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Economic & Market Summary
July 2022

Economic growth softened in the first quarter with annualized real GDP shrinking 1.6%. Pandemic-driven distortions in inventory and weak net exports masked otherwise strong consumer spending. Spending has been good over the last few quarters, supported by massive government stimulus and an incredibly strong job market. While we expect GDP growth to be positive in the second quarter, early evidence of economic weakness is emerging. Retail has softened, home sales have slowed, and consumer confidence has plummeted. All of this can be traced back to inflation, especially in basic necessities such as food, energy, and housing.

The Federal Reserve has clearly been caught off guard by inflation and is now trying to catch up. The Fed is raising its target fed-funds rate at the fastest pace since the 1980s – the last time inflation was a serious problem. Each of the three rate increases this year has been larger than one before it. The recent 75bp increase came after the Fed indicated only a few weeks prior that such a sizable move wasn't being considered. Fed policymakers are now in the unenviable position of needing to subdue dangerously high inflation without disrupting the economy. Historically, sticking this "soft landing" has been very difficult which is why so many prognosticators fear that a recession is forthcoming.

While recession risks are elevated, an abundance of job opportunities and financially resilient consumers should cushion the economy in a downturn. It's difficult for businesses to find employees which is why there are two job openings for every available worker. In this environment, businesses have a lot of room to slow hiring before they need to cut staff, which should soften the inevitable rise in unemployment. Also, household debt to GDP is nowhere near levels seen before the 2008-2009 recession. And interest on that debt is a very low percentage of disposable income.

Stock and bond prices have been under pressure this year, reflecting rising interest rates and a possible downturn in the economy. After three strong years, the S&P 500 stock index is down about 20% year-to-date. Because interest rates are going up, bonds are a less effective hedge against stock market volatility. The 2022 first half return for the 10 year US Treasury note was about -12%. Stock valuations have fallen back to around "fair." The forward price-to-earnings (PE) ratio for the S&P 500 is about 16x – in-line with the 25 year average. But the PE is probably higher than it appears. Full year earnings estimates call for about 10% year-over-year growth which looks aspirational to us. We foresee high inflation, tightening financial conditions, and rising input costs curbing revenue growth and pressuring profit margins thus leading to lower earnings estimates.

Rising interest rates and declining earnings estimates will likely lead to more market volatility. However, high-quality stocks are still the best way to achieve long-term growth in our view. Even in a challenging macro environment, companies with durable competitive advantages and entrepreneurial management teams will be able to mitigate higher costs with higher prices and use elevated costs as a catalyst to streamline operations. Market disruptions, painful as they feel, are a normal part of long-term investing. The selloff has provided attractive buying opportunities for many companies on our Working List. Stock prices tend to begin recovering before "all clear" signals become evident which is why it's crucial to focus on quality and maintain a long-term perspective.

Mark J. Sprtel, CFA

If your financial situation has materially changed or you would like to discuss your accounts in detail, please contact your investment manager. To request our SEC Form ADV Part II, please contact Mark J. Sprtel, Chief Compliance Officer, at the address above.