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INVESTMENT ADVISORS

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INVESTMENT REVIEW AND OUTLOOK

No Refuge

The three months ending June was one of the most challenging quarters in recent financial history and the broad stock market, as measured by the S&P 500, had a total return of -16.1%. Value stocks continued their leadership, and the S&P Value Index had a return of -11.3% while the S&P Growth Index returned -20.8%. In response to higher inflation readings (the Consumer Price Index (CPI) registered an annual gain of 9.1% for the month of June), the Federal Reserve increased its benchmark lending rate by 0.75% during the quarter. As interest rates rose, bond prices declined, and the Bloomberg 3-10 year U.S. Treasury Index had a return of -2.5% while the yield on the 10-year U.S. Treasury Bond rose from 2.36% to 2.98%. Gold, which is often a safe haven during periods of higher inflation, had a return of -6.6%. There truly was no refuge during the quarter.

The Economy Is Not the Stock Market

The second quarter provided a vivid illustration of how a healthy economy does not always ensure a rising stock market. Broad measures of the U.S. economy, including retail sales and employment, continued to demonstrate strength: during the month of May, retail sales rose 8.1% and according to the Bureau of Labor Statistics the unemployment rate was 3.6%.

Under the surface however, there are signs that the combination of higher inflation and more restrictive Federal Reserve policy are beginning to take a toll on economic growth. Real wage growth (wage growth after the effect of inflation) was estimated to be -7.6% annualized during the first half of 2022 according to Piper Sandler Research. Existing home sales declined by 8.6% during the month of May and new home sales were 5.9% below the May 2021 level. Consumer confidence, as measured by the Conference Board, declined during the quarter and the Expectations Index has declined to its lowest level since March of 2013.

During the first few months of 2022, the stock market responded to the acceleration in inflation and the increase in interest rates and this was reflected in a decline in the 2022 estimated S&P 500 price/earnings (P/E) ratio from 21 times earnings to 16.7 times earnings. The more recent decline in the stock market may be attributable to the economic impact of inflation and higher interest rates on specific industries. By way of example, some sectors of the stock market such as housing, retail and automotive have been notable laggards during the second quarter as earnings estimates for these industries were reduced in response to actual or anticipated earnings shortfalls.

Supply and Demand

Last quarter we wrote about the inflationary forces at work in our economy which include the after-effects of extraordinary monetary and fiscal policies of 2020-2021 as well as the impact of supply chain bottlenecks across various industries. Given the 9.1% gain in the CPI for the month of June, it is natural to wonder if there is any relief on the horizon. Within the CPI, energy had the largest price gain, and during the 12-month period ending June the energy component of the CPI rose 41%. According to data collected by Energy Information Administration, higher prices for gasoline and other fuels have begun to impact demand. For the four week period ended July 8, 2022, domestic gasoline consumption declined 8% from the prior year, occurring at a time when gasoline production declined by only 2%. The result of these conditions was a short-term excess of supply vs. demand. Since early June, average retail prices for gasoline have declined 7-8%. Importantly, expectation for energy prices in the future have also declined; in recent months the futures contract price for gasoline delivery in the month of October of 2022 has declined by over 20%. Following energy, the next largest component gain within the CPI for June was food, which had a 12 month increase of 10%. Similar to the forces at work in the energy markets, higher food prices have impacted consumption and recent reports from the food and beverage industry indicate flat year-to-year volume trends among consumers. Recent developments in agricultural and industrial commodities have mirrored the dynamics of the energy markets. Futures prices for wheat have declined by over 30% and this pattern has been repeated across other agricultural and industrial commodities which have declined from their peaks earlier this year, including corn (-13%), lumber (-40%) and copper (-27%).

There are a variety of factors behind the recent decline in commodity prices. As we discussed last quarter, additional capital spending has been allocated to the energy industry. In the case of gasoline specifically, the recent surge in prices has attracted new supply via imports. Higher interest rates have had a dampening effect on new home sales and this, along with increased supply has impacted lumber prices. Ukraine is a significant supplier of wheat to global markets and the war has increased the possibility of a serious disruption to supply. However, recent reports from both Ukraine and Russia indicate that negotiations are ongoing to unblock wheat exports from Ukraine.

The causes of and remedies for inflation will be forever vexing. There are simply too many variables to analyze in a timely and coherent manner. However, in the current setting, there is increasing evidence that the combination of more restrictive monetary policy and the law of supply and demand are having the desired effect upon prices. There are many components to the CPI, and we have covered only a few. The coming months should provide additional clarity on the inflation outlook.

What We Know

In the world of finance and investments, it is tempting to opine about the future course of events, and the financial press provides daily coverage of the prognostications of various Wall Street professionals. Our experience is that our clients are best served when we focus on the facts we know and make our investment decisions accordingly. With this in mind, the following are a few observations about the current setting.

The fiscal and monetary tightening of the last six months have begun to have a measurable effect on economic activity. Lower federal spending (largely the absence of COVID relief funds) is estimated to have reduced first quarter GDP by -2.9% according to Piper Sandler. Tighter monetary policy has resulted in a significant increase in borrowing costs, particularly for short-term borrowers, and the yield on the 2-year U.S. Treasury has risen from 0.1% in the first quarter of 2021 to 2.92% in the second quarter of

2022. Higher interest rates, and an increase in home prices, have impacted affordability and as cited above, we recently have witnessed a slowing in new and existing home sales.

Despite the fiscal and monetary headwinds, the employment picture remains strong as evidenced by the low unemployment rate. There are several factors working in favor of the strong job picture including demographics (aging baby boomers retiring from the workforce), tighter immigration policies, shortages of skilled workers and the lingering effects of the COVID pandemic. Consumer spending remains resilient despite the pressure from inflation and higher interest rates.

We have previously written about the correction of speculative excesses in the stock market and other assets. For example, Bitcoin, which reached a peak valuation of $60,000 in early 2021, has declined approximately 60%. The broad stock market, as measured by the S&P 500 index, has declined 20% from its January 2022 high; the forward P/E for the S&P 500 is 16.8 times estimated earnings for 2022 and this is above the average P/E of 14 times earnings for periods when inflation was in its current range since 1950, according to Strategas Research.

Outside the U.S., economic conditions are similarly mixed. European economies are facing headwinds from a combination of tighter monetary policies, higher energy prices and fallout from the war in Ukraine. Emerging markets, particularly in South America, are facing similar challenges. The strong U.S. Dollar, which has risen over 12% on a trade weighting basis in 2022, exacerbates challenges for emerging markets because the price of crude oil is quoted in dollars. Sovereign debt priced in dollars can provide another challenge for emerging economies. China, the world's second largest economy, faces slowing economic growth due to a combination of factors including COVID lockdowns, higher energy costs and a slowdown in the real estate sector.

Given the various cross-currents in the economy and markets, our investment positioning continues to emphasize cash generating businesses with above average dividend yields. Aerospace and defense, health care and consumer staples have been prominent themes of the past year. More recently, our attention has been focused on sectors that have lagged the broader stock market and trade at below-average valuations. One area of interest is financial services, where we feel valuations are attractive, and the sector should benefit from modest economic growth and higher interest rates. Outside of equities, we have made additions to our fixed income allocations where 3-5 year U.S. Treasury securities offer competitive yields

As always, we welcome your comments and questions.