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The only constant is change

Times of Great Change are Unnerving

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As I sit down to write this newsletter, I feel the need to point very specifically to the date. As rapidly as things are changing in this environment, much of what I say here could already be old news by the time this is published. Quite honestly, that's one thing plaguing the markets… a rapidly changing environment. Markets tend to like certainty over uncertainty. There isn't much certainty to be found these days. Right now, I expect they are looking toward the Congressional midterm elections. If the GOP is able to flip one or both houses of Congress, that might be stimulative. Why? Do markets like Republicans? No. They like gridlock.

COVID-19 Update

To date, the fatality rate of the current pandemic is at the low-end of historical outbreaks. The economy wasn't so much affected by the pandemic itself as by government action shutting down significant areas of economic activity in an attempt to control the spread of infections. The effectiveness of these efforts will be debated for years to come. However, the pandemic is more or less under control now and should not be an economic factor going forward—barring further government intervention. Although recent case numbers have risen from their lows, fatalities remain muted… and that is despite a near return to normal activities. We have learned to cope with it.

Economic Growth

Entering the second half of 2022, there is a growing danger that the U.S. economy could slip into recession—and may technically already be in recession. While real GDP shrank in 1Q22, monthly data suggests there was some growth in the 2nd Qtr as the Omicron wave subsided and spending picked up in pandemic-impacted areas such as travel, restaurants, leisure and entertainment. Although official numbers won't be released until later this month, initial readings are suggesting real GDP shrank overall in the 2nd Qtr. This would be the textbook definition of recession but it won't be "official" until declared by the National Bureau of Economic Research. They may look beyond the overall numbers to other factors. We shall see.

Regardless, entering 3Q22, there are gathering forces slowing economic momentum. After two years of record stimulus, the economy is facing huge fiscal drag, with the federal budget deficit likely to fall from 12.4% of GDP in 2021 to less than 4% of GDP this year – the single biggest decline since the demobilization following the end of World War II. This decline reflects an end to stimulus checks, enhanced unemployment benefits, enhanced child tax credits and a host of other programs that were supporting lower and middle-income households during the pandemic. In addition, a surge in 30-year mortgage rates is weighing on the housing sector and an 8%+ rise in the trade-weighted dollar year-to-date is impeding U.S. exports. All of this, combined with collapsing consumer confidence, has raised the risk that the U.S. economy falls into recession in the near term.

Unemployment

The labor market continues to be a bright spot in an otherwise gloomy environment, with the official unemployment rate remaining at 3.6% for the third consecutive month in May, just 0.1% above its 50-year low in 2019. There continues to be massive excess demand for labor, with roughly 5.45 million more job openings than unemployed workers in May. This excess demand should fade over the next few months, reflecting slowing economic momentum and diminished business confidence. However, it is likely to keep wage gains elevated and hopefully encourage an increase in labor force participation—particularly as an aging baby-boom generation and limited immigration continue to hamper labor supply. Importantly, strong wage growth may also limit declines in inflation, which has become the biggest concern for consumers, investors and policymakers.

Inflation

Inflation continues to run hot with June 2022 headline CPI showing a 9.1% year-over-year (YOY) gain, the highest reading since December 1981. Note that this high number follows last Summer's number when we were already debating whether inflation would be transitory. High inflation during this expansion has largely reflected the impact of higher energy costs and strong consumer spending colliding with supply shortages across major sectors of the economy. More recently, this has been amplified by a general recovery in airfares, hotel rates, and rents from their pandemic lows. Inflation has been further exacerbated by continued supply chain problems due to the Russian invasion of Ukraine and China's attempts to maintain a "zero-COVID" policy, pushing out the peak of YOY CPI inflation.

By the end of 2022, some of the supply-driven issues are expected to fade, allowing headline inflation to ease. However, the longer high inflation persists, the stickier it gets and core PCE inflation could remain above 3% YOY throughout 2022 and 2023. While longer-term forces are likely to cut inflation further by the middle of the decade, the potential persistence of inflation well above the Fed's 2% target over the next two years has major implications for monetary policy.

Equity Markets

Following a strong 2021, in which S&P 500 operating earnings-per-share (EPS) rose by 70%, profits are growing much more slowly in 2022. Honestly, it wasn't hard to set a record last year after a disastrous year in 2020. In the first quarter of this year, operating EPS rose just 4.2% YOY and analysts now expect a less than 8% gain for full-year 2022.

However, even these estimates may be optimistic. Companies are facing a number of different headwinds—rising wages, higher commodity and input costs, higher interest rates and slowing nominal sales growth. While energy companies will continue to benefit from high margins, elsewhere, these headwinds should cut into profits. A much higher dollar will

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also erode the value of overseas sales while recession concerns could cause companies to cut discretionary expenses while they have a macroeconomic excuse to do so.

A recession would, of course, lead to a sharp decline in profits. However, if this eventually led to less wage pressure and easier monetary policy, it could create a better long-term environment going forward. Gridlock in Washington and the prospect of a Republican takeover of Congress this year also reduce the likelihood of an increase in corporate taxes, allowing after-tax profit margins to remain high relative to history.

Those relying on unmanaged indices enjoyed a decade of outperformance relative to the average money manager. The top 10 holdings in the S&P 500 grew to be almost 30% of the market capitalization of the index. The opposite has been true in the current downturn and those larger names are having an oversized impact on their index.

However, while concerns are justified, it is worth noting that the S&P 500 forward P/E ratio is now below its 25-year average of roughly 16.9x. This drawdown should set investors up for better returns in the long run, particularly if today's stressful environment is eventually replaced by one reminiscent of the last decade, with slow growth, low inflation, low interest rates and high profitability. However, higher interest rates will likely continue to put pressure on valuations across financial markets, leaving U.S. value stocks and international equities best positioned to outperform.

The Global Economy

The global economy presents a mixed picture entering the second half of 2022. On the positive side, the effects of the pandemic are fading in most parts of the world due to widespread immunity gained from inoculation and infection and less deadly variants of the virus. However, the Chinese economy continues to be impacted by the pandemic as it struggles to sustain a "zero-Covid" policy. European economies are also being badly impacted by much higher energy prices resulting from reduced global supply and the war in Ukraine.

Inflation has become a global concern and most central banks are tightening policy to combat it. While it's not yet certain this could lead to a global recession, it should slow the pace of economic recovery around the world.

The Fed

A rapidly improving labor market and persistent inflationary pressures have pushed the Federal Reserve (the Fed) to adopt a much more hawkish stance. At its June meeting, the Fed increased the federal funds rate by 0.75%, following increases of 0.25% and 0.50% in March and May, respectively. In addition, the Summary of Economic Projections indicated a median expectation, among FOMC members, of cumulative further increases of 1.75% this year and 0.5% next year, bringing the federal funds rate to a range of 3.25%-3.50% by the end of 2022 and 3.75%-4.00% by the end of 2023. On quantitative tightening, the Fed is also ramping up the pace of reduction of their massive bond holdings to up to $95 billion/month by September. They will soon vote to raise again and I expect an increase of .75% as they will walk a fine line between tightening to fight inflation and avoiding a deep recession.

Notably, the Fed expects inflation will fall towards its 2% target over the next few years. In its Summary of Economic Projections, the Fed forecasts annual core PCE inflation will fall from its current 4.9% to 4.3% by 4Q22, 2.7% by 4Q23 and 2.3% by 4Q24. While futures markets now roughly agree with the Fed's forecasts of the federal funds rate for the rest of 2022, they expect the Fed to ease policy starting next Spring, reflecting the risk that a too-aggressive Fed may tip the economy into recession.

Fixed-Income Markets

High inflation, falling unemployment and the Fed's much more hawkish stance led to a sharp back up in bond yields in the first half of 2022, resulting in negative returns across fixed-income markets. However, while the likely persistence of stubbornly high inflation suggests continued tightening from the Federal Reserve through the end of the year, increased recession risks could limit further increases in long-term Treasury yields. Credit spreads have also widened out in anticipation of a slowing economy which may present opportunities in areas such as high yield bonds and convertibles—if the economy can avoid a deep recession.

Although yields have risen on the 10Y Treasury, investors in those securities are still accepting a real negative yield relative to inflation. If interest rates rise further, not only will yields remain negative to anticipated inflation, values on the held bonds will continue to fall.

Do Something

Investors should still remain vigilant with their portfolios and review their holdings. I believe this environment is where the best managers will have an edge over "passive" managers that seek to match index performance. Sit down with your financial advisor and ensure your investments are prepared for the future and consistent with your objectives.

Plan for the future. Has there been a birth or a death in the family? Marriage or divorce? Graduation or retirement? Each of these will have an impact on existing financial plans. Keep your documents relevant to your particular situation by reviewing them frequently.

Summary

My long-term outlook favors equities over bonds—just don't expect higher than average gains this year. This is an environment for strong investment managers and careful stock selection. Overseas holdings may benefit long-term investors with greater growth potential. Income-oriented investments may struggle in a low interest rate environment. Equities are my recommendation for a 10-year outlook. With bond yields at historic lows, bond investors may realize low income and a risk of capital losses. Greater income will require higher interest rates which may drive down bond valuations. This isn't a recipe for long-term wealth-creation.

Take the long view with your investment assets and dust off financial plans. When was the last time you reviewed your plans? Your estate plan should be reviewed at least bi-annually and updated with every change of life. Most importantly, make sure you have carefully delegated who will execute your documents for you. To review existing documents, develop new plans, or do end-of-year planning, talk to an advisor soon.

Source: General economic statistics are from JP Morgan "Guide to the Markets" 3Q2022.