Economic & Market Outlook for August 2022

WORLD ECONOMY

- The U.S. economy experienced its second consecutive quarterly gross domestic product (GDP) contraction, which for some market observers is the definition of a recession. While the first quarter contraction was largely due to a widening trade deficit and the second quarter primarily driven by lower inventories, consumer spending remained positive in the first half of the year with business spending holding up reasonably well. It is difficult to confidently predict a recession in the coming quarters with job growth still strong and the unemployment rate currently at 3.6%.
- There is no doubt the economy is slowing, with certain sectors like housing hurt by both higher prices and higher mortgage rates. Demand is beginning to be destroyed by this combination although inventories in the space have not grown excessively and will not have to be worked down dramatically. Beneficiaries of the COVID-19-inspired stay-at-home sectors of the economy may be suffering from involuntary inventory liquidation, but this has yet to become a broader problem in the economy and should lead to reduction in goods price inflation.
- Achieving the peak in headline and core inflation rates has been harder than expected, but beyond the supply shocks inherent in this volatile geopolitical environment, there are few factors that can sustain demand at these higher price levels. Savings rates are declining, and wage growth should slow with reduced job openings and layoffs in certain sectors. Strong balance sheets and cash positions in both the consumer and corporate spaces should cushion the downturn and mitigate the severity of any recession that may develop.
- The energy supply disruptions caused by the Russian invasion of Ukraine is hurting the European economy more than the United States. Germany imports the bulk of its natural gas supply from Russia, and it is used both for personal consumption and in the manufacturing processes of this heavily industrialized economy. Fortunately, other European countries are not as dependent on Russian energy imports and the southern-tier countries are beginning to see the benefits from a reopening of the economy and a marked pickup in travel and tourism.
- China continues to try to execute a zero COVID health policy, which entails the nearly complete lockdown of infected cities and regions. Closing Shanghai for approximately six weeks slowed GDP growth to a crawl in the second quarter although the recent reopening and some fiscal policy relief around spending and tax cuts should help engineer a second half rebound assuming no major outbreaks in key industrial regions.

OUR PERSPECTIVE

Equity Markets

- U.S. and European equity markets have rallied sharply from their mid-June lows. Bulls believe the lows in this bear market may have been seen in June with the end of Fed tightening on the horizon and corporate earnings not yet showing the collapse forecasted by many of the top-down macro strategists. The bears are viewing this 12% advance from the trough as nothing more than another bear market rally that will stall and hit new lower lows once the magnitude of the corporate earnings declines becomes more apparent.
- While we fully appreciate the risk of the Fed feeling forced to stay tight for too long should inflation remain persistently high, the Fed understands the contra risk of deflation and will not continue to tighten until inflation reaches its target but will pull off the brakes once inflation starts to consistently turn lower, which we should see by year-end.

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Equity Markets *Continued*	» The more reticent approach to tightening at the European central banks may forestall the magnitude of valuation contraction in European equities that has been seen year-to-date in U.S. equities. These are also markets that started this bear market at relatively low levels so the earnings outlook will be key in determining whether they too have reached a true bottom. Currency weakness will help the earnings of their multinational constituents. » Emerging market equities will continue to be largely driven by the crosscurrents in the Chinese political economy. The zero COVID policy has not been effective in preventing outbreaks, but the government seems committed to it so the continued trajectory of COVID will be arguably more impactful to markets there than anywhere else in the world. Stirrings around a potential invasion of Taiwan is another factor that will keep risk premiums high in China. Latin American markets are heavily dependent on commodity prices, which have faltered recently due to weakening demand but also increased supply.
Bond Markets	» Intermediate- to longer-maturity Treasury bond yields have begun to shift lower, and the yield curve is now inverted from 6 months to 10 years, which is indicative of a slowing or faltering economy. It can also be viewed as a sign the Fed is near the end of its tightening cycle. Given the expectation of slow, but positive GDP growth in the United States going into 2023, the 10-year yield should restart its advance toward a more normalized level and the curve should steepen through the remainder of the year. » The high-yield debt market has become more attractive with nominal yields approaching 8%, allowing the asset class to generate positive real returns. Default rates should increase slightly in a slowing economy but relatively strong corporate balance sheets and strength in the energy sector should prevent substantial spread widening from these levels. » Potential fiscal and monetary policy ease out of China, the end of the strong U.S. dollar advance, and higher energy prices should help stabilize emerging market debt and offset continued weakness in eastern European issuers.
Monetary Policies & Currencies	» The U.S. Federal Reserve (Fed) has been forced to fight high and persistent inflation with a much more aggressive rate tightening stance than was originally envisioned at the beginning of the year. The Fed is attempting to engineer a "soft landing" of this once hot economy without inadvertently causing a deep recession. With the federal funds rate now at a rather neutral 2.50%, any further rate increases would be viewed as contractionary, especially when balance sheet reduction policies are also considered. » The Fed will need to see distinct and consistent signs that inflation has peaked and is beginning to turn down before it signals an end to rate tightening. As some signs are already developing in the commodities and retail sectors, the Fed should decrease the magnitude of its rate increases over the remaining 2022 meetings and be finished by year-end with a terminal federal funds rate expectation of 3.50%. » The Bank of England appears to be on a similar path to the Fed, but the European Central Bank has gotten off to a later start in moving away from extremely easy policies and there is internal dissonance within its rate setting committee around the dangers inherent in tightening too much into an economy beset by external supply shocks. » *Continued*

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OUR PERSPECTIVE

Monetary Policies & Currencies
Continued

- The Bank of Japan so far refuses to give up on its aggressive easing and yield curve control programs while the People's Bank of China has signaled a willingness to lower rates to offset the negative impact of its zero COVID policies.
- Beyond its haven status in a roiled geopolitical landscape, the U.S. dollar has had notable appreciation against most other currencies due to the stark difference in central bankers' approaches to fighting inflation. With the Fed much closer to achieving its goal of rate normalization, further appreciation should be muted, but it is difficult to create a near-term rationale for much depreciation from these levels.

Commodities

- A growth slowdown and increasing recessionary fears have muted demand for energy and industrial metals although the supply of crude oil and especially natural gas is dependent upon the progress of the Russia-Ukraine war in which Russia appears willing to weaponize energy exports to punish the western European nations for their sanctions.
- With a slight indication that the end of Fed tightening is on the horizon, gold prices rebounded somewhat at the end of July, although higher real interest rates will continue to provide a strong headwind to further meaningful advances.

WHAT THIS MEANS FOR INVESTORS

- The faster-than-expected move to a neutral federal funds rate has roiled equity markets this year. The risk of continued tightening leading to a recession in the economy and a decline in corporate earnings has grown. The July rebound seen in stock prices has been welcome relief as has been the lack of major negative surprises in the second quarter earnings season. Markets now need more consistent signs that inflation is turning down due more to the natural balancing between supply and demand as opposed to a strong recession that destroys demand.

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