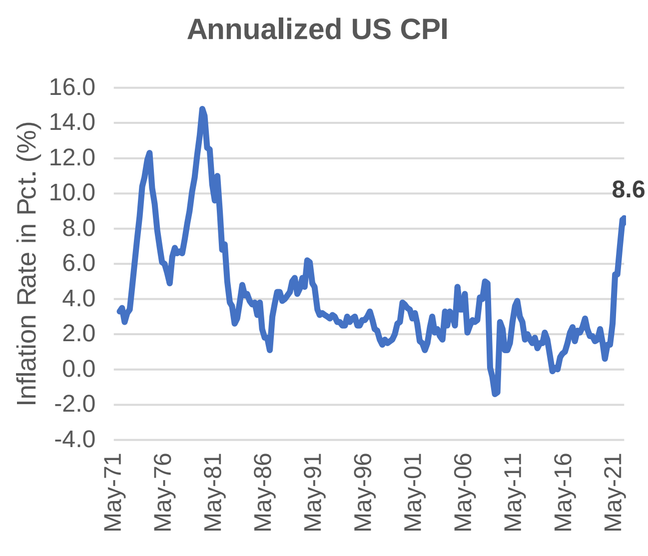
AndCo's Monthly Market Update

June 2022

THE ECONOMY

" Gradually, and then suddenly" – Ernest Hemingway

Hemingway discusses in his 1926 novel, "The Sun Also Rises," the shock of the world around us collapsing under our feet. We are slow to realize what is happening at first, then suddenly realize that the outcome is predictable and inevitable. To that point, in previous updates we have identified that the global economy has been slowing. The final measure of the 1st quarter's GDP growth was reported at -1.5%. Presently, the Atlanta Fed GDP Now model is estimating that growth for the second quarter will be below 1.0%, meaning that the economy contracted during the first half of the year.[1] The combination of the continuing conflict in Ukraine, rising global inflation, surging energy and food costs, persist supply chain issues, and tighter monetary policy all act as headwinds to growth. While the US is technically not in recession, it is increasingly likely the economy may experience stagflation, or a period of low economic growth combined with persistently high inflation. US inflation increased in May with the Consumer Price Index (CPI) reporting 8.6%, up from 8.3% in April.[1] Rising food, energy, and housing costs continue to drive inflation higher. Not surprisingly, market and consumer sentiment has declined in recent months as the expectations of tighter monetary policy sinks in. The University of Michigan Consumer Sentiment Index dropped to 50.2 in June, down



Source: Bloomberg as of June 10th, 2022 from 58.1 in May.[2] For context, the index measured a low of 55.3 during the Great Financial Crisis in 2008.[3] While there is the potential for the acceleration in the year-over-year change in inflation to moderate due to basing-effects, it is likely the inflation will remain elevated well above the Federal Reserve Bank's (Fed) average target level of 2.0% for the foreseeable future.

Persistently high inflation will likely hasten the Fed's pace of rate increases in the coming months. The Fed's mandate calls for full employment and price stability. Overall, the labor market remains strong with unemployment registering 3.6% in May, up slightly from April's 3.5%.[4] Any change in monetary policy would typically be tied to the condition of the labor market first, and then inflation conditions second. As a result, historically, the relationship between the Fed Funds rate and unemployment has remained strong. However, this relationship looks to be deteriorating. The fall in unemployment during the recovery from the pandemic was met by a largely unresponsive Fed that was committed to providing the market with liquidity in order to stimulate the economy. As inflation began to rise, rather than being proactive given the significant amount of stimulus that had been injected into the economy, the Fed believed that the inflationary increase was "transitory" in nature. Now that inflation has significantly increased, the Fed has acknowledged that it misjudged the situation and is "behind the curve" on inflation. The market is now pricing in 10 rate hikes with an implied Fed Funds rate of 3.0%.[5] There is a risk that the Fed will tighten more than the market anticipates, which could create a policy error that chokes off economic growth just as the economy begins to slow.

EQUITIES

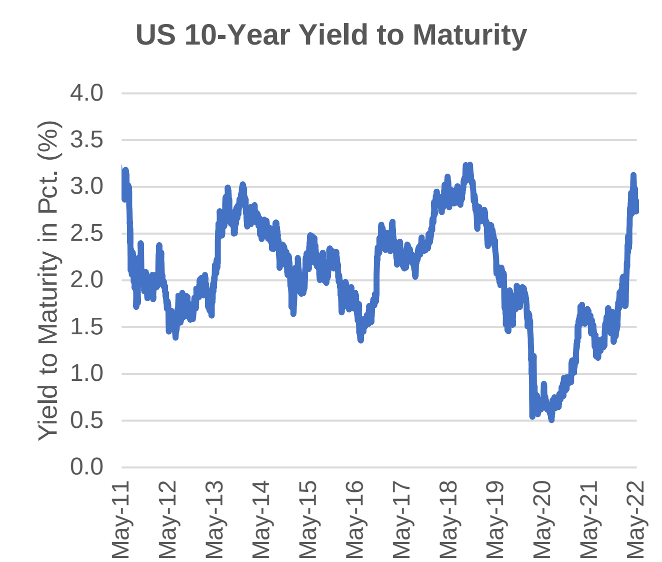
Equity markets were slightly positive, rising roughly 0.2% in May as investors faced increased volatility and continued challenges related to rising inflation and tighter monetary conditions. Between April and May, the index recorded seven consecutive weekly declines, an event that has only occurred four times since 1928.[6] As a result of the declines, the index is down approximately -12.8% year-to-date.[7] Digging deeper into the month, rising food and energy prices have finally reached a level where retailers are beginning to forecast that profits will likely decline in coming periods. Wal-Mart and Target both reported earnings below expectations for their respective first quarters of 2022, resulting in significant stock price declines.[8] While most sectors of the index that have exposure to the consumer declined during the month, both the energy and utilities sectors performed well as oil prices increased during the period.[9]

Overseas markets continued to outperform their domestic counterparts during the month with the MSCI ACWI ex-US returning roughly 0.8% while the MSCI Emerging Market Equity Index rose by nearly 0.5%.[10] In the Eurozone, inflation recorded a new monthly high of 8.1% in May, up from

7.4% in April.[11] The primary driver of inflation in Europe remains energy costs which have spiraled upward following the onset of the Russia-Ukraine conflict and the subsequent sanctions. In May, the Head of the European Central Bank confirmed their intention to increase interest rates at the next meeting and to end the bank's bond purchase program. Similarly, the Bank of Canada increased interest rates by 0.5% in June to slow the rise of inflation. The Bank of England is also expected to raise interest rates in June as prices in the UK continue to climb. Finally, in China, the country has experienced challenges related to the country's "zero-Covid" approach which has led to the shutdown of major cities such as Shanghai. The world's second largest economy remains in contraction with the manufacturing PMI Index reading 49.6 in May. A reading below 50 signifies deteriorating conditions.[12]

FIXED INCOME

Despite expectations of tighter monetary policy and rising inflation, fixed income markets rebounded in May. For the month, the Bloomberg US Aggregate Bond Index rose by roughly 0.6% while the yield on the 10-Year US Treasury declined to 2.84%.[13] Overall, the Treasury yield curve steepened in May as short-term rates rose in anticipation of future Fed rate hikes while longer-term yields declined on concerns about future economic growth. The Fed increased interest rates by 0.5% in May and indicated a likelihood that future rate hikes will be required to combat inflation. Returns across corporate bonds were mixed with investment grade bond spreads tightening by one basis point while high yield bond spreads widened by 25 basis points.[14]



Source: Bloomberg, May 31st, 2022

APPENDIX

1. Bloomberg, June 10, 2022
2. Bloomberg, June 10, 2022
3. Bloomberg, May 31, 2022
4. Bloomberg, June 3, 2022
5. Bloomberg, June 13, 2022
6. https://www.spglobal.com/spdji/en/commentary/article/us-equities-market-attributes/
7. Bloomberg, May 31, 2022
8. Bloomberg, May 31, 2022
9. Bloomberg, May 31, 2022
10. Bloomberg, May 31, 2022
11. Bloomberg, May 31, 2022
12. Bloomberg, May 31, 2022
13. Bloomberg, May 31, 2022
14. Bloomberg, May 31, 2022

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