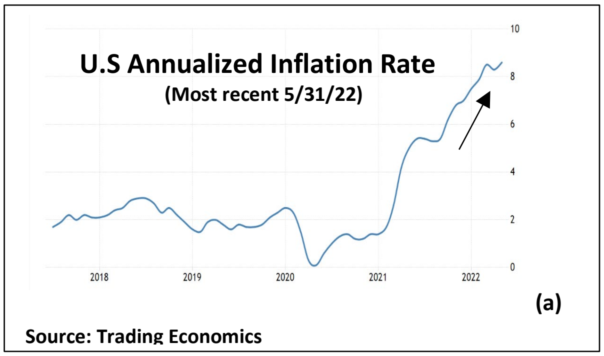
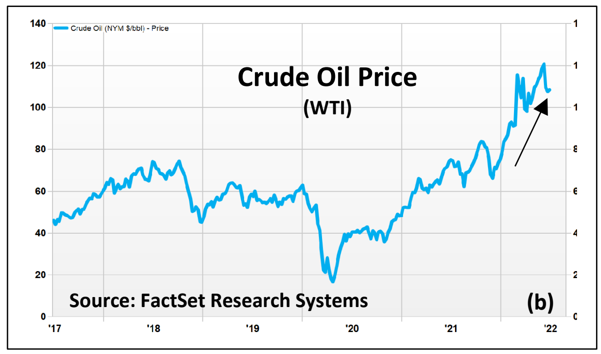
Economic and Financial Market Update – July 2022

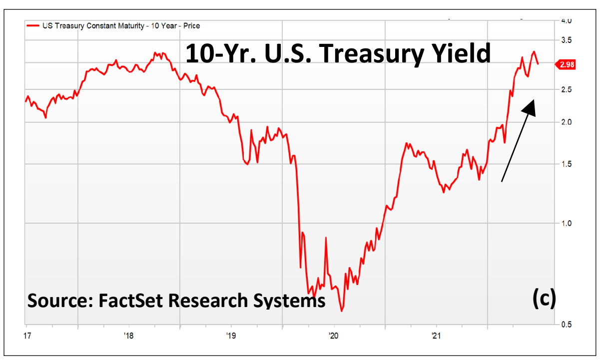
"In the midst of challenge, lies great opportunity" – A. Einstein

It was a bruising first half-of 2022 for all sectors of the financial markets around the globe. Accelerating inflation, rising interest rates, geopolitical conflict, and still "tight" supply-chain conditions were reasons for the worst first-half performance for the S&P 500 since 1970.[i]

At the close of the second quarter (6/30/22), the S&P 500, NASDAQ, and Dow Jones Industrial Average had declined by -20.6%, -29.5% and -15.3%[ii] respectively. It was not just stocks that lost value, bonds also declined during the first half. The Bloomberg Aggregate Bond Index, a proxy for the total bond market, has a negative total return thus far in 22' of -10.29%.[iii] The few items that have risen year-to-date have been commodities +15.8% (Dow Jones Commodity Index)[iv]. Crude Oil and Natural Gas advanced by +40.6% and +45.4%[v] respectively.



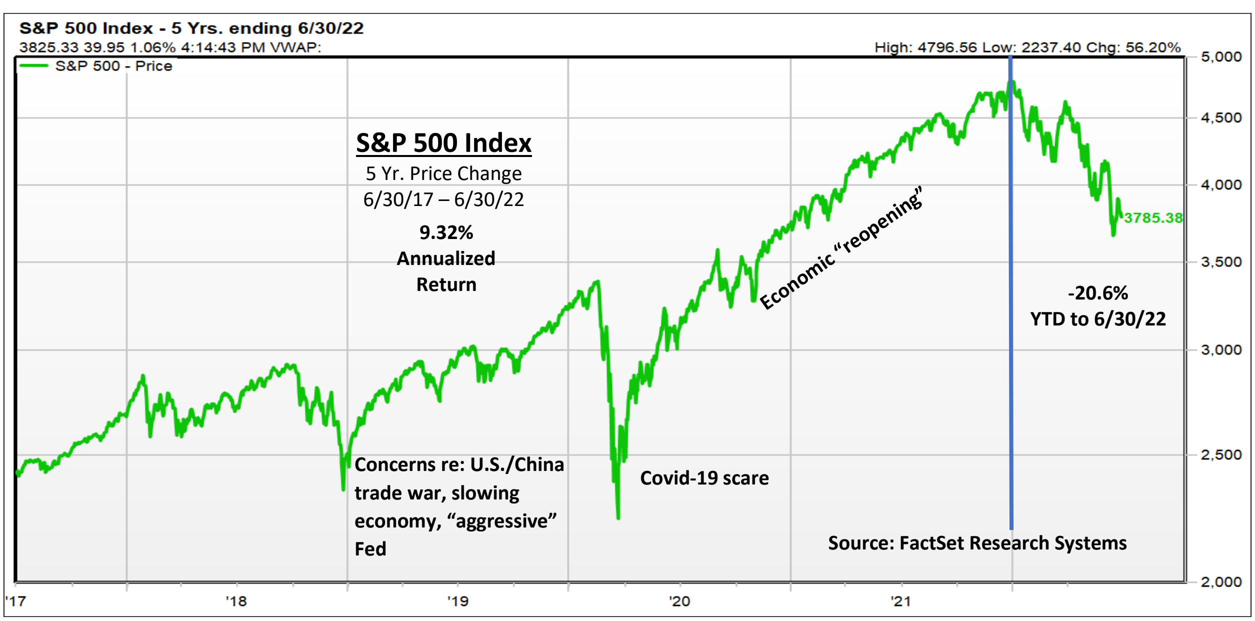




The charts, left and above, display significant changes in the annual rate of U.S. inflation (a), the current price of crude oil (b) and the yield on a U.S. 10- year Treasury note (c).

These factors, and others, can impact the health of our economy and the confidence investors and consumers have in the economy. The current uncertainty initiated the stock market volatility and weakness shown below.

We share our outlook in later pages.



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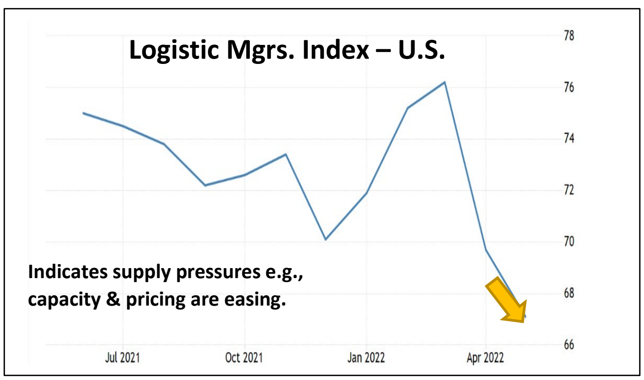
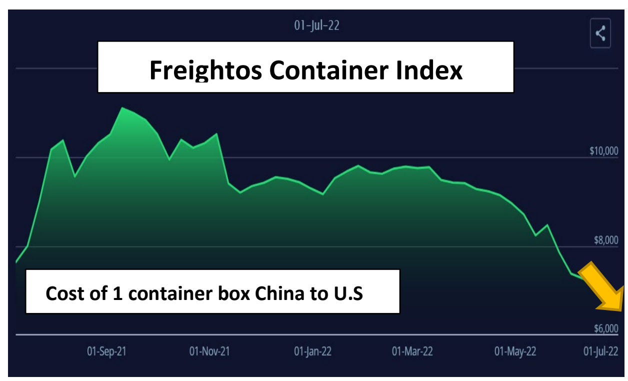
Recession?

With Consumer Sentiment near all-time lows, gasoline prices at all-time highs, no-more stimulus payments and slowing housing demand due to rising interest rates, a question now asked regularly is "will the U.S. experience a recession?" While the consensus is moving in that direction there are sufficient crosscurrents and opinions to further investor's uncertainty. Some economist/strategists (Deutsche Bank) believe a recession is inevitable (90%)[vi], the recession model at the New York Fed concludes the likelihood of recession is remote (4.1%)[vii]. The Atlanta Fed has a separate model that suggests otherwise (?) and Goldman Sachs puts the odds of a recession at 50%[viii].

Differing opinions regarding the possibility of a U.S. recession result from rapid changes in data releases and even statements coming from the Federal Reserve. Two weeks ago, the rationale for increasing the Fed Funds rate by three-quarters percent rather than one-half percent was "economic activity appears to have picked up." Since then, there have been numerous economic reports that suggest the economy is actually "softer" than anticipated not stronger. The recent declines in some important commodity prices, trucking and freight rates, unfilled orders, and delivery times, may allow the Fed to do some "jawboning," rather than raising rates significantly, until trends become more apparent. If the trend in softening prices continues, the possibility of a soft-landing increases. If not, a recession is on the horizon.



Source: Trading Economics



Source: Freightos Data

Our Thoughts

The threat of a recession has clearly accelerated. However, the slowing of some inflation factors may alter the Fed's hawkish actions. The combination of these events would reinvigorate consumer and investor sentiment, currently at very pessimistic levels, and lay the foundation for a stock market rally. If there is a time when a rally is due, it is certainly now. The most critical factor on the inflation front will be the price of oil and gasoline and how long they remain near record levels. At current levels they are eroding consumers' standard of living and negatively impacting their outlooks.

If the U.S. experiences a recession (2 quarters of negative GDP), which the Atlanta Fed's economic model suggests, we believe the recession should be mild and of short duration, but again, that will be dependent on relief from high energy prices.

Our view is based on a multitude of factors. The U.S. economy is far less dependent on manufacturing than it once was and thus the time required to shut down, lay off, rehire, and then restart is minimal. Employment is strong with two jobs available for every individual seeking employment. Capital spending will remain strong to "on-shore" critical manufacturing capabilities and the shortening of the supply-chain will enhance productivity to reduce longer-term employment pressures. Corporate finances are strong, and banks are well capitalized. We believe inflation has peaked and will continue to subside.

The other side of the more optimistic viewpoint is that inflation remains higher for longer, estimates for corporate earnings decline significantly, little progress is achieved on the geopolitical front, and a moderate recession becomes inflamed due to an unanticipated financial "breakdown." Further increases in energy prices and an even stronger U.S. dollar would also hurt the domestic economy. We do not anticipate such an environment and use all the resources at our disposal to monitor changes that suggest our outlook and strategy requires modification.

The stock market performance during the first six months of the year spared nothing and was one of the few times (8) since the end of World War II that the S&P 500 dropped by more than 20% in a two - quarter span[ix]. As you have heard many times, history is no guarantee of future performance, but it is common for stocks to rebound sharply following dramatic selloffs. As the quote above suggests, "in the midst of change, lies great opportunity." We agree and have taken action to increase investment in stocks of high-quality companies whose valuations have compressed sharply.

Compressed valuations (P/Es), exceptionally low investor and consumer sentiment, an anticipated decline in inflation, increasing corporate stock repurchases and dividends, set the stage for meaningful recovery in equity market values during the second half of 2022 if our assumptions are correct. Most important though is keeping a moderate/longer-term investment perspective. As we have described before, despite multiple recessions, periods of inflation or deflation, declared or undeclared wars, Democrat or Republican administrations, and market extremes e.g., both highs and lows, the compound annual return from stocks has been very consistent at near double-digit rates of return. We don't think that long-term consistency will change. Patience and discipline are paramount.

Last year we reduced equity holdings, on multiple occasions when their values rose to very elevated levels. Sales were initiated then to keep portfolios within asset category guidelines consistent with client objectives and risk tolerance. During the past six months we purchased stocks as prices fell for much the same reason. In addition, as inflation rose faster than initially projected this year, we restructured bond portfolios by selling longer maturity bond investments and replacing them with short-term floating rate investments to reduce volatility and benefit from rising interest rates.

As always, thank you for your confidence. We are constantly focused on a long-term investment perspective (taking actions today that will benefit one "tomorrow"), adhering to the philosophy and disciplines we have discussed with you, avoid reacting to extremes, and to maintaining high quality, well diversified portfolios.

We appreciate your confidence, and we highly value our relationship and friendship. We look forward to any comments, questions, or critique you have, and we look forward to seeing you again soon.

Please see the disclosures on the following page.

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[i] Barron's Magazine, 7/4/22
[ii] The Wall Street Journal, 7/1/2022
[iii] Bloomberg L.P., 7/1/2022
[iv] FactSet Research, 7/1/2022
[v] The Wall Street Journal, 7/2-3/2022
[vi] The Wall Street Journal, 7/1/2022
[vii] The Wall Street Journal, 7/1/2022
[viii] Goldman Sachs, Mid-year Outlook
[ix] Bespoke Investments, 7/1/2022