WILKINS
INVESTMENT COUNSEL

2022 FALL INVESTMENT OUTLOOK

The equity market has resumed its downward momentum into the fall season with the S&P 500 declining 14.2% since mid-August, unwinding the entire bear market rally that occurred over the summer. Such a reversal was triggered by stubbornly high inflation data and Federal Reserve Chair Jerome Powell's hawkish comments at the Fed's own Jackson Hole symposium on August 26th where he emphasized the necessity to forcefully use the central bank's tools to fight rising prices. Chair Powell emphasized there is "no place to stop or pause" the current interest rate hike regime, which will bring some pain to households and businesses. The FOMC followed-up this tough talk with an additional 75 bps increase to its fed funds policy rate to a 3.25% upper bound at its September 21st meeting, with Powell explicitly warning that "the chances of a soft landing are likely to diminish because monetary policy needs to be more restrictive or restrictive for longer" to fight the highest inflation in more than 40 years.

Treasury yields for maturities out to five years moved firmly above 4% last week, the highest levels since 2007. The most recent inflection higher comes on the heels of hawkish CPI data released on September 13th for the month of August, which showed persistently high core inflation of +0.6% mo./mo., a rate of change that was double most economist forecasts. While headline inflation is moderating and broad commodity prices are 18% lower since early June, the high costs of shelter (housing/rents) and a tight labor market have led to a year-over-year acceleration in service sector inflation despite a moderation in the prices for some goods as supply chain issues resolve and retailers clear excess inventory.

The rise in interest rates and the widening of credit spreads has led to a 13.8% decline in the Bloomberg Aggregate Bond Index and the first time in two decades that bonds have become an ineffective hedge in balanced portfolios in the face of such steep equity market declines. Those investors broadly indexed to both asset classes without regard to maturity and quality have suffered relative to others more conservatively positioned as evidenced by the 18.1% year-to-date decline in the Lipper Balanced Fund Index. Unfortunately, equity markets are probably still in the early stages of contemplating the economic and corporate profit risks from tighter financial conditions, which takes time to play out and historically impacts at a 12-24-month lag.

2022 YTD Total Returns

	9/23/22	% Change
Dow 30 Industrials	29,590	-17.3%
S&P 500	3,693	-21.6%
NASDAQ Composite	10,868	-30.1%
MSCI ACWI ex-USA	252	-26.7%

Outlook

Capital markets are facing the fastest and sharpest monetary policy tightening in more than 40 years and policymakers are becoming quite desensitized to the decline in broad asset prices in order to regain their inflation-fighting credibility. This changed tone emanating from the central bank is quite a shift compared to the previous two recessions and economic cycles when the Fed implicitly fueled the rise in prices of most risk assets like stocks, real estate, and speculative instruments with easy money policies.

The bear market rally from mid-June to mid-August led to an easing of financial conditions over the summer, working against the Fed's own policy intentions. Thus, the central bank has become emboldened and even more explicit with their own commentary on markets and the economic conditions they are trying to achieve. Minneapolis Fed President Neal Kashkari was "happy to see how Chair Powell's Jackson Hole speech was received" by the stock market because "I was certainly not excited to see the stock market rallying after (the August) Federal Open Market Committee meeting. I know how committed we all are to getting inflation down. And I somehow think the markets were misunderstanding that" over the summer.

At his post-FOMC meeting press conference on September 21st Chair Powell was quite sober with his remarks regarding the pain that the economy is likely to feel in the coming quarters in order for the Fed to achieve its price stability goals. "We have to get inflation behind us," he said. "I wish there were a painless way to do that; there isn't." He further implored, "We have to get supply and demand back into alignment. The way we do that is slowing the economy" and "it will very likely mean some softening of labor market conditions." The labor market is a lagging indicator, however, with the peak in payrolls historically trailing the peak in interest rates by about six months. So the economy may slow well ahead of any confirmation by the labor market. Bloomberg consensus has average monthly payroll additions slowing to +165k per month in the fourth quarter (versus +378k per month over the summer) and to less than +50k per month by mid-2023. Some economists have outright declines occurring beginning in the first quarter of next year.

The FOMC raised its own projections of where the fed funds interest rate is headed for this year and next at its most recent meeting. The median forecast calls for another 125 bps of rate hikes between now and year-end, putting the key policy rate at 4.25%-4.50% by December 14th. Committee members currently expect to raise the rate another 25 bps in 2023 (median estimate) and keep it there for the entire year at a so-called terminal value of 4.50%-4.75% before hopefully easing in 2024 once inflation subsides. The Fed is also expected to accelerate its quantitative tightening (QT) program, reducing its balance sheet by selling $380 billion of bonds over the last four months of the year compared to just $52 billion since June, although this pace has been complicated somewhat by the spike in mortgage rates and the sharp drop in prepayments in its mortgage portfolio. Previous episodes over the past decade of the central bank reducing its balance sheet (2017-2018) or just stopping QE have seen equity markets trade sideways at best.

Housing, the most interest-sensitive sector of the economy, has cooled rather quickly in response to the tighter monetary conditions. Mortgage rates are near 6.5% (30-year fixed) for the first time since the early 2000s, making the average home purchase the most expensive since the mid-1980s. However, flipping the economy from a virtuous cycle to a vicious one takes time since other parts of it take longer to digest policy shifts than housing. Businesses are still generating decent profits and households continue to work and spend. However, the Conference Board's Leading Indicator Index is flashing a warning sign with the 6-month rate of change declining 2.7%, a magnitude that

has preceded each of the past eight recessions. Thus, conditions on the ground are likely to become more challenging in the months ahead once corporate investment and consumption slow to levels consistent with recent sentiment survey data.

Credit and capital are the mother's milk of economic activity. While the Fed transmits its policy mainly through the interest rate channel, it indirectly impacts broader financial conditions with its policies, and most of these measures continue to tighten. Wider credit spreads and tighter bank lending standards lead to less credit creation and hence less incremental economic growth; lower stock prices raise the cost of raising capital for public companies and impart a negative wealth effect on spending by the wealthiest households; and a strong dollar is a drag on exports and corporate profits. Combined, these measures lead economic activity by approximately 9 months and are likely to continue to soften over the short run as the Fed's policies are more broadly felt by the economy.

The continued decline in commodity prices since mid-June makes it increasingly likely that headline CPI peaked for this cycle on a year-over-year basis that same month at 8.3% y/y. Crude oil is down 37% from its peak to $79 per bbl; gasoline prices have declined 26% to $3.69 per gallon national average for regular unleaded; building materials like copper and lumber are also down sharply, declining 32% and 70% respectively.

Unfortunately, food prices remain stubbornly high as agricultural commodities are still somewhat elevated due to the war in Ukraine and draught conditions across many of the key growing regions. The food component of the CPI was up 11.4% y/y in August, the highest level since April 1979, and still rising. Heating fuel headed into the fall and winter months is also more expensive with current natural gas prices 56% higher in the U.S. than the average from last December-March and heating oil 47% higher. No wonder more than 40% of households reported difficulty paying for usual expenses in August in the latest Census Bureau survey of the consumer. Such inflation will continue to pressure the marginal spender and shift dollars away from the more discretionary parts of the economy over the coming quarters. This is consistent with what many retailers were reporting during their most recent earnings calls.

The European economy faces a stark energy crisis which could push the region into recession rather quickly with the winter heating season just around the corner. The EU relied on Russia for 40% of its natural gas in the past but such energy flows have become unreliable as the war in Ukraine continues in its eighth month. European natural gas prices and electricity bills have tripled since last year and little can be done on the supply side in the short run to bring relief and to meaningfully displace Russian gas. Governments are worried about a potential financial crisis for European utilities, who often sell power in advance and are sourcing inputs at prices unthinkable less than a year ago. Several countries have passed fiscal measures to cap household heating costs as well as provide loans and guarantees to cash-strapped utilities.

Unfortunately, European policymakers will likely need to act on the demand side as many analysts believe it will be quite difficult to avoid some sort of rationing and restrictions of natural gas on the continent. A sustained period of very high natural gas and electricity has the potential to dramatically impact industrial activity in the region over the coming quarters. Bloomberg models the probability of a Eurozone recession at 73% based on economic forecasts as GDP is expected to decline over the next three quarters. Business sentiment measures such as the ZEW Survey have fallen to levels consistent with previous recessions.

Nonetheless, the European Central Bank accelerated its own rate hikes at its September meeting with headline inflation closing in on 10%, which will do little to lower power and heating costs for European consumers this winter but further raise the chances that the economy soon dips into recession. The euro has crashed nearly 21% over the past 16 months and now trades below parity versus the U.S. dollar for the first time since 2002. The U.S. Dollar Index (DXY) has rallied a sharp 27% over the same time period against a broader set of currencies, exacerbating the inflation challenges in many geographies beyond Europe and necessitating even tighter monetary regimes.

The rise in both real and nominal interest rates throughout 2022 in the face of higher inflation have put downward pressure on price-earnings (P/E) multiples and valuations for most equities, especially those in growth-oriented sectors. Speculative parts of the capital markets have been hit especially hard such as IPOs, SPACs, meme stocks, and cryptocurrencies.

Markets in general, however, have yet to feel the impact of lower corporate earnings, which is why bear markets take time to form bottoms since a shift in underlying fundamentals can be less acute than the initial shift in policy (which often leads to a quick re-pricing). Earnings regression models at a 12-month lead based on the ISM manufacturing index, consumer confidence, housing starts, shape of yield curve, credit spreads, and the direction of the dollar portend a y/y decline in profits at some point in 2023 for the S&P 500. The downward breadth of recent earnings revisions at a 6-month lead also points to a similar trend. While the range of earnings declines during recessions can vary, the peak-to-trough change usually averages 20% or more for the S&P 500. Recent warnings from a few bellwether companies like FedEx and Ford raises a yellow flag for upcoming third quarter reports.

Equity market bottoms rarely occur before a peak in short rates and instead usually trough well after turning points in policy. According to a study by Bridgewater Associates of market data as far back as the early 1900s, short maturity Treasury rates peak an average of seven months before a stock market bottom. Furthermore, the timeframe between the last rate hike and the first rate cut by the Federal Reserve has averaged about six months across all cycles going back to 1970. Thus, investors would be wise to have some patience and diligence as new fundamental information arrives during earnings season despite the recent decline in stock valuations.

Investment Conclusion

The current economic and market environment has recently enabled active portfolio management to outshine pure indexing for those managers who favored risk management over chasing returns by maintaining a higher quality stock portfolio. Taking some gains earlier in the year while many stocks were still near historical peak levels and maintaining a shorter maturity bond portfolio into the rise in interest rates has also helped our client accounts do quite well on a relative basis. With the rise in interest rates likely in the latter innings and the yield curve becoming more inverted, reinvestment risk is now a greater consideration in fixed income portfolios. With Treasury yields now north of 4% it makes sense to extend maturities. We continue to research individual company fundamentals in anticipation of a broadening of opportunities in the stock market over the coming quarters, where history shows that buying at steep discounts leads to better long term returns for those investors with patience, diligence, and ample liquidity during periods of stress.

September 26, 2022

The firm is pleased to announce that Sarah Valerio has rejoined us as Director of Client Services.