Outlook for June 2022

WORLD ECONOMY

- Following a surprising decline in first quarter GDP, caused primarily by a burgeoning trade deficit, U.S. economic growth should resume in the second quarter as both the consumer and businesses have continued to spend at relatively healthy rates. Consumer spending will be largely supported by job and wage growth and will inevitably slow from the unsustainable levels of 2021.
- Business leaders are becoming more cautious amid an economic slowdown. However, U.S. corporations have generally healthy balance sheets which should allow for continued growth in capital spending with an emphasis on technology spend that will help boost productivity in this high labor cost environment.
- Overall inflation likely peaked in April and should begin to decline over the rest of the year, despite higher energy and food prices which are largely a function of the Russian invasion of Ukraine and subsequent sanctions imposed by the West. An easing of supply bottlenecks, increased labor force participation, less fiscal support, and a moderation in demand for labor should all combine to reduce both aggregate demand and cost pressures on corporations. The aggressive replenishment of inventories in the goods sectors may lead to price declines in certain categories although the transition of consumer spending to services will exert continued price pressure in the travel/leisure industries.
- Europe, particularly those northern tier countries on the continent, are clearly impacted more by sanctions placed on Russia and supply constraints out of Ukraine, than other parts of the world. Sharply higher energy and food prices may have already put the region into recession. Although the magnitude of the decline will be mitigated by stronger results expected in the southern tier countries that are more leveraged to recovering services spend as consumers emerge from Covid-induced hibernation.
- With Covid cases rapidly declining, Shanghai is on the verge of reopening its economy. This should allow China to begin recovering lost production induced by the lockdowns. However, some permanent economic damage was likely sustained by the government's zero Covid policy as well as the pre-Covid trade wars with the U.S. which has led to a meaningful amount of manufacturing activity leaving the country.

OUR PERSPECTIVE

Equity Markets

- U.S. equity markets remain buffered by analyst expectations of positive earnings growth in both 2022 and 2023. However, cracks are developing in the goods sectors as high prices are beginning to restrain demand just as inventories are being replenished. Managements will be aggressive in trying to right size costs to maintain margins. The services sectors of the market should continue to see strong revenue growth although margins will be challenged by higher fuel and labor costs in the travel/leisure industries.
- Valuation multiples have contracted notably this year due to both higher interest rates and concern about downward earnings revisions as managements adjust and guide analysts to the reality of slowing demand and stubbornly higher costs. With no recession in our forecast, overall corporate earnings should continue to grow albeit it at a much slower rate. Stabilization of intermediate term interest rates should prevent multiples from declining further.
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Outlook for June 2022

OUR PERSPECTIVE

Equity Markets

Continued

- European equities are outperforming U.S. equities through May in their local currencies likely because these markets do not have as large weightings to the technology and communication services sectors where multiples have declined the most this year. While valuations are cheaper in these markets, they are likely to perform in line with the U.S. given their greater exposure to the recession prone sectors.
- The promise of fiscal and monetary relief in China and the apparent end of lockdowns in the key industrial city of Shanghai may help produce stronger relative performance in the emerging markets as higher energy prices continue to support Latin American markets.

Bond Markets

- The U.S. bond market is sending very strong signals that the Fed may have previewed enough future moves to slow the economy and reduce inflation. The 10-year treasury has settled into a 2.75%-3.00% trading range and the 2/10 year treasury curve has steepened somewhat heading into June. Consistent with the Fed's path towards a neutral fed funds rate in a growth slowdown environment, the 10-year should gradually move above 3.00% this summer and settle around 3.50% by year end.
- High yield bond spreads stopped widening in May with the non-investment grade market currently confirming the U.S. economy is experiencing a slowdown, but not weakening to the extent that would cause a spike in corporate defaults. We still do not believe investors are being adequately compensated at these yield levels for the risk the economy may weaken more than currently anticipated.
- Relaxation of Covid lockdowns in China and some loosening of supply constraints in the rest of Asia may brighten the outlook for emerging market debt which should also benefit by the effect of continued energy price increases on the debt of Latin American issuers.

Monetary Policies & Currencies

- The Federal Reserve is still at the beginning of the process of removing extreme monetary ease and is attempting to quickly catch up to address current inflationary trends. Expect two 50 basis point fed funds rate increases at both the June and July Federal Open Market Committee (FOMC) meeting which would take the rate to 2.00%.
- The Fed will be better positioned to assess the progress of inflation at the end of the summer. It can then decide on the future rate increase cadence in their quest to return to a "neutral" rate which most economists believe to be in a range of 2.50%-3.00%.
- The Bank of England should basically follow the Fed in its tightening plans over the summer as the economic strength and inflation situation in the UK is like that in the U.S. The European Central Bank (ECB) is apparently more reticent in its tightening approach due to the weakening economy which is apparently bordering on recession. Indeed, the ECB will finally take rates out of negative territory but will likely be more cautious in the frequency and magnitude of rate increases over the second half of 2022.
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Outlook for June 2022

OUR PERSPECTIVE

Monetary Policies & Currencies
Continued

» With other central banks catching up to the Fed in their monetary tightening approach, the dollar may have seen most of its appreciation over the first half of this year. It should settle into a rather narrow trading range as heightened geopolitical tensions will prevent any meaningful decline in U.S. currency.

WHAT THIS MEANS FOR INVESTORS

» A slowing economy should begin to relieve inflationary pressures and allow the Fed and other central banks to remove excessive monetary ease on a more gradual basis. The biggest risk to markets continues to be inflation. Should inflation remain stubbornly high over the summer into the fall, there is the high probability the Fed will tighten too aggressively.

» Expect downward revisions to earnings estimates after second quarter earnings, but earnings growth to remain positive at lower levels which should provide a floor for equities.

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