LaFleur & Godfrey
PRIVATE WEALTH MANAGEMENT

Summer 2022 Commentary

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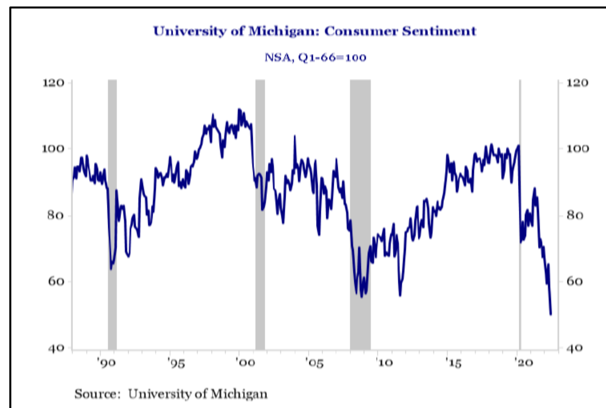
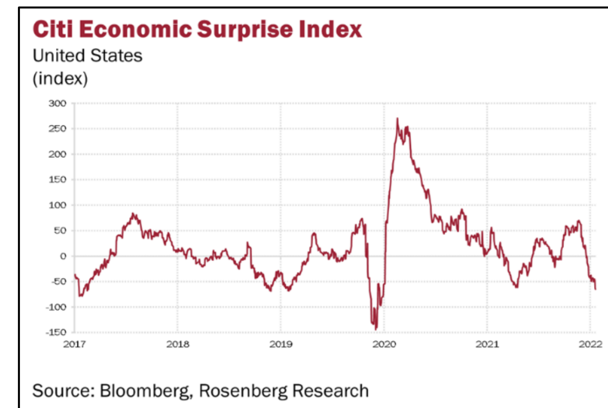
The Worst Start Since the 1930s!

Economic Perspective: Consumers have had enough. Inflation (led by food & energy) has surged. Housing seems to have 'rolled over' in many areas of the country due to mortgage rates running close to 6%. The stock market had its worst start to the year since the Great Depression. The bond market provided no relief with many bond indexes declining double digits. In short, there was nowhere to hide! It's no wonder that the University of Michigan Consumer Sentiment Index (see chart) has retreated from pre-pandemic highs around 100 to 58 recently. This puts sentiment near the previous Global Financial Crisis lows of 2007 – 2009 when the index hit 55! As a result, the economic data has softened, and the Citi Economic Surprise Index is flashing potential recessionary warning signals (see chart).





We often remind our clients economic cycles are to be expected. The good news is that expansions typically last many years and contractions (recessions) a few quarters. This time could prove to be no different. With fiscal spending likely to be reigned in post-midterm elections, the key will be how nimble Jerome Powell and the Fed can be in removing monetary policy accommodation. There is reason for economic optimism. First, the stock market has already priced in a recession. Why is this positive? A reset in investor expectations from exuberance & speculation to pessimism & conservatism is often necessary for the market to finish its bottoming process. Any economic outcome other/better than this is bullish. Second, we are seeing inflation peaking in several important areas. 40-foot shipping container rates from Shanghai to LA are down 38% from recent highs. Oil is now sub-$100 after peaking in the $130s. Copper just hit a 17-month low. Finally, wheat is now back to pre-Russia/Ukraine invasion levels. These data points suggest that year-over-year inflation data will moderate during the second half of 2022. Third, we expect wage pressure to abate. The gap between job demand (11 million available) and supply (5 million people looking for work) should close as the Powell-induced demand slowdown results in a more balanced jobs market. This remains incredibly important as wage data has historically been a key driver of sustained inflation. Net-net, economic imbalances should improve during the second half of 2022 which set us up for a much better economic backdrop come 2023.

Market Perspective:

You would think with all the doom-and-gloom economic news we are set up for a multi-year period of under performance and 'pain' in stocks. History suggests otherwise. We looked back to a similar inflationary period for stocks (1973 – 1981) to look for insight and test our 'glass half-full' market outlook. The nine-year period in the mid to late-70s experienced inflation averaging 9.0% (ranging from a low of 5.7% to a high of 13.5%). We were a little surprised to see that the S&P 500 Index posted POSITIVE RETURNS – up +5.3% on average! Even better, high-quality dividend-paying stocks returned +10.1%!! Importantly, we believe this bodes well for our clients as the vast majority of the companies we own in our strategies have solid, fortress-like balance sheets that also pay above-average dividends. Time and time again we have said that quality wins the race in the long run.

Trends in earnings and stock market valuations also matter. At the beginning of the year, earnings estimates for the S&P 500 stood at $220 per share. Surprisingly, at the midway point of 2022, they currently stand at $228. Therefore, the ENTIRE DROP in the stock market this year is due to P/E multiple / valuation compression! The market's valuation has dropped from over 22 times earnings to approximately 16 times earnings – matching the broader market's decline of 25-30%. We are hopeful that the market has already 'discounted' even the worst-case economic scenario(s). The key will be whether companies will be able raise prices to pass along higher costs & cut other expenses to maintain solid profit margins during the second half. If not, we expect 2023 earnings estimates to come down and likely stocks with them. This is not our 'base case' but it is certainly on our radar as an underlying market risk for the remainder of the year.

Looking Ahead:

The bond market has long been a key stock market barometer. The trend in rates, as well as the slope of the yield curve, are important signals for economic forecasters as well as stock market investors. Our investment committee is encouraged by the recent change in trend of U.S. Treasury yields. After hitting highs near 3.5% late-Spring, the 10-year U.S. Treasury yield has retreated to near 2.85%. The 2-year note has declined from 3.1% to near 2.80% today. These are substantial moves! The decline in rates and the 'flattening of the curve' tell us a few things: 1.) The safe haven status of U.S. Treasuries remains intact. This correlation had broken down during the first half of the year, 2.) The bond market believes inflation may have peaked & a repeat of the 1970s and its double-digit rates is likely off the table & 3.) Our economy is currently teetering on the brink of recession. Typically, the yield curve is less flat and upward sloping. The current flatness urges economic caution.

Fed Chair Powell is very aware of the above-mentioned risks. We are confident that the Fed will become more 'data dependent' as the year goes on and take a wait-and-see approach with the frequency & magnitude of future rate hikes. Flexible monetary policy increases the odds that any recession will be short-lived which in turn keeps us constructive on the stock market. The last thing the Fed Chair wants is to become the scapegoat that drives our economy into a sustained decline. His Fed predecessor Ben Bernanke once said: "Economic expansions don't just experience a natural death. They are murdered (by the Fed)". If history is any guide, current Federal Open Market Committee members will heed his advice and the 'Fed put' will remain in play. As a result, we expect a gradually improving economy during the second half and a much better investing climate in 2023.

Please do not hesitate to reach out to us to discuss your portfolio. We welcome your thoughts and comments. Finally, be on the lookout in your email for the investment committee's most recent video commentary. Thank you for your continued confidence!

This document contains forward-looking statements, predictions, and forecasts ("forward-looking statements") concerning our beliefs and opinions in respect of the future. Forward-looking statements necessarily involve risks and uncertainties, and undue reliance should not be placed on them. There can be no assurance that forward-looking statements will prove to be accurate, and actual results and future events could differ materially from those anticipated in such statements.