LaFleur & Godfrey
PRIVATE WEALTH MANAGEMENT

Spring 2022 Commentary

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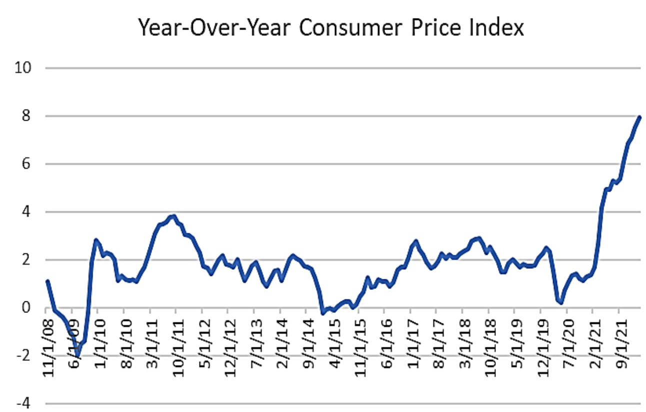
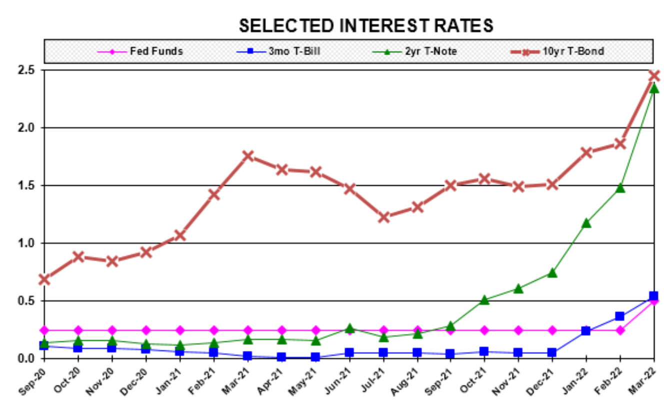
Light At The End Of The Tunnel?

Economic Perspective: Our economy is being negatively impacted by inflation. Pent-up demand post-COVID, ongoing global supply chain constraints and the Russian invasion of Ukraine (a new worry) have made inflation a persistent problem that our economy and markets are having a hard time trying to digest. As a result, the ‘s word’ (stagflation) has become commonplace in many Wall Street strategist’s morning research notes. The prospect of a stagnant economy with higher inflation presents a great challenge to policymakers in Washington D.C. The key question is: Will the U.S. economy experience a hard or soft landing?

The Russia-Ukraine geopolitical situation has stressed the already-challenged global supply chains. While the human impact dwarfs any economic impact, the conflict has resulted in considerably higher prices for food (grains & wheat), energy (oil & natural gas) as well as commodities (nickel, neon, etc.). It has made a challenging inflationary environment even worse. We are optimistic that the economic sanctions coming from NATO countries will increase pressure to de-escalate and/or negotiate a cease fire. This would be very well-received by the markets and it would help to bring down inflationary pressures & expectations to more reasonable levels.

So far, we have heard from management teams that demand has been solid and, for the most part, companies have been able to pass along higher raw materials and labor costs. Therefore, corporate profit margins have ‘weathered the storm’ and come in better-than-expected. While a lot of the recent demand has been from durable goods and inventory build, we see it moderating throughout the year. We anticipate a change in economic leadership as the year progresses from goods/inventory build/spend towards services spending. With our economy more levered to services than goods, the opening up of our economy post-COVID gives us hope that Fed Chair Powell can engineer a soft landing.





Market Perspective:

Historically, the Fed does not have a great track record fighting inflation (raising rates) without pushing the economy into a recession. What is different this time? First, our economy still has considerable momentum coming out of the pandemic. This could help stabilize / dilute the anticipated economic slowdown from rate hikes. Second, the market is anticipating a front-loading of interest rate hikes (0.50% hikes in May & June). As a result, the U.S. Treasury yield curve has already moved quite dramatically. For example, yields are already up over 1.00% year-to-date after only a small 0.25% rate hike in March! With some shorter-term maturities now yielding more than longer maturities, the yield flattening that has taken place could result in the Fed taking a wait-and-see approach. Third, Fed Chair Jerome Powell is very aware of the wealth effect and its impact on future consumer spending. Stock market weakness, combined with a moderation in housing prices (affordability is down with mortgage rates up 1.50% from just a year ago), will negatively impact consumer confidence. Because a strong consumer is necessary to keep us out of a recession, we see Powell being vigilant in supporting the consumer. Finally, there has been much written about Fed independence, but we believe that as we approach midterm elections in November, there will be political pressure from Washington D.C. to slow down the size and pace of rate hikes. With the current administration's approval ratings at lower levels, we are likely to hear more pro-growth rhetoric out of D.C. as we near election time.

Looking Ahead:

A decline in inflationary expectations (as well as actual inflation) is key to our constructive outlook for both the economy and the stock market. While the companies we own have done a very good job of managing higher costs and passing some of them along, it is important to remember that historically stock market valuations have had an inverse relationship with inflation. Therefore, a reversal and decline of the inflationary trend we are currently experiencing is necessary for the broad market to trade at a higher valuation (P/E: price-to-earnings ratio). Thankfully, as we enter the second half of the year, year-over-year inflation comparisons become easier. This will reduce some of the pressure on Powell to raise rates aggressively. We should also begin to see a deflationary impact from previous rate hikes. Our investment team is encouraged that recent projections from the Fed point to some optimism from the Federal Open Market Committee. In the Fed's March 16, 2022 SEP (Summary of Economic Projections), the FOMC now sees the median Core PCE Inflation reading to decline from a recent high of 7.9% to 4.1% by year-end 2022 and to 2.6% by year-end 2023. It will certainly be a bumpy ride. As always, we will be closely monitoring and making portfolio adjustments as necessary.