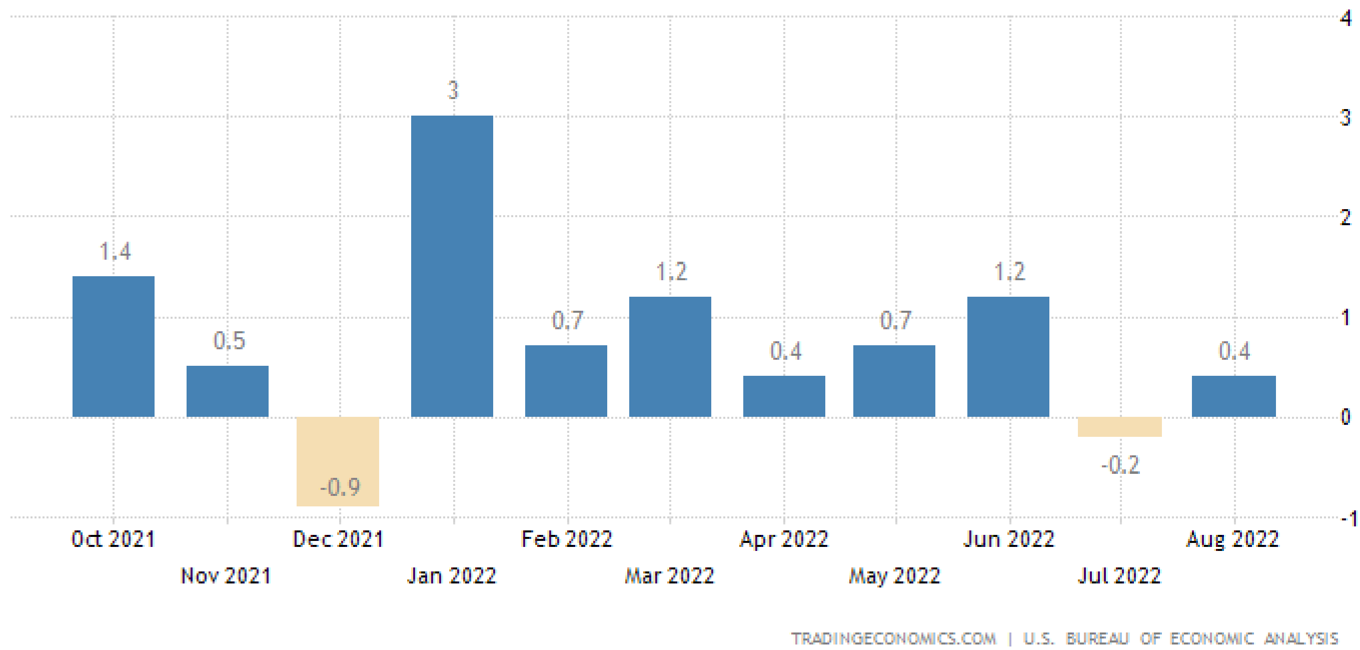
ECONOMIC AND INVESTMENT OUTLOOK
Fall 2022

The Economy The stock market just realized its worst three quarters of performance since the 1970's due to initial headwinds of high inflation and sharply rising interest rates combined with growing recession risks and extreme geopolitical uncertainty. Those declines are understandable considering inflation reached a 40-year high, the Federal Reserve raised interest rates at the fastest pace in decades, the world's second–largest economy effectively shut down, and the Russian/Ukraine war raged on. Regarding inflation and Fed rate hikes, markets have aggressively priced in stubbornly high inflation and numerous additional rate hikes from the Fed between now and early 2023. But if we see definitive peak inflationary pressures in the coming months, then it is likely the Federal Reserve will hike less than feared, and that could be a catalyst for the economy and financial markets. On the war in Ukraine, any sort of a truce between Russia and Ukraine will likely reduce commodity prices and global recession fears should decline as a result.

Sales and Spending Falling gasoline prices helped consumers buy more gasoline and other stuff in August, adjusting for price changes. Inflation adjusted sales were up 0.2% in August, but that followed three months of declines. Consumers have become more cautious in the current high inflation environment. E-commerce sales declined 0.7% after a 1.8% jump in July that was helped by Amazon Prime Day Sale. Motor vehicles sales jumped back after July's decline, but continue to be hurt by long-standing low inventory problems and high prices. The grocery stores also are hurt by high prices. Restaurants sales were flat after adjusting for inflation due to the higher food ingredients and labor costs to the restaurants. Going forward, some sales weakness will be the result of consumers switching their buying patterns to move services. We should see retail inventories high this holiday season which will likely cause heavy discounting for major retailers. (See chart Personal Spending 1 year).



Inflation While gasoline prices dropped for the second month in August, other prices accelerated, leaving the inflation rate at a very high 8.3%. Medical care increases have picked up their pace this year, and their inflation rate would approach 10% if continued for a year. New car prices have already hit a 10% inflation rate. It had been hoped that price increases would start slackening, but that has not been the case as of yet. Falling gasoline prices by themselves will likely not be enough to dissuade the Federal Reserve from another .75 basis point increase in short-term interest rate at their next policy meeting in November. We can expect price inflation at the end of the year to be a close to 8%, down a bit from the peak of 9.1% reached in June. (See chart Inflation Rate 1 year).

Monetary Policy comprises the Federal Reserve's actions and communications to promote maximum employment, stable prices and moderate long-term interest rates. U.S. economic activity posted further impressive gains in the third half of the year, but inflation rose to its highest level since the early 1980's. The labor market tightened substantially further amid high demand for workers and constrained supply. The Fed expects to raise the Federal funds rate and reduce its balance sheet.

Fiscal Policy While inflation pressures are global in nature and fairly well correlated across developed market economies, differences between monetary and fiscal authorities, and even differences across policy tools are all now evident across the globe. In the US, such tensions have thus far remained reasonably well contained - the Fed remains aggressively hawkish, while fiscal policy inclinations (as indicated by, for instance, last month's Inflation Reduction Act) reveal a preference for inflation-neutrality.

The Dollar The foreign exchange value of the dollar has continued its recent dizzying ascent, and as we've discussed discus, the lagged effect of the dollar should hit hard next year. On top of the dollar strength, mortgage rates have continued to grind higher, and household wealth (both equity and now housing) has continued to drift lower.

Corporate Profits in the United States rose 6.2% to a fresh record high of USD 2.53 trillion in the second quarter of 2022, less than previous estimates of 9.1 percent surge and following a downwardly revised 2,5 percent drop in the previous period. Net cash flow with inventory valuation adjustment, internal funds available to corporations for investment, rose 4.1% to $2.95 trillion, while net dividends fell 0.2% to $1.74 trillion. Meanwhile, undistributed profits skyrocketed 24% to USD 0.78 trillion.

MARKETS

Uncertainties The United States inflation problem along with supply chain issues seemed to be on everyone's mind but there are other pressing issues. The upcoming flu season which is expected to be severe as well as the ongoing coronavirus epidemic. The Ukraine /Russian war now shows much uncertainty and Putin's unpredictability in using nuclear weapons.

Positives The vaccines being distributed to most people now register more than 262 million people fully vaccinated. Approximately 79% of the U.S population has now been vaccinated with one dose and 33% of the population have received a booster dose. A fourth booster shot now available to people 50 and older as added protection is being administered. All children ages 6 months through 5 years are eligible for a pediatric three-dose vaccine. The virus does not seem to be life threating now that many are vaccinated. Looks like inflation has reached its pinnacle and should be headed lower in the coming months.

Negatives The BA.2 strain is still the dominant strain of Covid-19 which seems to be very contagious virus but less likely to be hospitalized if vaccinated. There are the lingering supply chain constraints hampering many companies and still a shortage of workers primarily in the hospitality business. Washington still seems behind the curve on a number of issues in the economy.

Interest Rates As expected, the Federal Reserve raised its short-term interest rate by three quarters of a percentage point, a large hike, but less than the full point some expected. Either three-quarter or a half point hike are likely at the November meeting, taking the fed funds rate down. After this, the Fed is likely to slow its pace significantly as inflation pressures ease. Mortgage rates along with home equity lines of credit will typically move in lock-step higher. Currently the Treasury 10-year trades close to 3.6%.

Common Stocks Wall Street wrapped up three quarters of 2022 with a loss of almost 25% on the S&P 500 ended around 3,586. The third quarter started with a solid rebound in stocks and bonds that was driven by resilient corporate earnings, signs of a possible peak in inflation, and hints from the Federal Reserve that the end of the rate hiking cycle may come sooner than markets initially expected. Hope for a less-aggressive Fed paired with resilient earnings and a possible peak in inflation fueled a 9.2% gain in the S&P 500 in July, its best monthly return since November 2020. To wrap up the third quarter which began with much optimism surrounding a resilient corporate earnings outlook, a potential peak in inflation, and a closer-than-expected end to the current Fed rate hiking cycle. But throughout August and September that optimism was eroded by sticky inflation data and a more hawkish- than expected Federal Reserve. As we start the fourth quarter markets remain in search of concrete positive catalysts that signal declining inflation pressures and a less-aggressive Federal Reserve.

October 7, 2022