AndCo's Monthly Market Update

August 2022

THE ECONOMY

" Be careful what you wish for, you may receive it." – W. W. Jacobs

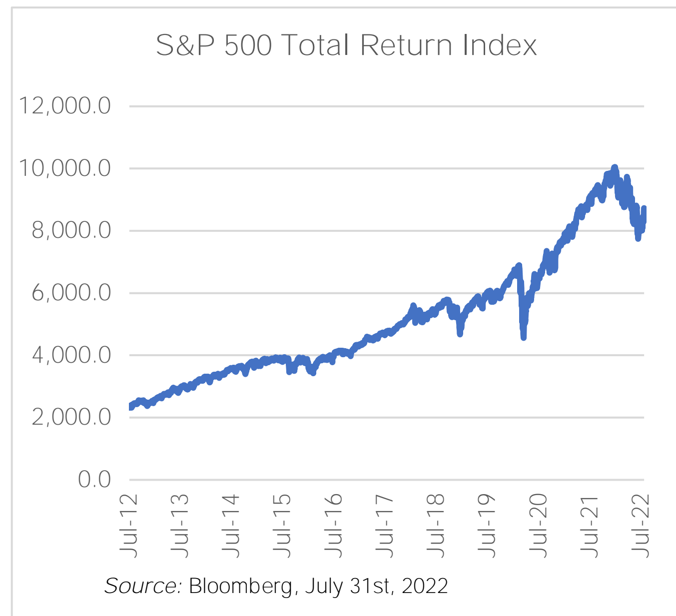
So, when is a recession not a recession? The latest GDP reading confirmed the US economy contracted for the second consecutive quarter, albeit at a less negative pace than in the first quarter. For the period, the economy decreased at an annual rate of -0.9% compared to -1.6% in the first quarter.[1] Historically, two consecutive quarters of negative GDP growth qualified as a recession. However, in a classical sense, we have not seen the typical follow through associated with recession. Specifically, labor markets have shown no signs of slowing down. For the month of July, nonfarm payrolls increased by 528,000, more than double the consensus estimate of 250,000, and the unemployment rate fell to 3.5%.[2] Additionally, other measures associated with consumption also showed signs of strength during the first half of the year. Unfortunately, because of these mixed signals, the Federal Reserve Bank (the Fed) may be boxed in with only one path forward.

With inflation remaining stubbornly high, the market was anticipating a second consecutive 0.75% increase in interest rates from the Fed, and the Fed delivered. Following the official announcement, the Fed reiterated its commitment to fighting inflation and hinted at additional future rate hikes. While similar hawkish comments have acted as a market headwind in the past, the comments were largely "shrugged off" and the market reacted positively to the news. We believe this reaction is primarily due to the expectation that the Fed would begin to slow the pace of rate hikes as inflation moderates. Indeed, there are some signs that inflation may be receding such as declining gas prices and decreasing rents. While we appreciate the relief from surging prices, some of the decline can be attributed to the demand destruction that occurred in the economy**. Given that inflation remains well above the Fed's stated target of roughly 2.0%, and** labor markets remain tight, the more likely scenario is that the Fed will continue raising interest rates until inflation falls back to more manageable levels. Our concern is that the market has not felt the full brunt of the past rate increases and that future rate hikes will only add pressure to

both the consumer and companies. If the market is right, and inflation does moderate enough to allow the Fed to pivot, the economic outcome may not be "soft landing" everyone hopes will occur.

EQUITIES

Equity markets rebounded strongly in July with the S&P 500 Index rising 9.22% for the month.[3] Despite the strong performance in July, the index is still down -12.58% year-to-date.[4] While there are concerns about whether or not the economy may be in recession, corporate earnings were resilient and increased by roughly 7% during the second quarter.[5] Importantly for the outlook of future earnings growth, consumers have remained resilient and continued to spend. The splurge in spending does come at the expense of personal savings which dropped to its lowest level in more than a decade.[6]



Source: Bloomberg, July 31st, 2022

Digging deeper into the numbers, it comes as no surprise that growth stocks outperformed value stocks for the month across all market capitalizations. With the market anticipating lower interest rates in the future, technology companies outperformed their counterparts. As a result of their relative index weights, US markets outperformed foreign markets during the month with the MSCI EAFE benchmark returning 4.98% and the MSCI Emerging Markets Index returned -0.25%.[7] Concerns about economic growth in Europe as a result of rising energy prices and China's falling real estate market acted as headwinds to performance during the month.

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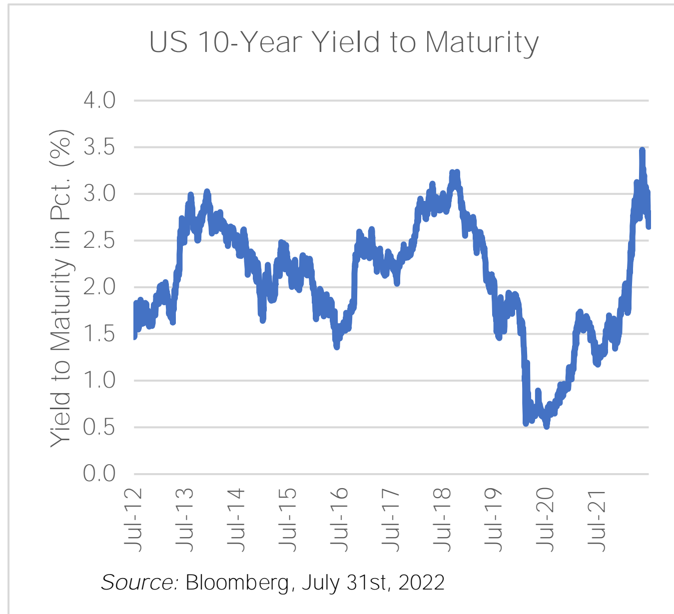
FIXED INCOME

Fixed income markets were broadly higher during the month on expectations that the Fed would begin slowing the pace of rate increases. The US Treasury 10-Year bond finished the month at roughly 2.7%, down from nearly 3.0% in June.[8] Despite the drop in the yields, the forward-looking inflation **expectations remain well above the Fed's** target with the 10-year break-even inflation rate closing the month at 2.6%.[9] For the month, the benchmark Bloomberg Aggregate Bond Index returned 2.44%.[10] Year-to-date performance remains disappointing with the index delivering -8.16% for the period.[11]



Source: Bloomberg, July 31st, 2022

In terms of answering the question if economy is already in a recession, the bond market is flashing a warning sign. The yield curve remained inverted and the spread increased during the month of July, meaning the shorter-term US Treasury 2-Year bond yielded more than the 10-Year bond. Currently, the spread between the these two rates is roughly -0.35%.[12] This is the widest spread since August 2000, prior to the Dot.Com market crash, and exceeds the level reached prior to the Great Financial Crisis.[13] Our concern is that the Fed has stated its intent to fight inflation at any cost. Additional rate hikes will put further upward pressure on short-term rates, which raises the potential for an even steeper inversion in the yield curve. This metric has historically been fairly accurate in predicting future recessions. Importantly, the Fed is mindful of this metric and the potential self-fulfilling behavioral implications for the economy. From our viewpoint, if the Fed persists in raising interest rates to slow the economy to combat inflation, it will likely achieve its goal through demand destruction, thereby proving the bond market right in its prediction.

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APPENDIX

1. https://www.bea.gov/data/gdp/gross-domestic-product
2. https://www.bls.gov/news.release/empsit.nr0.htm
3. Morningstar, July 31, 2022
4. Morningstar, July 31, 2022
5. https://www.spglobal.com/spdji/en/commentary/article/us-equities-market-attributes/
6. https://tradingeconomics.com/united-states/personal-savings
7. Morningstar, July 31, 2022
8. Bloomberg, July 31, 2022
9. Bloomberg, July 31, 2022
10. Morningstar, July 31, 2022
11. Morningstar, July 31, 2022
12. Bloomberg, August 8, 2022
13. https://fred.stlouisfed.org/series/T10Y2Y

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