since the 1970s, U.S. recessions are officially classified by the National Bureau of Economic Research (NBER), based on the depth, diffusion and duration of a given slowdown. Regardless if this ends up categorized as an official recession, which we likely won't know until year-end, there is no doubt growth so far this year has been weak, and inflation has remained high.

Whatever “this” is, sadly, it's likely still not enough from the Fed's perspective. While recent economic data has typically been disappointing, there is currently still a strong labor market and occasional bright spots, such as retail sales (excluding autos and gas) coming in significantly higher than expectations. This suggests that although the economy is slowing, we still haven't reached the levels of demand destruction necessary to allow the Fed to stop its rate hikes.

While it has become difficult to read financial news and not come across words like “slowdown” or “recession” it should not elicit feelings of panic. Instead, remember an economic slowdown is the desired result for the Fed and will help it achieve its ultimate objective of decreasing inflation. As long as they don't overcorrect, which could cause a larger slowdown than necessary, the overall impacts should be mild. And fortunately, they will have access to at least two more months of inflationary data before they must make any further decisions.

Positives

Strong July payrolls more than doubled expectations (528k vs 250k est.)

Retail sales month-over-month exceeded expectations (1.0% vs 0.9% est.)

Durable goods orders had its largest increase since January (2.0%)

Negatives

The advance print of 2Q22 GDP came in at -0.9% (1.5% below expectations)

Global PMIs are at their lowest levels since the onset of the pandemic

Pending home sales are down nearly 20.0% year-over-year

EQUITY OUTLOOK

Summary

The S&P 500 rallied 9.2% in July very nearly recouping the losses incurred during the previous month. It was the index's best monthly performance since November 2020. Growth stocks, which have generally been out of favor in 2022, led the charge with the Russell 1000 Growth Index rising 12.0%. The Russell 1000 Value Index, by contrast, rose 6.6%.

As we mentioned last month, the market's primary focus has seemingly shifted from the threat of persistent inflation to slowing economic growth and a potential recession. Heading into August, more than half the S&P 500 companies have reported second-quarter financial results with the average company growing earnings around 8.0% and beating expectations by approximately 4.0%. More significantly, earnings guidance for the S&P 500 for the balance of the year has modestly declined but not nearly as much as some feared. There had been some concern that disappointing earnings and guidance this quarter would give the markets an excuse to take another leg lower. To date, that has not been the case.

There is some debate about whether the strong market action in July is the start of a new bull market or simply a rally inside of an ongoing bear market. In other words, has a near-term bottom already been established, will the market retest, or make new lows? An argument can be made to support any case. If earnings are going to in fact hold up, oversold

conditions and reasonable valuations promote the idea this is the beginning of a sustainable rally. Regardless of whether an official bottom has been established, it seems clear to us the majority of the potential bad news is already priced into the market. Even if volatility persists and we see renewed downward pressure on stocks, we believe we are at least nearing the end of the bear market. Maintaining a long-term focus we are positioning portfolios for a potential market recovery.

Positives

Peak inflation/supply chain

Equity valuations reasonable

Negatives

Consumer confidence & sentiment

Hawkish Fed speak

Unknowns

Slowing corporate earnings growth

FIXED INCOME OUTLOOK

Summary

Staring into the face of a historically large 75 basis point (bp) rate hike by the Federal Reserve is not the typical environment in which one would expect a sizable drop in interest rates, especially following a hike of the same magnitude implemented just a few weeks prior. It is even more confounding when you add in an exceptionally strong jobs report and the highest Consumer Price Index (CPI) inflation in 40 years at 9.1%. But that is exactly what happened in July. In fact, yields hit a peak on June 14, the day before the Fed rate increase, and trended mostly lower through July and into the first few trading days of August.

The 5-year and 10-year Treasury notes each dropped 36 bps during July to end at 2.68% and 2.65%, respectively. The 30-year bond declined 17 bps to end at 3.01%. More reflective of the higher overnight rate, the 2-year note eased by only 7 bps to end at 2.88%. Corporate credit spreads declined by about 10 bps. As measured by the Bloomberg Aggregate Index, the investment grade bond market returned 2.44%, which was the 8th best monthly return in the past 30 years. This was near the top 2.0% of monthly returns over a period that may forever be considered the greatest bond bull market in history. Like the stock market, missing out on any strong month can leave investors in a hole from which it is difficult to climb out.

The decline in rates can be attributed to all sorts of economic data, other than the labor market, indicative of an economy that is slowing and inflationary pressures that appear to be easing. Investors are either believing the Fed will be successful in their efforts to rein in inflation, or that the rate hikes will push the economy over the cliff and into a recession. Either way, the thinking is that rates come down in the long run. This belief is illustrated by the fact the widely followed 2-year/10-year spread is now inverted by about 24 bps, the most in over 20 years, and the futures market for Fed Funds has two rate cuts priced in for 2023.

Following the July rate hike, Fed Chairman Powell reiterated they remain strongly committed to fighting inflation and they will move expeditiously to remove their accommodative

monetary policy. Through these actions, they believe they can bring demand down to be in better balance with supply. Tough monetary policy cannot fix all the contributors to inflation but it can break just about everything and cause hardship for the people who have been most impacted by the high inflation already. The Fed will likely follow through with the rate hikes that are forecasted for this year but we agree they will need to pivot by sometime mid-year 2023 as the effects of the rate hikes fully kick in. The yield on longer maturity bonds has declined a lot since mid-June and it should be reasonable to expect some retracement back towards 3.0% or so on the 10-year Treasury note. We believe credit spreads are still attractive and investment grade corporate bonds will outperform government debt through the remainder of the year.

Positives

Treasury yields are higher than long-run inflation expectations

Most of the world's central banks are increasing interest rates as well

Bonds now offer increasing diversification benefits

Negatives

The Fed will accelerate their balance sheet run-off

Some retracement of a sharp drop in yields would be normal

Inflationary pressures will persist in certain sectors

Unknowns

Resolution of the Russia/Ukraine war