

July 5, 2022 – Economic and Investment Commentary

Economic Commentary:

The tug-of-war between inflation and economic growth continues unabated. More and more it appears that the US is entering a period of reduced economic activity — it is probable that Q2 GDP growth will be negative— without, as yet the conclusive proof that declining demand will cool inflation. It may be that the concept of a “soft-landing” (aka “Fed Success”) is being redefined as a shallow recession playing out over the remainder of 2022 and into 2023, with modest increases in unemployment and inflation that finally slows in Q4. Consumer savings remain relatively high and corporate balance sheets are generally solid, serving to minimize the structural damage that might otherwise be associated with such a rapid increase in interest rates.

Data to Watch:

1. US Purchasing Managers Index for Non-manufacturing in June, released Wednesday, July 6
2. FOMC minutes, released Wednesday, July 6
3. US Non-Farm Payroll data, released Friday, July 8

Suggested Reading:

[Strong U.S. Dollars Sends Euro, Yen to More Than Decade Lows](#)

[If the U.S. is in Recession, It's a Very Strange One](#)

[U.S. Aims to Expand Export Bans on China Over Security and Human Rights](#)

Investment Commentary:

Investment Considerations

The markets remain volatile and trade on hopes and fears about growth and inflation. Investors are changing their belief on whether the economy can withstand the higher rates that the Federal Reserve says that it's going to impose in a bid to quell inflation. Three weeks ago, there was confidence the Fed would have to hike until it slayed inflation. Now, there's a belief that it can't hike too far without forcing a recession, and thereby will be forced to cut rates again. The macroeconomy matters to the stock market, but chiefly for the way it affects the two key variables that drive share prices: the earnings that a company makes, and the multiple that people are prepared to pay for those earnings. Multiples are driven by many things, but we can agree that higher bond yields and fears of a recession are not good for them. Investors will be less inclined to pay more for a future earnings stream in such circumstances.

Equities

Last week, US markets fell 2%-3% in a volatile week that saw the market recover late in the week from steeper losses. Rates fell across the curve as recession fears increased. Value outperformed growth (across all market caps). Within the S&P 500, defensive sectors (consumer staples, healthcare, utilities) along with energy had positive returns. DM outperformed EM.

From a valuation perspective, EAFE is trading relatively less expensive (>1 Std vs trend) with a 3.5% dividend yield.

Fixed Income

On the back of falling rates high quality fixed income sectors posted positive returns while credit-sensitive high yield and EM had negative returns on the back of significant spread widening. High yield and EM spreads are now at their post-pandemic wides. Leveraged loans also posted negative returns on spread widening and continuing outflows.

Rates

Rates were lower across the yield curve (2Y-30Y). The recession-watch 10Y-3M continued to fall (31 bps) as did the 10Y-2Y (3 bps). While the 10Y-2Y is barely positive, the 10Y-3M remains wide enough away from inverting (120 bps). Rates fell in other developed markets are well.

Currencies/Commodities

The dollar strengthened while the commodities complex continued to fall as in the prior week led by industrial metals and agriculture. Natural gas fell a further 12% in the week on the back of a 10% drop in the week prior. Copper, closely-watched as a leading indicator for inflation, also continued to fall.

Market monitors

Substantial high yield spread widening (78 bps) pointed to increased recession fears. Volatility remained elevated (MOVE = 144, VIX = 27).

Disclosures

Investment Commentary Sources: Bloomberg and Morningstar

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