SPECTRUM
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Say It Again SAM

A QUARTERLY REPORT ON ECONOMIC VIEWPOINTS AND INVESTMENT STRATEGY

THE END OF THE BEGINNING

There is no scarcity of reasons for markets to be concerned about the investment backdrop. Inflation has risen at its fastest pace in four decades, major central banks have started to hike interest rates at a time of elevated uncertainty, global supply-chain problems persist, and the Russia-Ukraine war has upended commodity markets. In addition, we have also experienced a lengthy period of historical excess. As the tides come in, so do they go out.

> *"WITHOUT PRICE STABILITY, THE ECONOMY DOESN'T WORK FOR ANYBODY."*
>
> **- FED CHAIRMAN, JEROME POWELL**

Financial conditions have been tightening as the war in Ukraine has become more entrenched and the Chinese "zero-Covid" response remains a challenge for global supply chains. Surging prices are a threat to both corporate profit margins and consumers' purchasing power. In response to this uncertainty, both stock and bond markets have seen seismic changes in valuations.

In stark contrast to robust growth of 6.9% in 4Q22, US gross domestic product (GDP) growth decreased at a -1.6% annualized rate in 1Q22. This marked the first decline since the Covid lockdowns in 2Q20. While the lessor important 'trade' and 'inventory' components were largely responsible for the negative figure, the trend in consumer spending (which makes up the lion's share of the US economy) decelerated, and sentiment deteriorated further in the second quarter.

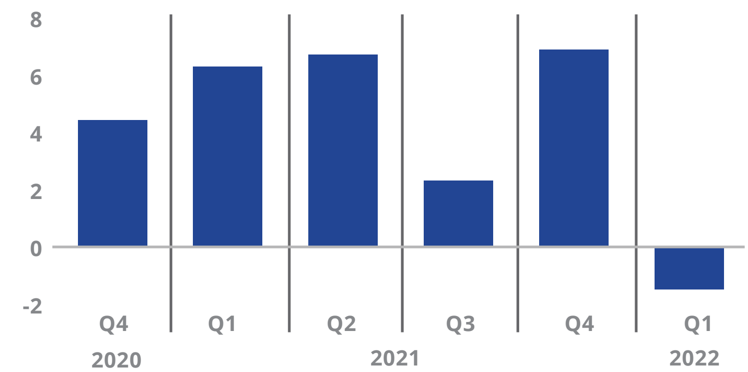
With aggregate demand essentially recovered from the Covid Crisis by late spring 2021, it would have been prudent for the Fed to begin normalizing monetary policy. Instead, the Fed continued with crisis-based policies. At the same time, unprecedented fiscal spending continued, and rising demand came up against constrained supply.

Now the Fed is setting out to reduce inflation by about 4%, without significantly raising unemployment. Fed officials think it is possible with calibrated interest-rate increases to slow demand just enough to take the steam out of an overheated economy. However, over the past 80 years, the Fed has never lowered inflation as much without causing a recession.

Admittedly, Fed Charmain Powell said during May's meeting, "tools don't really work on supply shocks, [they] work on demand." The problem is that the economy does not appear to need "the steam taken out of it." At June's end, the Atlanta Fed's estimate of real GDP growth for 2Q22 was a contraction of -1.0%. Several other economists also forecast a second straight quarterly contraction.

As the risk of recession has continued to rise, both bonds and equities have produced negative returns year-to-date. Not only is this an exceedingly rare occurrence throughout history, but the magnitude of recent bond declines in the midst of stock market volatility simply has not happened - ever. For recent reference, the table on page two shows the fifteen largest stock market downturns of the last 60 years, and the corresponding performance of bonds for each period.

REAL GDP: PERCENT CHANGE FROM PREVIOUS QUARTER



Source: U.S. Bureau of Economic Analysis

Global bond yields remain schizophrenic as investors wrestle with expectations for a stalling economy, rising short term interest rates and persistent inflation all at the same time. Currently, the signals are mixed. The 10-year, 2-year Treasury yield spread, which is a regularly watched recession indicator, is barely still in positive territory. The alternate 10-year, 3-month spread, which some consider a better predictor, is decidedly in positive territory at around 1.3%. Several points along the Treasury curve have inverted, which implies investors may have begun to think about rate cuts down the road instead of near-term hikes.

For now, the Fed funds rate is poised to increase to 3.00% in 2022, and the central bank's balance sheet will eventually run off at a rate of nearly $100 billion a month. These actions are positives in the sense that they

15 LARGEST MARKET DOWNTURNS
AND BOND PERFORMANCE OVER THE PAST 60 YEARS

	FROM	TO	DEPTH	BOND PERF.
1	2007-10-10	2012-04-02	-55.25%	52.94%
2	2000-09-05	2006-10-23	-47.41%	48.76%
3	1973-01-12	1976-07-09	-44.80%	12.80%
4	2020-02-20	2020-08-10	-33.79%	17.12%
5	1987-08-26	1989-05-15	-32.93%	15.90%
6	1968-12-02	1971-03-15	-32.58%	9.51%
7	1961-12-13	1963-04-15	-26.88%	8.06%
8	2022-01-04		-22.99%	-18.95%
9	1966-02-10	1967-03-23	-20.21%	7.62%
10	1980-12-01	1982-10-07	-20.16%	39.41%
11	2018-09-21	2019-04-12	-19.36%	6.39%
12	1998-07-20	1998-11-23	-19.19%	6.07%
13	1990-07-17	1991-02-11	-19.18%	10.12%
14	1980-02-14	1980-06-18	-16.71%	24.19%
15	1977-01-03	1978-06-06	-14.40%	-1.54%

Source: @leadlagreport

bring monetary conditions more in line with long-term averages, but there is increasing evidence that liquidity will be drained as a slowdown in both domestic and global economies is worsening.

Manufacturing data in the U.S. still appears relatively healthy for now, but companies have been voicing concerns about lead times and the ability to cost-effectively acquire materials and other inputs. The services side of the economy is also reasonably stable, but wage pressures will likely grow, and discretionary spending may decline heading into the second half of the year.

Recessions have never been a matter of "if" but simply a matter of "when." Financial media often portray recession as a catastrophe, but the reality is every economic cycle will end in a recession, allowing excesses to be wrung out and making way for the start of a new cycle.

ECONOMIC VIEWPOINT

In June's Fed meeting, the committee raised the Fed funds rate by 0.75% and confirmed the implementation of its balance sheet reduction plan. After three hikes so far this year, the Fed funds rate currently stands at 1.75%, and the bond market expects the rate to top out around 3.25 – 3.5% in the coming quarters.

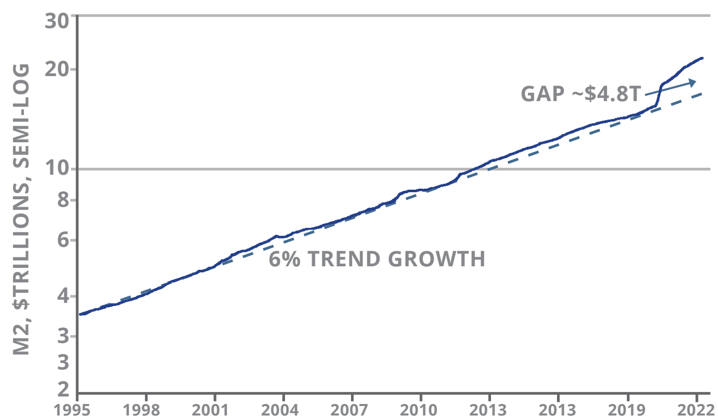
To reduce its balance sheet, the Fed will primarily choose to not reinvest capital from maturing securities rather than outright selling securities it holds. Any sales of the Fed's holdings should be small enough to be digested by the bond market. All told, the Fed is still far from taking aggressive steps to curtail the money supply (M2).

The growth of the M2 money supply registered double-digit rates for the past two years. This is without precedent in US history. For reference, M2 growth averaged about 6% a year from 1995 through early 2020.

M2 growth has slowed to an 8% annual rate over the past six months, and a 6.2% rate over the past three months. While growth rates are back to "normal," it is the cumulative growth of M2 (40% higher than 2020) that remains the fuel for persistent inflation.

The chart below shows the level of M2 plotted against its 6% per annum long-term trend rate of growth. M2 is now about $4.8 trillion larger than it would have been with a continuation of 6% annual growth. Said differently, today M2 is running about 28% above trend, which equates to more than four years of normal growth.

M2 GROWTH OVER TIME



Source: Federal Reserve; as of 3/22

This is a key component of why inflation has far surpassed expectations this past year, and today many believe inflation would continue to run rampant without Fed action. However, it may be time to prepare for the idea that deflation could be coming faster than most are anticipating. Commodities have been a key driver of the current inflation cycle, but prices have already declined in energy, agriculture, and metals. Wheat is down around 27% from May's peak. Corn is off by 14%, natural gas has fallen by 30%, and copper is down about 20%. These declines will still take some time to be reflected in the final prices of goods at grocery stores and at the pump, but it certainly appears prices may have peaked.

In addition, retail inventories have unexpectedly ballooned. There have even been anecdotes of Target stores letting customers keep their returns instead of restocking item. It is primarily inflation in the price of services that will continue to rise.

The headline inflation numbers over the coming quarter will be meaningful. If a significant decline is observed, a potentially big drop in bond yields could occur, ushering in a strong rally in fixed income. Should inflation retreat, absent a deep recession, then stocks too will rally.

The National Bureau of Economic Research (NBER) officially defines a recession as, "a significant decline in economic activity that is spread across the economy and that lasts more than a few months." The NBER looks at the trends of four primary components to determine whether the US is in a recession: real personal income, nonfarm payroll employment, wholesale and retail sales, and industrial production. Currently employment and industrial production have been resilient, while real income and consumption have slowed.

Consumers are estimated to have boosted their spending by 0.4% in May, a slowdown from the 0.9% increase in April. Economists estimate personal income to have grown by 0.4% over the quarter. Adjusted for inflation, after-tax income is flat at best, showing that wage increases have been struggling to keep up with price rises. As a result, the household savings rate is declining as consumers are dipping into savings to maintain spending habits.

The Establishment Survey's Nonfarm payrolls showed an increase of 390,000 jobs after twelve consecutive months of better than +400,000 for payrolls. Importantly, though, even averaging better than 400,000 per month for over a year, an unprecedented dislocation between the supply and demand of labor remains.

JOB OPENINGS VS. UNEMPLOYED PERSONS

Source: U.S. Bureau of Labor Statistics

There are now approximately two job openings for every unemployed person (who is looking for a job). The Establishment Survey for last month still shows total payrolls are 800,000 fewer than recorded in February 2020, now twenty-seven months in the past. Including an estimated 5 million jobs that would have been created in line with long-term trends (and realistically should have in a true recovery), the true labor situation is roughly short of six million workers. In fact, the current labor force participation rate at 62.3% remains slightly below the post-Great Financial Crisis low of 62.4%.

INVESTMENT STRATEGY

As uncertainty around the Russian invasion, elevated inflation readings, and Fed action has taken hold, broad market volatility has pushed the S&P 500 and NASDAQ into bear market territory.

By the time the S&P 500 had peaked in early January, it had practically doubled from the March 2020 low. However, about 70% of that ascent was attributed to P/E multiple expansion and only 30% was due to earnings growth. In other words, the rise in the price of the index was extreme relative to the growth of underlying profits.

Since then, speculation has been rapidly unwinding. Far from the heyday of "stay at home," cloud, big tech and "FAANG," many of the most extreme valuations have declined 50-70%.

It is telling that an established mega cap name like Netflix can suffer a dramatic -30% in a single day! Currently the stock is down -70% from its all-time high in just seven months.

The lesson learned from history is that no stock is immune from punishing valuation resets no matter how good the story sounds. And when liquidity leaves the market, the highest valuations have farthest to fall.

At the beginning of the downturn, the most speculative, highest valuation and weakest names crumbled (i.e., meme stocks, exotic crypto, SPACs). Then the highest-octane new economy stocks got hit (Zoom, Peloton, Robinhood, etc.). Not everyone felt the rout would extend to established mainstream growth stocks.

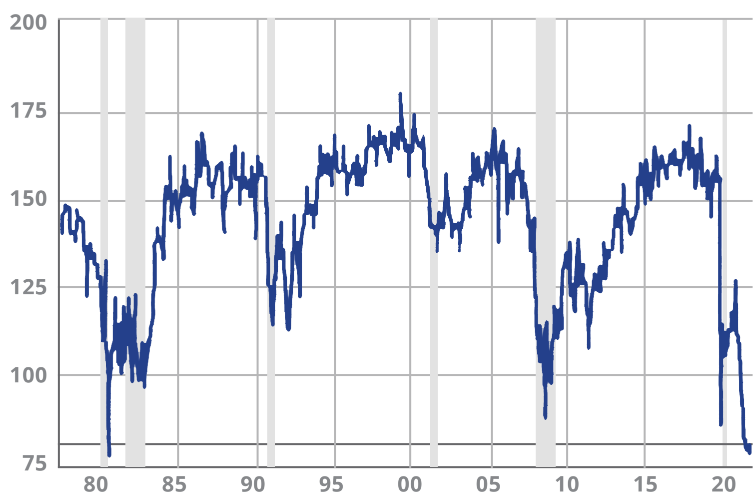
The "Big 5" [Apple, Microsoft, Alphabet, Amazon, and Tesla] were collectively down almost 20% in April – their worst month as a group ever. For the NASDAQ 100, there have only been three periods with worse readings: The Dotcom bust around 2000, the Great Financial Crisis around 2008, and the US debt downgrade in 2011.

Courtesy of strong 1Q22 earnings growth, and stock market weakness during the first half of the year, the S&P 500's valuation has declined more than 35% from its recent peak. That ranks among the largest drawdowns in valuation since the 1950s, and its valuation now sits slightly lower than 40-year averages. The good news is valuations have been reset, and a vast amount of froth has been removed.

Expectations are calling for earnings deceleration ahead as profit margins are squeezed by rising input costs. However, future stock returns tend to be good following large valuation drawdowns. That is a healthy and necessary part of the investing cycle. Investors allocating to stocks at current levels have the potential for better returns over a medium to long-term horizon.

The cure for inflation might just be inflation itself. Costs have risen to the point where they are negatively affecting demand. The University of Michigan's gauge of consumer sentiment reached a final reading of 50 in June. That is the lowest reading on record going back to 1952. Similarly, the National Federation of Independent Business (NFIB) 6-month business outlook also has dropped to its lowest level in its 48-year history.

CURRENT BUYING CONDITIONS FOR LARGE HOUSEHOLD GOODS (INDEX)



Source: Haver Analytics, Rosenberg Research

Inflation has pushed longer-term rates higher, and those higher rates are starting to bite. The national 30-year fixed mortgage rate averaged 5.9% in late June; a level not seen since 2008. The speed at which mortgage rates

"Stocks were bipolar today as delirious euphoria gave way to abject despair and back again."

went from 3% in January to 6% in June is astonishing. Mortgage applications have since dropped to a 22-year low, cooling housing related areas of the economy.

The Fed is no longer the stock market's friend, but while short-term interest rates remain below the rate of inflation, the economic incentive remains to borrow and spend (or invest). Fed policy has transitioned, but it is a long way from tightening. The question is whether the current headwinds fade away in the latter part of the year or if their impact persists.

Over the past 100 years, there have been eighteen bear markets (about every 4-6 years). About one-third have been "Grizzly" bear markets with losses exceeding -40% or more. Nobody can predict how far bear markets will go, but the beginning of the current one is behind us. Experience suggests that navigation from here requires patience, discipline, and anticipation rather than reaction. We will continue to look for opportunities beyond the current challenges.

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