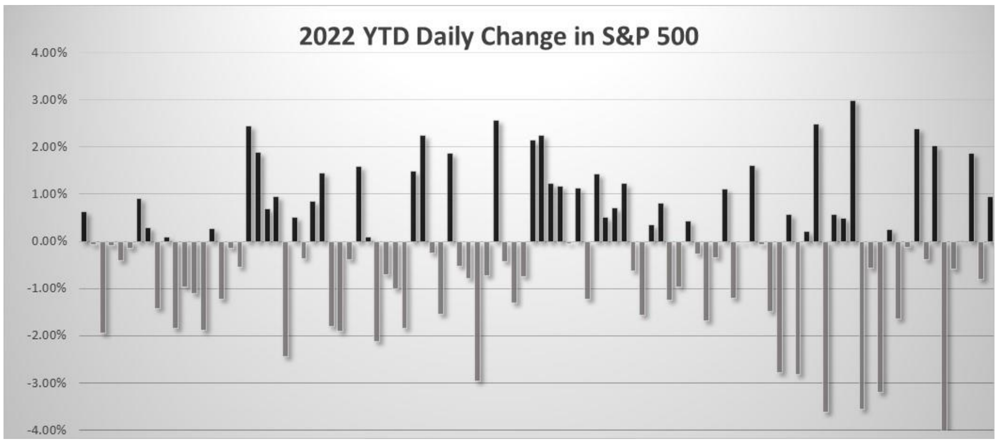
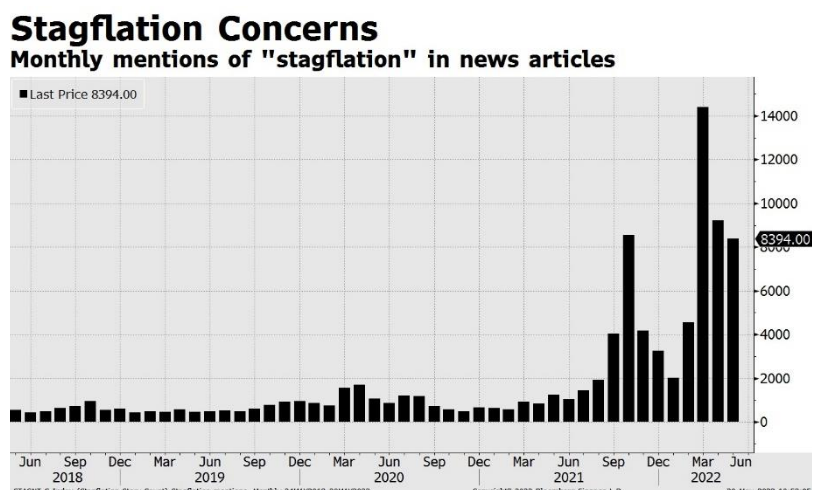
Courier Capital, LLC
Registered Investment Adviser
An affiliate of Five Star Bank

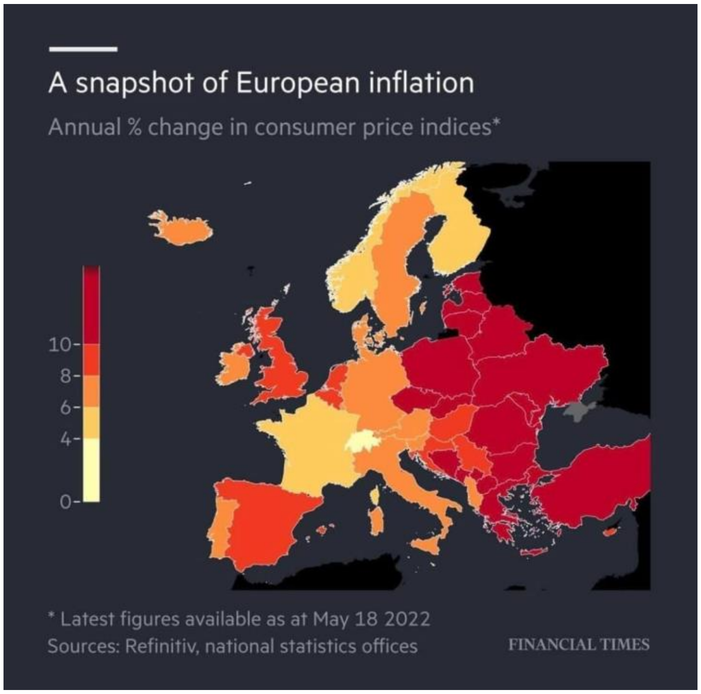
Economic and Market Update – WALKING A TIGHTROPE (05/31/2022)

Latest Developments and Economics

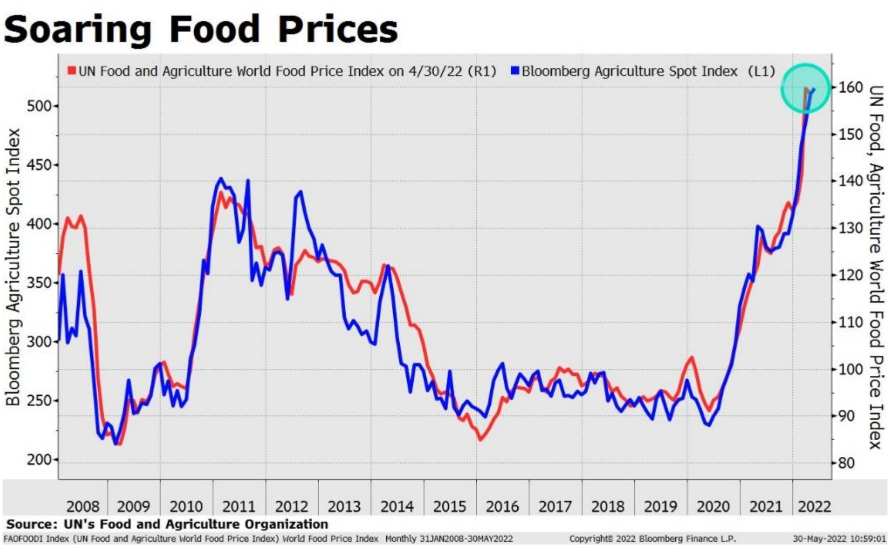


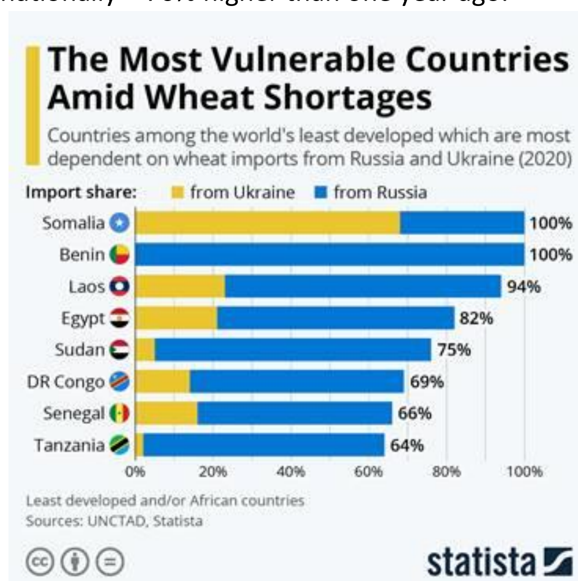
The recent volatility in equity markets is reflective of the near-term uncertainty currently facing the U.S. and global economy. The U.S. economy may take one of three potential broad paths in the near-term and they have caused the financial markets to wobble in trying to keep its balance. The YTD daily changes in the market have included many moves of 2% or more - both positive and negative in 2022. The tightrope walker that we see holding the balancing rod looks to be Federal Reserve chairman Jerome Powell. The economic signals this summer will help to determine which of three camps looks most plausible. The first is a 'soft landing' where the Fed successfully navigates the economy towards lower inflation without tipping into a recession – the ultimate example of walking a tightrope. This includes raising rates just enough to cool demand more in line with an equilibrium of supply. The problem is that there is a lag effect with rate increases impacting the economy and no one really knows where the tipping point exists. The second state is a recession where we would see unemployment tick up and consumer spending pull back for some period which would generate negative GDP growth. Finally, there has been talk of 'Stagflation' – persistent high inflation coupled with low economic growth. This was last seen in the late 1970's and currently conditions do not exist that points to the low growth for longer that defines stagflation. There are plenty of jobs available in the U.S. currently (in fact more than workers who are seeking) and jobless claims are at historically low levels (and well below pre-COVID). One thing common among all three paths is slower economic growth – it is just a matter of depth and length. So, what are some of the signals that may give a clue as to which of the potential states we may enter?





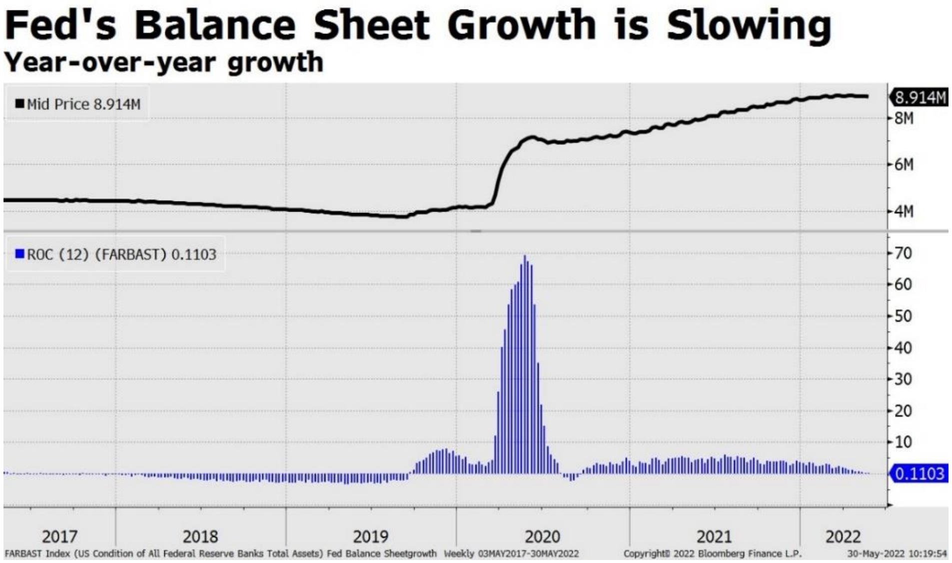
The balancing act that is in play right now is between economic growth and inflation. This is where we must look in order to see what path deserves the highest odds going forward. Of the two inflation is the main driver. As inflation has been increasing it is eroding consumer confidence, reducing corporate profitability and causing the Federal Reserve to take an aggressive stance. Inflation has not only been high in the U.S. but globally as well. The U.S. inflation of over 8% was matched by the Eurozone which came in with a latest year-over-year reading of 8.1% - although, as illustrated in the graph, is spread unevenly throughout the different countries. Inflation is coming from many sources and has a domino effect. Energy – especially oil – has been one of the primary drivers of inflation. This not only impacts consumers directly through fueling their autos and heating their homes but also indirectly. Some of the inflation we see in food and other goods is due to the transportation costs of getting the goods where they are sold. This is especially true for diesel which is required for semi-trailers and is over $5.50 a gallon nationally – 70% higher than one year ago.





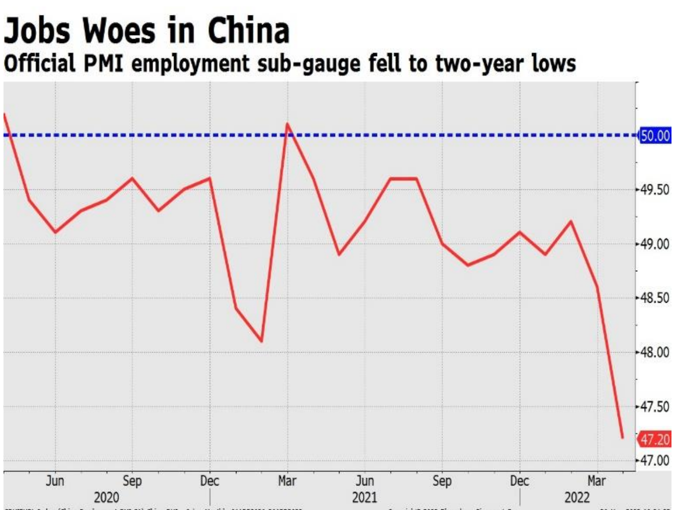
Another inflation factor includes the Russia-Ukraine conflict which has also impacted the food supply through less production. Food insecurity has increased over 100% in the past two years to approximately 276 million people globally. Russia and Ukraine produce about one third of the world's wheat and barley and Russia is the second largest producer of potash, which is a critical element in fertilizer. The increase in food prices and the projected food shortages will impact developing nations even harder than developed economies. The situation in Ukraine does not look to be changing anytime soon and may continue as a prolonged stalemate. The security concern generated by Russia's actions has prompted its historically neutral neighbors to apply for inclusion to NATO in order to deter Russian aggression. Both Sweden and Finland, the latter sharing an 800-mile long border with Russia, hope to be admitted quickly. This would be a strategic expansion of countries promising mutual allegiance in Eastern Europe which would essentially make the Baltic Sea entirely NATO controlled.

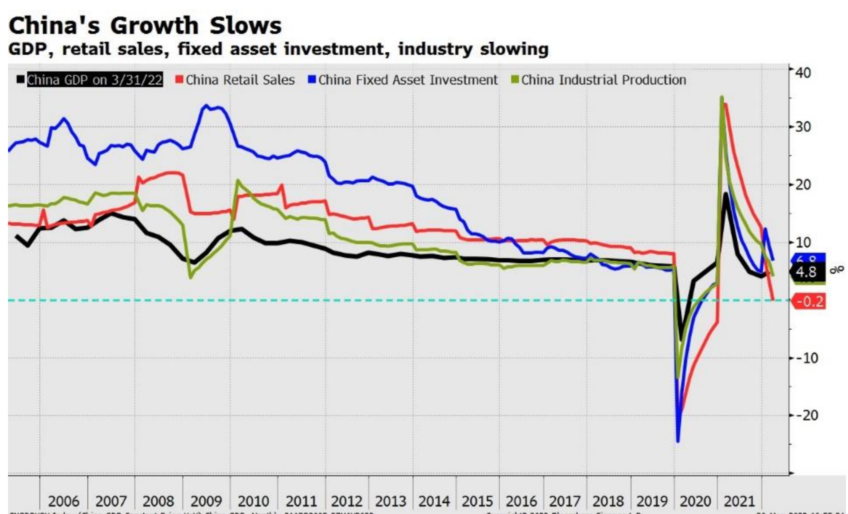
The condition of a significant increase in demand coupled with shortages caused by supply chain issues has caused inflation and, in turn, the Federal Reserve to embark on an aggressive path of rate increases. The Fed started with a 0.25% raise in March followed by 0.50% in May. They have signaled an additional 0.50% in June and July as well. This would bring the upper bound of the overnight rate to 2.0% by July – an increase of 175 basis points in four months. It is more likely that they will front load these rate increases as described since they will not meet again until September – 8 weeks in between meetings rather than 6 weeks and it is rare for them to make rate changes without a meeting. They have also indicated that they will reduce their holdings of bonds by about $47.5 billion in June increasing to $95 billion per month in September. This will also put upward pressure on interest rates, but it is a very slow pace given that they are holding about $8.9 *__TRILLION__* in bonds



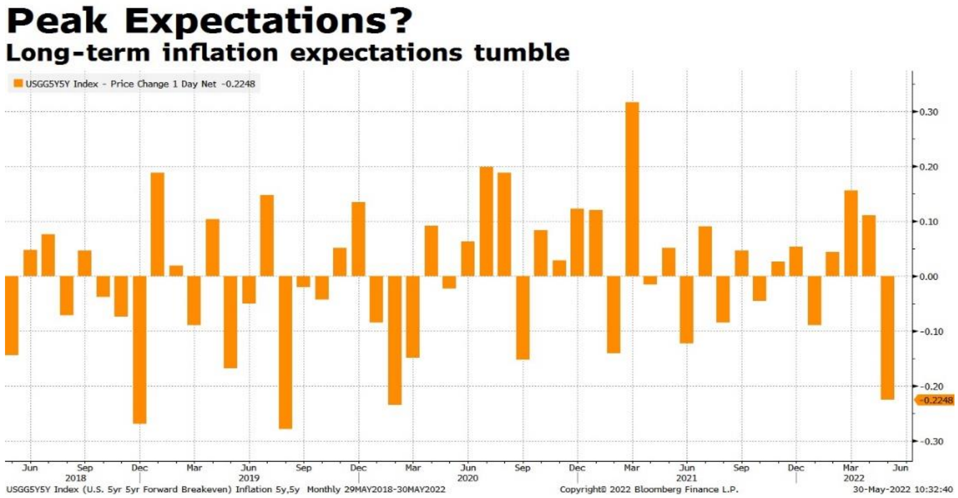
In addition, the massive fiscal stimulus of the federal government sending checks to most citizens has ended. This also helps to reduce inflation by making less discretionary money available to spend by consumers but will also lower growth.

While interest rate increases and absence of fiscal stimulus work on the demand side of inflation, we also need the supply side to catch up. Much of this depends on getting people back to work and for China to get over the COVID situation that has been shutting down whole cities and major industrial centers. This has taken its toll on world growth and the Chinese economy. Job growth and Gross Domestic Product (GDP) have fallen significantly in China. GDP growth in the world's second largest economy was revised down for 2022 from 5.5% to 4.5%.

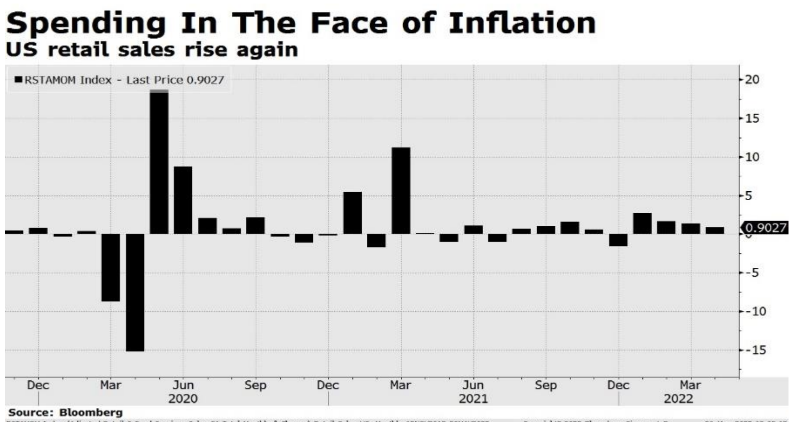




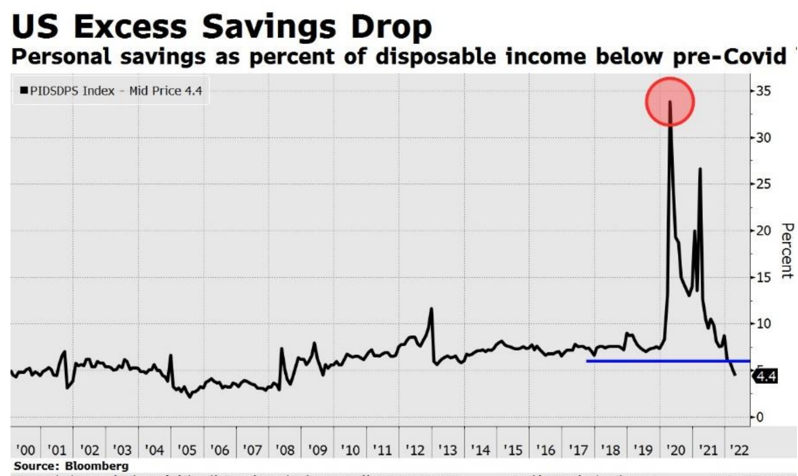
Of the inflation data we are seeing now some of it can be attributed to temporary factors, which could reverse, and some of it is stickier and will not generally come down. Inflation sources such as supply chain issues, chip shortages and the war in Ukraine are temporary (hopefully). Others, like wage increases due to labor shortages, tend to stick and not return to previous levels. Similarly, demand elements can be impacted by interest rate increases while other factors (i.e.: people returning to work) may not be affected by interest rates levels at all.

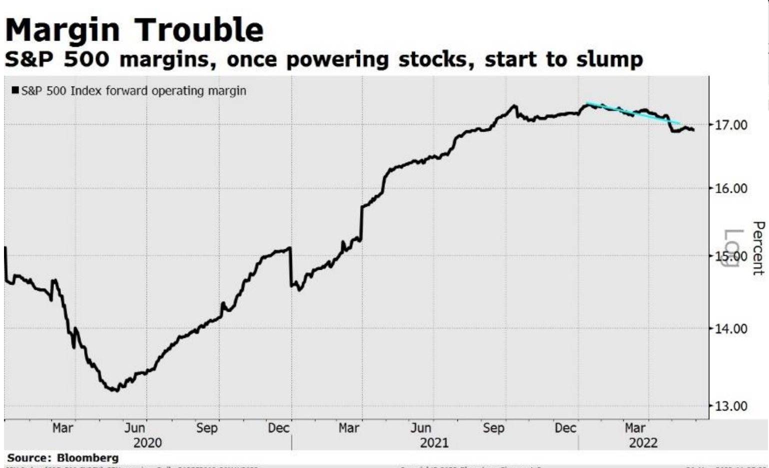


So, have rate increases started to make an impact? The sign would be inflation peaking and starting to reverse. The latest information looks promising that inflation is no longer increasing. Some of the monthly data suggests a slower pace but still a long way to go in terms of a sustainable reduction in the rate of inflation. Also, we are well beyond the Federal Reserve's stated average inflation rate of 2.0%. The key is when will the Fed feel comfortable enough to take their foot off the brake and reduce or stop the rate increases - before triggering a recession? One thing that can be said so far is that the message about the Federal Reserve's intent on battling inflation is starting to hit home with consumers and investors. Longer term inflation expectations have dropped significantly. The five-year inflation expectations have declined from 3.7% to 3.0%.

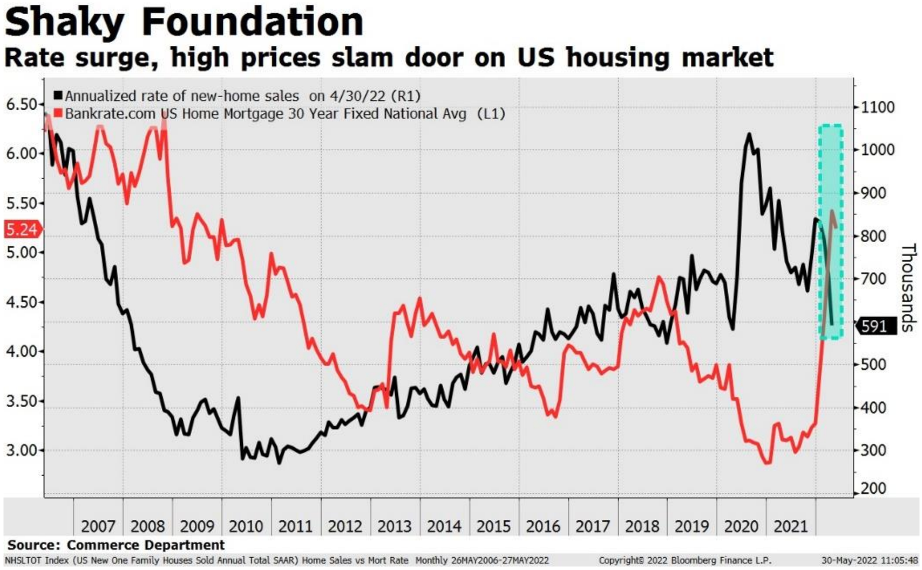


Now, turning to the other side of the issue is growth. Too much growth and inflation may continue unabated and too little growth we end up in recession. The first signal we look to are jobs which, as stated above, have shown no signs of deterioration. Also, the consumer continues to spend despite inflation. Consumer spending is still out pacing inflation – rising 0.9% the last month. They are, however, not feeling good about it as consumer confidence also continues to decline. Furthermore, spending is coming from a different source. Inflation has caused the consumer to start to dip into savings and/or use credit to fund the spending. Data indicates that the average consumer is spending about $5,000 more in gasoline this year than last which is money they cannot spend on other goods or services. The COVID lockdowns have also made consumers prioritize the services they could not do much of over the last few years – vacations, dining out, movies etc. This has caused the savings rate to decline to levels below the pre-COVID era. Savings as a percent of disposable income has fallen to 4.4% when it is usually over 5.0% (and as high as 35% during COVID).

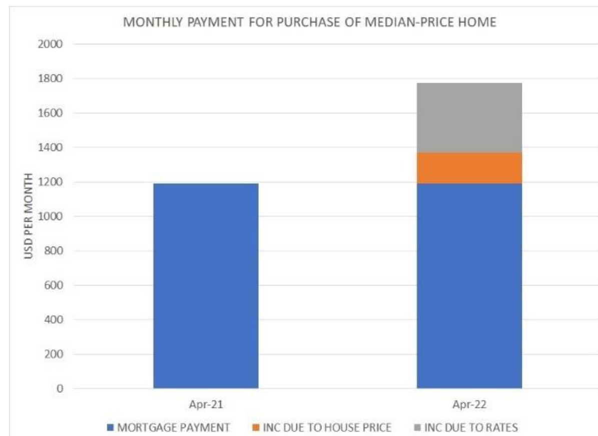




We are also seeing corporate profits impacted by inflated costs. In the retail space Nordstrom, Home Depot and Lowes all reported good quarterly revenue and profit results while both Wal Mart and Target missed badly mainly due to higher costs and lower margins – which they expect to continue. An earnings decline or recession would be another potential red flag for the economy and the equity markets.



Where we have seen growth starting to decline is in the housing market. Despite home prices rising about 21.2% recently the demand had not been impacted. Now with interest rates on mortgages rising with Federal Reserve rate increases the influence is becoming visible. The current average 30-year rate of 5.25% is up significantly over mortgage rates at the beginning of the year. This has had a significant impact on the housing market already. New home sales are down 16.6% while pending home sales are down 3.9%. In addition, homes for sale are up about 9.0%.



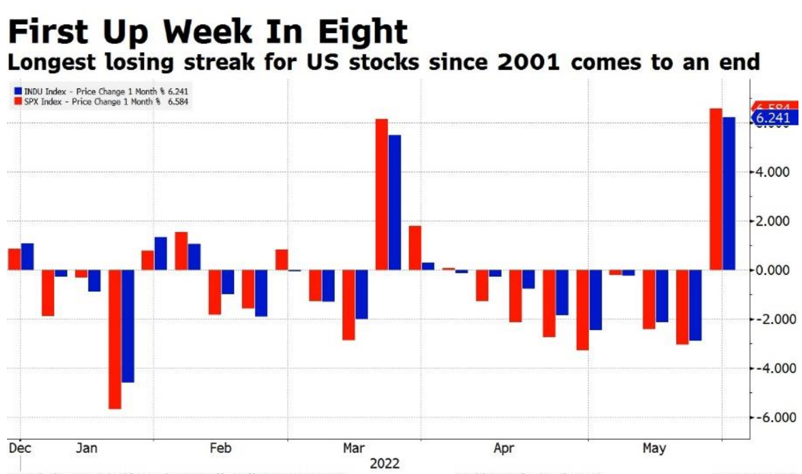
Looking at the micro level the median home price has increased from $345,000 to $397,000 from April 2021 to April 2022. In addition, the mortgage rates increased to the 5.25% mentioned above. This had caused the principal and interest payment on a median priced home to rise from $1,190 in April 2021 to $1,775 in April 2022 – a difference of $585 per month. The difference due to house price increase is $180 while the remaining $405 is due to the increase in interest rates.

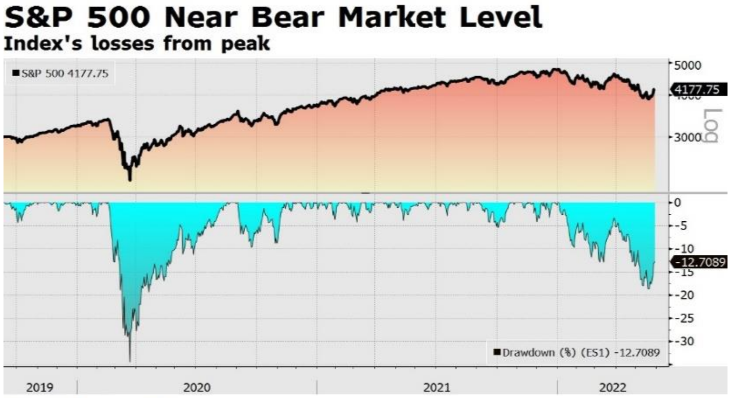
Financial Markets

All this uncertainty has caused volatility in most financial markets.

In a sign that the bond market believes that inflation will eventually be under control we saw that long-dated treasury yields started to decline after a significant run up. Certainly, some welcome relief to long-dated bond holders who saw their 2022 return somewhere around -18%. The chart on the right shows how quickly the yields have risen on the 10, 20 and 30-year treasury bonds since January of 2022.

Equity markets have performed somewhat better, depending on your investment mix, but not by much. The Dow Jones had its longest weekly losing streak since the dotcom bubble of early 2000s. The index was negative for eight weeks in a row before posting a positive week. The S&P 500 almost matched the Dow Jones by being down seven straight weeks.





The S&P 500 has almost touched bear market territory – which is defined as a 20% decline from the peak. The index was down about 18.5% during one the days in May but then turned up. This has been the largest decline of the index since March of 2020 which did not hang around long enough to really be felt as the S&P 500 was back even within a few months of that drawdown.

This decline has made U.S. large company stocks significantly less expensive than they have been recently as measured by trailing Price/Earnings (P/E) ratio. By that measure stocks are about where they were back in 2002 after the dotcom bubble. The P/E ratio is currently about 19.6 – the difference is that it took a couple years for the decline to that level in early 2000's while in 2022 the decline from similar highs happened in a very quick few months.

Finally, this has been a year so far where there were few places to hide. The traditional 60% equities/40% fixed income portfolio has traditionally had positive annual returns as both rarely decline at the same time. This is one of those rare years as a 60/40 portfolio is down about 11.5% given that both equities and fixed income have declined significantly. The last time this happened at this magnitude was 2008.

Should you have any questions please contact us.

Image sources: Bloomberg and CNBC unless otherwise noted

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