Last year at this time the debate was whether or not inflation was going to be transitory or sustained. Unfortunately, we know the answer to that all too well and it is the reason the Federal Reserve (Fed) has embarked on its most aggressive monetary tightening campaign since the early 1990's. Indeed, the Fed's ambiguously transparent monetary policy response to combat inflation, along with other headline risks, elevated uncertainty and sent stock markets into further turmoil and bear market territory. For the quarter, stock markets were routed in April, flat to slightly up in May, and crushed in June. For the S&P 500, this was the worst first-half of the year since 1970. All the indices listed in Table 1 are in bear market territory except the Dow Jones. A bear market is a decline => -20% from its most recent peak.

Table 1 – Stock Index Total Returns – June 30, 2022

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Dow Jones Industrial	-6.56	-10.78	-14.44	-9.05	7.24	9.98	11.70
MSCI Emerging	-6.64	-11.45	-17.63	-25.28	0.57	2.18	3.06
S&P 400	-9.62	-15.42	-19.54	-14.64	6.87	7.02	10.90
MSCI Developed	-9.28	-14.51	-19.57	-17.77	1.07	2.20	5.40
S&P 500	-8.25	-16.10	-19.96	-10.62	10.60	11.31	12.96
Russell 2000	-8.22	-17.20	-23.43	-25.20	4.21	5.17	9.35
NASDAQ	-8.65	-22.28	-29.23	-23.43	12.18	13.47	15.40

Now the debate focus has shifted to if the Fed will be able to corral inflation without pushing the economy into recession. With supply challenges independent of Fed control, the main task at hand is to lower robust demand. The Fed along with the Biden administration and some economists contend the economy is strong enough to endure the rate hikes without moving into recession. Other economists and market analysts believe the Fed is too far behind the inflation curve and will be forced to push short-term rates higher and for longer than previously anticipated leading to a recession.

There is no question that as the Fed embarks on fulfilling its price stability mandate it does so from a position of strength as consumer and business balance sheets are solid, demand remains strong, and in many respects, the labor market is one of the strongest in history. Table 2 below outlines the change of various U.S. labor measures from February 2020 to May 2022 and shows most measures are almost back to their pre-COVID levels with the exception of those Not in The Labor Force or "lost workers".

Table 2 – U.S. Labor Market Analysis

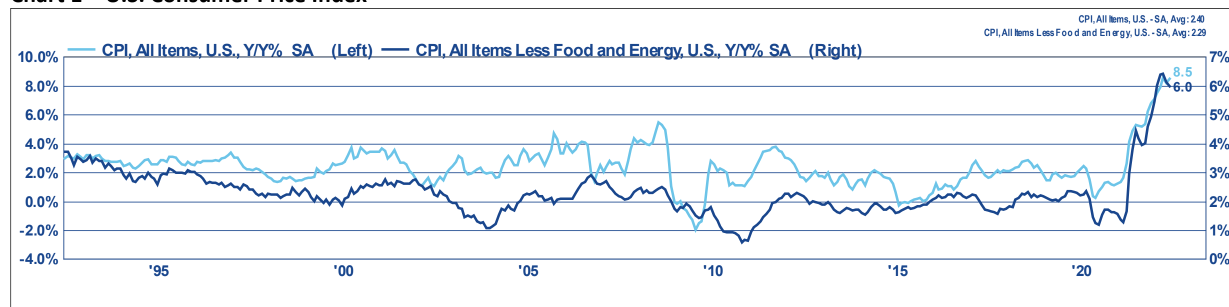
Month	# In Labor Force (Mil)	# Employed (Mil)	# Unemployed (Mil)	Unemployment Rate %	Participation Rate %	# Not in Labor Force (Mil)
Feb 2020	164.6	158.9	5.7	3.5	63.4	95.0
Aug 2020	160.7	147.2	13.5	8.4	61.7	99.9
Feb 2021	160.4	150.4	10.0	6.2	61.5	100.6
Aug 2021	161.5	153.2	8.3	5.2	61.7	100.1
Feb 2022	164.0	157.2	6.3	3.8	62.2	99.3
May 2022	164.4	158.4	6.0	3.6	62.3	99.3

A recent essay by Federal Reserve Bank of St. Louis Economist Miquel Faria-e-Castro postulates the majority of the lost workers are due to accelerated COVID related retirements, that most of the losses are permanent, and the lost worker gap is much smaller than 4.3 million. The essay noted, "a significant number of people who had not planned to retire in 2020 may have retired anyway because of the dangers to their health or due to rising asset values (housing & stock market) that made retirement feasible." Essentially, there is little to no slack, or gap, in the labor force.

Other labor measures and surveys show labor strength as well. Over the past twelve months, monthly hourly wage gains have averaged +5.0%; businesses continue to struggle to hire workers; the April JOLT report showed the number of vacant or unfilled jobs at 11.4 million, or for every unemployed worker there are 1.9 jobs available; and over the last 12 months, monthly non-farm payroll gains have averaged 545,000. In this very tight labor market, the demand for workers, or lack thereof, has forced employers to raise wages in order to keep and attract workers, which is aiding higher inflation.

The Consumer Price Index (CPI) in May posted a 12-month ending reading of +8.6%, its highest level since December 1981. Even with starting from a position of strength, the Fed acknowledges tackling inflation is going to be challenging. During Congressional testimony in June, Fed Chair Powell acquiesced telling lawmakers “The Fed does not want a recession, but it is pursuing the kind of rate increases that could cause one.” This surprise reading supports those economists who contend the Fed has been behind the inflation curve.

Chart 1 – U.S. Consumer Price Index



Heading into the June FOMC meeting provides the latest example of the Fed being behind the inflation curve. At May’s FOMC meeting Fed Chair Powell communicated that a 0.75% rate hike was off the table. Subsequently, most Fed Governor speeches reiterated the same mantra. On June 10th, the higher-than-expected May CPI number was posted. Then, a couple of days later the Fed leaked it was considering a 0.75% hike and did so the next day. For an institution so hellbent on transparency, their actions are often opaque. No wonder the bond market has been in the dark on how Fed policy is going to evolve. Bond yields were crushed with the May CPI release pushing bond returns sharply lower.

Table 3 – Bond Index Total Returns – June 30, 2022

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Barclays Municipal 5-Year	-0.31	-0.42	-5.50	-5.34	0.15	1.17	1.62
Barclays Inter Gov't/Credit	-1.11	-2.37	-6.77	-7.28	-0.16	1.13	1.45
Barclays Municipal	-1.64	-2.94	-8.98	-8.57	-0.18	1.51	2.38
Barclays Michigan Muni	-1.57	-3.37	-9.28	-8.87	-0.12	1.70	4.66
Barclays Aggregate	-1.57	-4.69	-10.35	-10.29	-0.93	0.88	1.54
Barclays High Yield	-6.73	-9.83	-14.19	-12.81	0.21	2.10	4.47

For the quarter, the 2-year note rose from 2.29% to 2.93% and the 10-year treasury from 2.32% to 2.93%. Bond credit spreads widened significantly as well and are now trading at levels above their historical averages making it more attractive to assume credit risk. High yields spreads went from 365 bps to 587 bps. As we wrote last quarter, the bond market is struggling to figure out how high the Fed must raise rates to curb inflation. For the next few months, bond market volatility is going to be high with each monthly CPI release date. We continue to expect interest rates to trend higher.

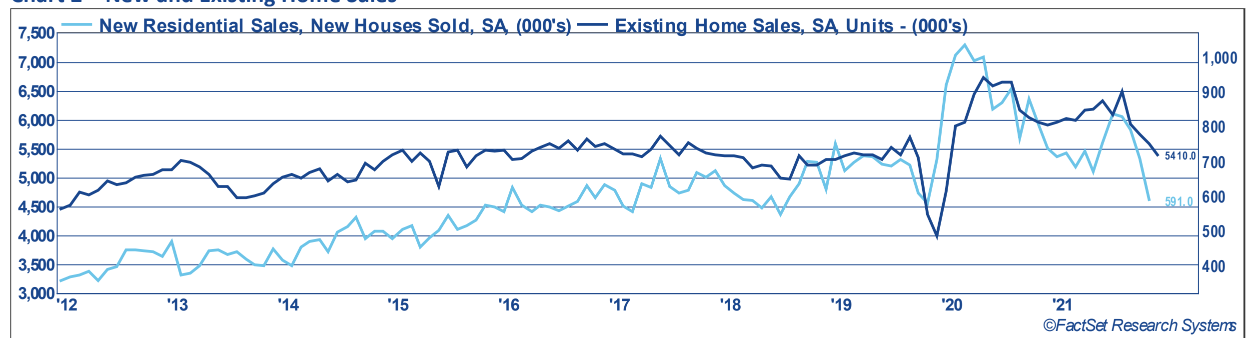
One thing the bond market is sure of is that the economy is going to be slowing down. The yield curve briefly inverted again last quarter and remains flat. Historically, a flat or inverted yield curve has been a reliable predictor of economic weakness or recession, respectively. GDP Now, a model by The Atlanta Federal Reserve Bank, estimates a -1.0% decline for second-quarter GDP. If this holds true, the U.S. economy would be in a recession for first-quarter GDP shrank -1.8%. At the June FOMC meeting, the Fed updated their year-end 2022 economic projections. They raised the inflation outlook, increased the unemployment rate estimate, raised the short-term rate outlook, and lowered forecasted economic growth. Wait a minute, isn't this the definition of Stagflation? There are already signs of stress cracks in the economy.

Several major retailers have warned of increasing inventories, shifting consumer spending habits, and lower earnings growth. U.S. retail sales in May declined -0.3% with most categories posting declines except gasoline and food & beverage sales, which increased +4.0% and +1.2% respectively. Makes sense given the average price for a gallon of gas reached a new all-time high almost daily for a month and that food prices are up 10.1% from one-year ago. Household budgets are being stretched thin as more dollars go towards food and energy and less towards discretionary items.

According to ISM surveys, manufacturing and service activity readings remain in expansion territory, but the rate of expansion began trending slower last fall. These surveys ran above 60 for all of the prime pandemic period from late 2020 through 2021. For May, manufacturing posted a level of 56.1% while service posted a level of 55.9%. Readings above 50 are considered expansionary and below 50 contractionary. Supply bottleneck, shortages of labor, and higher costs continue to plague companies.

Housing is another area that looks to be weakening. Headwinds are forming as the combination of rising mortgage rates and strong home price gains are cooling off home sales. Existing and new home sales have been posting monthly and year-over-year declines for a bit now and inventories are starting to rise as well, albeit from historically low levels. Like sales, we expect home price growth rates to follow suit and begin to decelerate from very elevated levels in the coming months. Storm clouds are brewing for housing, but we do not expect a tornado.

Chart 2 – New and Existing Home Sales



Overall confidence is taking a hit as well. Surveys related to small business optimism, home builder confidence, and consumer confidence all fell again in May/June. The Conference Board's Consumer Confidence Index dropped to 98.7 in June, its lowest level since February 2021. The University of Michigan's June reading of U.S. Consumer Sentiment came in at the lowest level ever recorded at 50.0. It also showed consumer long-term inflation expectations rose to 3.1%, the highest level since 2008. This inflation expectation did not go unnoticed by the Fed either.

During the June FOMC press conference, Chair Powell was asked what drove their sudden change in rate expectations from 0.50% to 0.75%. Chair Powell alluded to the most recent CPI data but also highlighted the rise in longer-term inflation expectations from the U-of-M Consumer Sentiment survey and the Fed's own Index of Common Inflation Expectations. The Fed noted the Michigan reading was "eye catching" and that "we're absolutely determined to keep them (long-term inflation expectations) anchored at 2 percent." Short-term expectations for inflation are already high and the last thing the Fed wants is for longer-term inflation expectations to rise as well, for it potentially becomes a self-fulfilling prophecy.

Sticking with the Fed, one of the over-arching themes from the June FOMC press conference was the posturing, or admission, from Chair Powell on their ability to control inflation. Numerous times throughout the press conference he noted there were many factors affecting inflation outside of their control including the Ukraine war, energy production, supply chain challenges, and COVID mandates (China). What the Fed can control is demand, and if the other factors that are independent of their control continue to drive inflation, then it is likely the Fed will need to take more aggressive rate measures to restore price stability.

The Fed's primary goal now is to bring inflation under control even if it means pushing the economy into recession. They will continue to raise rates until they see concrete evidence that demand is moderating, and inflationary pressures are abating. Higher inflation and interest rates are going to restrain consumer and business demand, raise the unemployment rate, lower profitability, and push the economy into recession. Next year at this time the debate will be whether the recession is going to be mild or more severe. Given the strength of the labor market and overall solid financial condition of consumers and businesses, we lean toward a milder recession.

For over a year now our tactical strategy has been defensive for both stocks and bonds. For stocks, we employed a moderate underweight due to stretched valuations and rebalanced into market strength. For bonds, duration was shortened to limit interest rate risk as we expected interest rates to rise. We continue to employ a defensive strategy, but this is likely to change as risk premiums are at much more appealing levels to assume risk. Stock valuations have compressed considerably, and bond credit spreads have widened significantly.

Fed monetary policy is the fuel that sets the stock market on fire or the water that douses it. Right now, the water spigot is wide open and anticipate the market to trade sideways to down near-term. Once there are signs the spigot may be closing, we will employ more aggressive investment strategies and start rebalancing into market weakness.

Prepared by Perry Adams – SVP & Director – West Shore Bank Wealth Management – July 5, 2022

Sources: FactSet, The Federal Reserve, U.S. Department of Labor, U.S. Bureau of Economic Analysis, St. Louis Fed Bank, Atlanta Fed Bank, The Conference Board, ISM, U.S. Department of Commerce, National Association of Realtors, & University of Michigan

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