AndCo's Monthly Market Update

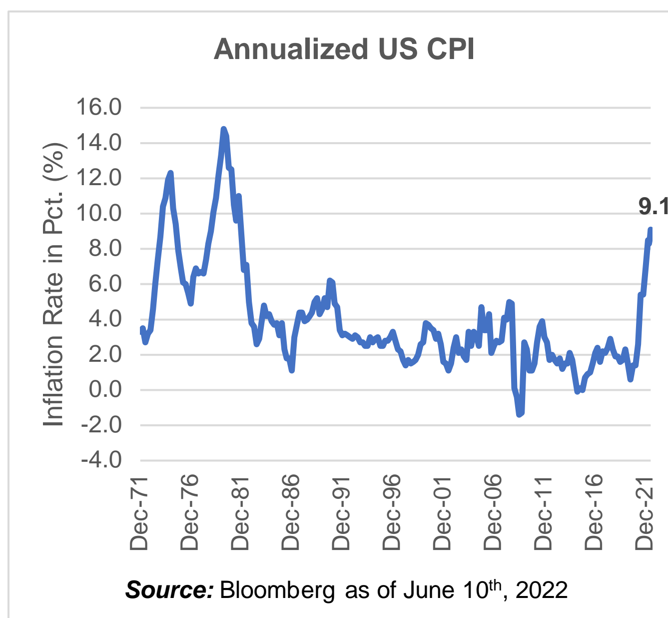
July 2022

THE ECONOMY

" What is right is not always popular and what is popular is not always right" – Albert Einstein

The world is struggling to deal with severe inflation and slowing economic growth. Prices for such things as gas, food, and rent continue to contribute to high headline inflation. In an attempt to arrest rising inflation, the Federal Reserve Bank (the Fed) began raising interest rates earlier this year and hiked by an unprecedented 0.75% in June. While we will resist the temptation to debate the timing of change in monetary policy, we believe that the move was the right thing to do. Beginning with the Great Financial Crisis in 2008, global central banks sought to reflate the economy by lowering interest rates to close to zero. Western economies benefited from artificially low interest rates even though economic growth had largely returned. In 2015, the Fed attempted to wean the economy off low rates only to fall back and lower interest rates economic growth slowed. More recently, following the onset of the pandemic and subsequent lockdowns, the Fed again moved quickly to lower interest rates to near-zero. With inflation rising above the Fed's 2.0% target, the right thing to do is raise interest rates and drain the excess liquidity from the economy. Unfortunately, given the current economic environment, these actions will most likely result in the economy slowing as the market adjusts. Moving forward, our concern is that in an effort to reign in inflation, the Fed is forced to raise interest rates significantly higher than expected which could result in a protracted economic downturn.

US inflation continued to rise in June with the Consumer Price Index (CPI) reporting 9.1%, up from 8.6% in May.[1] The primary drivers of rising inflation remain food, energy, and housing costs.[2] Importantly, real wages fell for the 15th consecutive month in June, meaning that the consumer is falling farther behind as purchasing power diminishes.[3] The stronger-than-expected inflation report opens the door for the Fed to remain aggressive in tightening monetary policy longer than the market expects.



Source: Bloomberg as of June 10th, 2022

In looking at some of the other anecdotal economic indicators, we can see that the housing market has slowed as mortgage rates have risen. The year-over-year measure of pending house sales declined by -12.0% in May.[4] Importantly, both housing starts and building permits declined by -14.4% and -7.0% month-over-month, respectively.[5] This would suggest that the housing industry is now looking to match demand as it falls. Historically, the housing market has been a pilar of strength for the economy given the numerous other industries it supports like construction and retail. Importantly, for most in the middle class, over the years the home has become a store of wealth. This positive wealth effect has buoyed consumer sentiment. Should home prices decline it would most likely act as a headwind on consumers and their ability to maintain a standard of living.

EQUITIES

Equity markets suffered significant losses during the month as higher inflation, higher interest rates, and concerns over a slowing economy pushed the S&P 500 Index close to bear market territory for the year. For the month the index lost -8.25% bringing the year-to-date return to -19.96%.[6] Quarterly returns were equally painful with the index losing -16.10% marking the worst second quarter for the market since 1970's.[7]

The market is a forward-looking indicator with investors seeking to discount future cash flows and growth potential. To that end, one of the drivers of the recent pullback likely is the market's expectation of future consumption. Personal spending in May dropped for the first time this year.[8] Higher prices are eating away at consumers' discretionary income leaving fewer opportunities to spend on durable goods, vacations, and dining out. Unfortunately, this situation could lead to a negative feedback loop as falling consumption leads to declining corporate earnings resulting in increasing layoffs and further declines in consumer sentiment. If the Fed remains resolute in its intent to fight inflation with higher interest rates, it will likely result in further slowing of the

economy and investors will have to revalue their forward estimates for equity prices which could lead to further declines.

FIXED INCOME

Similar to equities, fixed income markets suffered declines as concerns about higher inflation and further Fed tightening acted as headwinds. For the month, the Bloomberg US Aggregate Bond Index fell by -1.57% as the yield on the 10-Year US Treasury rose to roughly 2.98%.[9,10] Quarterly and full-year returns are not much better with the index declining -4.69% and -10.35%, respectively.[11] The yield curve shifted higher across most maturities following the Fed's rate hike in June with the front-end rising slightly higher than longer dated bonds. The US Treasury 2-Year bond increased by roughly 0.45% while the 10-Year increased by roughly 0.21%.[12] Our concern moving forward is the potential for the Fed to push the Treasury curve inverted with additional rate hikes. Inversion happens when short-term rates are higher than long-term rates. This has historically been a good indicator of future recession. Given the inflation report in June and the likelihood of a strong response by the Fed, we will keep a close eye on the market to monitor for changes in growth expectations

Source: Bloomberg, June 30th, 2022

APPENDIX

1. Bloomberg, July 13, 2022
2. https://www.bls.gov/news.release/cpi.nr0.htm
3. Bloomberg, July 13, 2022
4. Bloomberg, June 30, 2022
5. Bloomberg, June 30, 2022
6. Bloomberg, June 30, 2022
7. https://www.spglobal.com/spdji/en/commentary/article/us-equities-market-attributes/
8. Bloomberg, June 30, 2022
9. Bloomberg, June 30, 2022
10. Morningstar, June 30, 2022
11. Morningstar, June 30, 2022
12. Bloomberg, June 30, 2022

Important Disclosure Information

This document is being provided solely for informational and educational purposes and should not be regarded as investment advice or as a recommendation regarding any particular course of action and additionally is not intended to provide, and should not be relied upon, for legal, tax, or accounting advice.

Any securities cited are for illustrative purposes only. References herein do not constitute a recommendation to buy, sell or hold such securities.

The material provided herein is valid as of the date of distribution and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available, or circumstances existing or changes occurring after such date. This document may contain opinions, observations, projections or forward-looking statements which are subject to various uncertainties whereby the actual outcomes or results could differ from those indicated.

Certain information is based on sources and data believed to be reliable, but AndCo cannot guarantee the accuracy, adequacy, or completeness of the information. The source for all data, charts and graphs is AndCo Consulting unless otherwise stated.

AndCo Consulting is an investment adviser registered with the U.S. Securities and Exchange Commission ("SEC"). Registration as an investment adviser does not constitute an endorsement for the firm by securities regulators nor does it indicate that the adviser has attained a particular level of skill or ability.