Outlook for May 2022

KEY MARKET DRIVERS

- In the first quarter of 2022, U.S. GDP surprisingly contracted, but in a perversely logical way. The decline was an indication and confirmation of the relative strength of the U.S. economy as a burgeoning trade deficit was the primary drag. A healthy U.S. consumer and the unclogging of West Coast ports led to a sharp increase in imports while exports were restrained by the strong dollar and relatively weaker consumer spending growth in many developed and emerging foreign economies.
- Business capital spending continues to grow with strength seen in technology spending on intellectual property and software. These investments should boost employee productivity and help offset the pressure on wages over the coming quarters and years.
- While inflation remains at generational highs, both an increase in inventories and much less government fiscal support should begin to relieve pricing pressure within the goods industries. However, any decline in the inflation rate will be gradual as supply chain pressures dissipate slowly and food and energy prices continue to be biased higher by sanctions on Russia and limited agricultural supply from Ukraine. An additional factor preventing inflation from declining more quickly is an apparently strong pent-up demand from consumers to spend on services in the leisure/hospitality sector which will continue to push prices higher in these industries.
- The European economy is struggling with the impact of the Russian invasion and subsequent sanctions. Because its economy is driven by manufacturing, Germany is highly dependent on Russian energy imports and most susceptible to supply chain disruptions. The countries in the southern tier of Europe, which are more reliant on travel and tourism, should benefit from a broad post-Covid economic reopening and increased consumer spending on services.
- The zero tolerance Covid policy exercised by the Chinese government since the beginning of the pandemic appears to be asserting undue strain on the economy as it is leading to major lockdowns in the greater Shanghai region. Factories still operate in the area, but consumer spending is plummeting as the Omicron variant spreads throughout the region. The virus may spread to Beijing. However, based on how they have behaved in other parts of the world, these variants are highly contagious and decline rather quickly, which suggests that any lost growth over the coming months should quickly recover over subsequent periods.

OUR PERSPECTIVE

Equity Markets

- As April ended, broader US equity indices retested and broke below the early March lows. The highly valued technology and communications services sectors of the market that benefitted most from Covid lockdowns were also most vulnerable to the inevitable slowdown in earnings growth rates as the economy returned to more normal growth patterns. First quarter earnings season has been generally solid in most sectors, particularly those cyclical industries more exposed to the economic reopening in what hopefully is a post-Covid world. The ability to pass through input cost increases to the ultimate consumer is characteristic of an early recovery cycle.
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Outlook for May 2022

OUR PERSPECTIVE

Equity Markets
Continued

- Guidance from companies for the second quarter and beyond is somewhat tepid as there is little visibility around supply chain disruptions caused by the Russian invasion of Ukraine and government-imposed mobility restrictions in China. Positive earnings growth expected over the next three quarters should provide support in this valuation driven correction unless interest rates were to spike notably higher from current levels.
- European equities are generally cheaper than US stocks and their heavier weightings to the more cyclical industries should lead to relative outperformance as the global economies reopen. An offsetting factor is the increasing probability of recession and declining earnings because of the Russian invasion and subsequent sanctions.
- Emerging market equities have suffered the most as a group in this 2022 correction. The Chinese government is pledging enough fiscal and monetary support to meet their economic growth goals despite the Covid driven lockdowns. If the lockdowns do not extend well into the year, this policy stance could put a floor on Asian equities while Latin American markets continue to be driven by higher commodity prices.

Bond Markets

- Interest rates continue to increase throughout the U.S. treasury yield curve reflecting both the current inflationary environment and prospective rate hikes by the Federal Reserve. Yield curve inversion and its recessionary implications have been temporarily rectified but should be monitored as a strong signal the Fed may have to back off from more aggressive tightening.
- Investment grade and high yield corporate bond spreads are another important market indicator of a potentially weaker economy. While the interest rate spreads to treasury yields have widened somewhat this year, they have yet to move to levels that would suggest a recession is imminent. Conversely, the high yield market still does not provide enough of a yield advantage to compensate an investor for the risk of an economic downturn.
- Emerging market debt has suffered this year from the impact of Russia's invasion and continued Covid lockdowns and supply constraints in Asia. Generally obscured has been the relatively robust performance of the debt of the Latin American issuers who have benefitted from commodity price increases.

Monetary Policies & Currencies

- The Federal Reserve has fully pivoted to fighting an inflation rate that has risen to levels not experienced since the early 1980's. A few 50 basis point rate increases are likely coming out of the May and June FOMC meetings. While markets believe the Fed will have to quickly move short term rates up to a neutral level of at least 2.50% to effectively address the situation, the inflation rate should begin to decline somewhat by the summer. This could allow the central bank to proceed with a more gradual tightening approach to both rate increases and balance sheet reduction.
- The European Central Bank needs to address similar inflationary concerns, but the economies on the continent are already beginning to see the demand dampening effects of shortage driven price increases, which will lead the ECB to be even more gradual than the Fed in tightening policy. Expect an end to emergency bond buying this summer and then a move away from negative policy rates sometime in the Fall.

Outlook for May 2022

OUR PERSPECTIVE

Monetary Policies & Currencies
Continued

» The Bank of Japan is strongly signaling their intention to maintain monetary policy at current levels. They will refrain from tightening policy as inflation rates in the demographically challenged Japanese economy have not risen to the levels seen in other developed economies.

» The Peoples Bank of China is bucking the global tightening trend by expanding fiscal and monetary policies to help neutralize the effects of Covid lockdowns, higher energy prices, and ongoing trade wars with the U.S.

» The strength of the U.S. economy and the relative aggressiveness of the Fed has driven the dollar higher this year with a further push coming from the greenback's safe haven status in a turbulent geopolitical environment. Currency weakness may help the export industries in these foreign economies, but the Chinese may be more cautious around currency depreciation to guard against large capital outflows from their economy.

WHAT THIS MEANS FOR INVESTORS

» Markets will continue to focus on inflation and the magnitude of Fed tightening as we enter the summer months. Inflation should slow along with economic growth with GDP staying positive through the rest of the year.

» Corporate earnings will continue to grow in this environment although goods-producing sectors may suffer from the transition of consumer spending to services. Equities should stabilize and not decline dramatically from current levels.

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