2022 SUMMER INVESTMENT OUTLOOK

The spring months have offered little relief to most investors as the capital market sell-off which began last winter has continued. In April, the S&P 500 suffered its worst monthly loss since the beginning of the pandemic as stocks declined over 8%. After trading nearly flat in May, the slump continued in June with stocks down an additional 9% so far this month. This occurred largely as a result of persistently high inflation readings which have caused the Federal Reserve to take a more hawkish tone. Three federal funds rate hikes, the first since December 2018, have lifted the central bank's key lending rate to a range of 1.50%-1.75%, up from 0.00%-0.25% at year end. At the same time, discussion has begun to prepare market participants for the unwinding of the Federal Reserve's balance sheet which more than doubled since March 2020 to its current size of $8.9 trillion. This has spooked investors who have grown accustomed to the most accommodative monetary policy on record over the past ten plus years. Stock markets have responded accordingly and, by late spring, all three of the popular stock market indices had entered bear market territory, defined as down 20% or more from the peak. Year-to-date results for some of the popular market benchmarks are detailed in the chart below.

While Wall Street analysts have been slow to reduce corporate earnings estimates for 2022, it is likely that the market has already begun to price in weaker profit growth relative to expectations earlier in the year. Several other factors have also been weighing on stock prices. Fiscal policy will be less of a tailwind as massive government spending programs are exhausted. Ongoing supply chain issues continue to impede progress for corporate America. War in Europe is exacerbating that trend while adding to geopolitical uncertainty. The top concerns of small business owners continue to be rising input costs and an inability to hire a sufficient workforce to meet demand. Higher energy prices are cutting into budgets and are beginning to negatively impact consumer confidence. Lockdowns in China have curtailed that country's growth rate which has had negative implications for overall global growth. The International Monetary Fund now predicts global growth will slow to 3.6% in 2022, down from a January estimate of 4.4%. This compares to 6.1% growth in 2021 which was boosted by a weak 2020 comparison due to Covid's initial surge and large government stimulus programs which are now winding down.

There is positive news as well. As noted, global growth is expected to exceed 3.5% in 2022 with the U.S. economy predicted to expand by 2.3% according to the Conference Board. This is expected to be supportive of corporate profit growth this year of some 10% according to current market estimates. Jobs remain plentiful with an estimated 1.9 jobs available for every person seeking work according to the U.S. Labor Department. Similarly, the current unemployment rate of 3.6% suggests the labor market is quite healthy. Aside from three months in late 2019 and early 2020, the U.S. unemployment rate has not been this low since the late 1960s. With jobs abundant and workers scarce, wage growth has been above average which has helped consumers withstand the recent surge in inflation. Pent up savings are also boosting American's appetites to spend. Some $2 trillion plus in excess savings are estimated to be on personal balance sheets, though this amount is not equally distributed across all consumers. Finally, monetary policy, while tightening on the margin, remains extremely stimulative as inflation adjusted interest rates remain negative both domestically and in many other parts of the world.

Equity Markets – 6/21/2022

	Index Price Level	2022 YTD Total Return
Dow 30 Industrials	30,530	-15.1%
S&P 500	3,765	-20.4%
NASDAQ Composite	11,069	-29.0%
MSCI All Country World Index ex-USA	279	-17.4%

Outlook

Sentiment has deteriorated in recent months as investors have focused on incoming inflation data which has shown no sign of cooling down. After reaching a forty-year high of 8.3% in April, inflation was expected to moderate. Instead, May's 8.6% inflation rate accelerated and convinced market participants that high prices would prove to be more durable than Federal Reserve officials and politicians had led them to believe. It has now become clear that monetary policy remained overly stimulative for too long and those inflationary forces were exacerbated by an unnecessarily excessive fiscal policy in response to the COVID pandemic. This contributed to the considerable imbalance between supply and demand in the economy as consumers were given money to spend at the same time that producers were limited by supply chain bottlenecks, rising labor costs, and higher raw material expenses. War in Europe and other geopolitical concerns are also adding to rising price pressures while reshoring of manufacturing is leading to more reliable, but higher cost, supply chains.

Inflation is particularly painful for the lower 60% of American wage earners who control only 16% of the nation's wealth according to Federal Reserve data. These individuals, who did not benefit from the favorable capital market cycle over the past twelve plus years, are now bearing the brunt of higher prices with little breathing room in their budgets. More broadly, inflation adjusted wages for all full-time wage and salary workers are now negative, implying a decline in the standard of living for the average U.S. worker. It is possible that employees may become more successful in demanding wages that rise sufficiently to offset inflation. However, this would likely lead to a dreaded wage-price spiral which causes even higher inflation that central banks would eventually have to extinguish with greater force.

The reality that all Americans are now suffering from the impact of higher prices is the reason that central bank officials have abandoned the notion that inflation is transitory and policy is being adjusted accordingly. Fed funds rate hikes of 25 basis points (March), 50 basis points (May), and 75 basis points (June) have been implemented this year with more rate increases anticipated. The June move was the largest increase in the central bank's key lending rate in twenty-eight years. This phenomenon is not unique to the U.S. with over forty-five countries having raised interest rates so far in 2022 with more expected according to FactSet. The goal is to lift borrowing costs to the point that demand falls for both consumers and businesses in order to cool economic growth sufficiently that hiring and wage growth slow without causing a recession. This task is a difficult one to achieve as the tools that central bankers use are not precise, they work with a lag, and they are implementing their strategy in a dynamic environment where the inputs are constantly changing. Recession risks are increasing with no historical precedent of policy makers successfully engineering a soft landing from today's starting point.

Federal Reserve action on the short end of the yield curve has led to higher long-term rates as well. The benchmark U.S. 10 year treasury rate has more than doubled this year, going from 1.51% on December 31st to a current 3.31%. Despite the sharp jump in interest rates, increased borrowing costs have yet to truly be reflected in broad based economic activity, though there are signs that consumer borrowing, housing, and other interest sensitive parts of the economy are beginning to feel the impact. One area that has definitely been affected by higher rates is capital market valuations. When the year began, the S&P 500 traded at a price-earnings multiple of 21.5x. Largely as a result of higher interest rates, which lower the value of future corporate earnings via a higher discount rate, the stock market multiple has fallen to 15.7x, a 27% decrease.

This multiple decline is one key reason stocks have fallen year to date. Earnings projections have actually increased modestly since the year began. First quarter S&P 500 revenue growth of nearly 14% resulted in earning growth of over 9%. Second quarter results will be reported shortly and estimates are for revenue growth of nearly 10% leading to mid-single digit earnings growth, not an unreasonable assumption. Results in the back half of the year are unlikely to meet expectations. Wall Street analysts currently call for high single digit revenue growth to result in approximately 10% earnings growth as corporate profit margins are predicted to remain near record levels. This seems doubtful and it is probable that those estimates will be revised downward as the reality of higher interest rates coupled with many of the other challenges noted act as a headwind for Corporate America. It is likely that the decline stocks have experienced in recent months partially reflects this outcome. The strong U.S. dollar may also dent corporate results. Due in part to the Federal Reserve being more aggressive than other global central banks in tightening monetary policy, it is trading near a twenty-year high against many other major currencies. All else equal, this will crimp corporate profit growth in the second half of the year as those foreign earnings are translated back into dollars.

Rising interest rates can be expected to cool demand in the housing sector which had become overheated. Data from the latest Case-Shiller 20 City index showed that home prices rose 21.2% in the most recently reported month versus one year ago, with all twenty cities showing strong double digit increases. With the average rate on a thirty-year mortgage up approximately 300 basis points over the past year, home affordability is becoming an issue for a greater percentage of buyers. Early evidence suggests that this impact is being felt with houses staying on the market longer, fewer bids above asking price, and outright price declines in some cases, particularly on higher end luxury homes which had become prone to speculation.

Areas other than housing, where people had been out on the risk curve, have also come under pressure in recent months. The NASDAQ market, dominated by technology and biotechnology companies, peaked back in November and is down some 30% since that time. So-called ESG funds, which purport to invest in socially responsible companies, are down approximately 20% this year. Special purpose acquisition companies (SPACs), non-fungible tokens (NFTs), meme stocks, some hedge funds, and crypto currencies have experienced ever larger declines. The pain is likely not over for many of these speculations. Private equity investors have yet to experience big asset price drops though it is unlikely this area of finance will be spared. Higher bond yields raise the discount rate on these assets, thereby lowering their valuations while declining capital markets make initial public offering exits more challenging. In addition, much of the activity in this area is funded with borrowed money and the cost of that financing has risen dramatically which negatively impacts returns.

A look back at the decade ending December 31, 2021 is instructive and may shed some light on what the current decade may bring. During that ten year span, the S&P 500 provided investors with an average annualized return of 16.6%. This was more than double the rate of profit growth during that time of only 7.7%. The reason stock investors benefited disproportionally relative to earnings growth is due to the fact that market multiples expanded significantly. Price-earnings ratios, which began the decade at 13.0x, ended it at 23.6x as low interest rates encouraged market participants to take on more risk. For perspective, a multiple of approximately 16x is closer to the historic average. Corporate profit margins also increased going from just over 9% to almost 13.5%, near a record. With little reason to think that such extremes can be maintained, it is wise for investors to temper their expectations. While stocks should provide positive returns over the coming decade, a mid-single digit rate for the S&P 500 is more likely than the mid-teens rate of the past ten years. Nevertheless, the merits of sound, long-term investing remain intact and a carefully assembled portfolio of select high-quality companies stands a reasonable chance of outperforming the broad market averages with less volatility over time.

Investment Conclusions

Since the financial crisis of 2008-2009, investors have grown accustomed to operating in a low inflation, conflict free world where corporations have easy access to credit, materials, and labor all at very low costs. As mentioned earlier, many of these tailwinds are absent in the current environment. Most notably, the inflation dynamic has changed which has caused the Federal Reserve to take a more aggressive approach to monetary policy than most thought possible. Over a decade of easy monetary policy has left investors complacent to the risks that higher interest rates can impart upon stock prices. Policymakers are now trying to guide the economy from a period of excessive support to one that is better balanced without such massive government intervention. In time, that goal will be achieved though volatility may persist as this process unfolds. This would likely present attractive investment opportunities to long-term investors, particularly in those accounts where cash balances have increased recently due to portfolio companies being acquired and due to maturing bond issues.

Despite the intermediate-term challenges noted, appropriately diversified, thoughtfully constructed portfolios can be expected to provide investors with acceptable risk-adjusted returns. Buying shares of well-managed companies with attractive growth prospects and solid balance sheets at favorable prices is a timeless investment philosophy. Complementing those holdings with short-to-intermediate term, high quality fixed income securities can balance out an overall portfolio which can be customized to meet individual investment objectives as appropriate. Importantly, rising interest rates are finally allowing investors to generate respectable current income returns from this portion of their portfolios.

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