INVESTMENT OUTLOOK

A PEAPACK PRIVATE WEALTH MANAGEMENT PUBLICATION

SECOND QUARTER 2022: POKING THE BEAR

Christopher Robin! Will you kindly shake your umbrella and say 'tut tut it looks like rain!"?
-A. A. Milne, Winnie the Pooh

Beleaguered investors struggled to find shelter from the weakest six months in the US stock market since the first Nixon Administration. As they contemplate what may be coming next, it's worth taking a moment to understand how we got here.

The initial response to the emergence of the COVID pandemic was widespread lockdowns—an understandable healthcare imperative but a devastating blow to the economy. 22 million Americans lost their jobs in a mere three months.

The policy response to the economic crisis was swift in speed and enormous in magnitude. On the fiscal front, three major legislative acts provided a total of $5.3 trillion in relief, primarily in the form of direct cash assistance, to households, small businesses, state and local governments, profoundly disrupted industries, and others. From a monetary policy perspective, the Fed brought interest rates down to zero, ballooned its balance sheet with $120 billion monthly purchases of Treasury bonds and mortgage securities, and established a series of lending facilities to prevent excessive tightening of financial conditions.

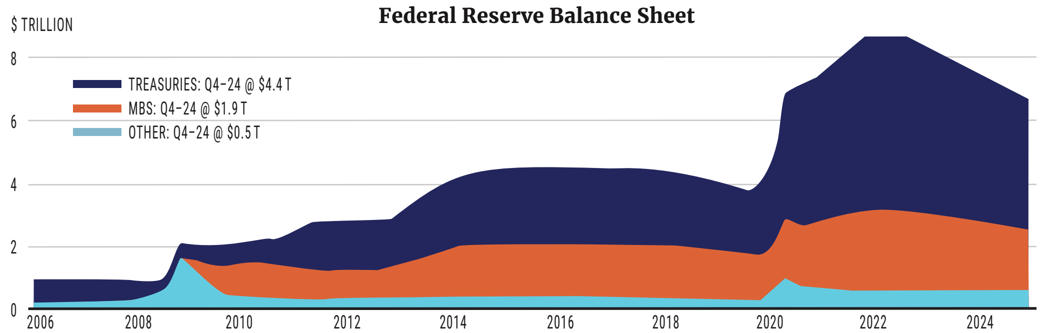
Fiscal Policy Response to COVID Crisis

Support for Small Businesses	$968 Billion	Tax Incentives	$566 Billion
Economic Stimulus Payments	$867 Billion	Direct Aid to Governments	$512 Billion
Expanded Unemployment Compensation	$764 Billion	Educational Support	$282 Billion
Public Health and Related Spending	$657 Billion	Other	$719 Billion

TOTAL COST
$5.3 Trillion

SOURCE: PETER G. PETERSON FOUNDATION

Federal Reserve Balance Sheet

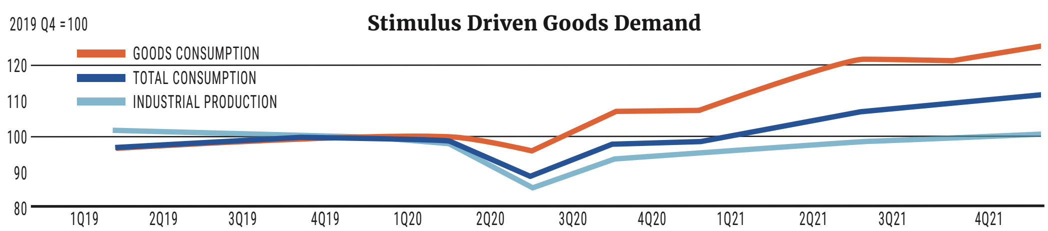


SOURCE: FEDERAL RESERVE BANK

This was very powerful medicine, and proved an effective treatment to prevent a potential deep economic depression. But powerful medicines are often accompanied by undesirable side effects—if the FDA had approved the pandemic policy prescription, it would have issued a 'black box' warning. This massive stimulus stoked demand to record levels—just when supply was most challenged. Recurring coronavirus-related plant shutdowns, shipping backlogs, labor shortages, and other factors all contributed to supply chain disruptions, product shortages, and price inflation.

It should also be said that monetary policy—in particular, a Fed funds rate of zero—proved inflationary for asset markets, too. Stocks, bonds, cryptocurrencies, real estate, fine art—all rose sharply in price, supported by a hyper-accommodative Fed.

There's little reason to be surprised by the upturn in inflation. After all, economist Milton Friedman, as long ago as 1963, defined inflation as too much money chasing too few goods. (Note to the Fed: he also wrote that inflation is always and everywhere a monetary phenomenon.) The imbalance between stimulus-driven demand and capacity-constrained supply results, in the short term, in higher prices for those sought-after goods.

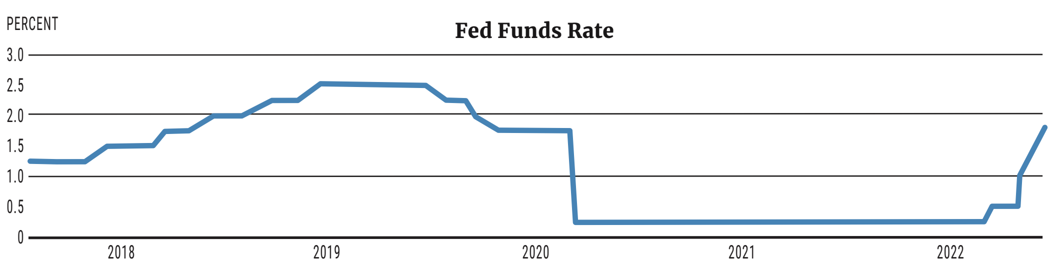


SOURCE: BUREAU OF ECONOMIC ANALYSIS, OECD NATIONAL QUARTERLY ACCOUNTS, HAVER ANALYTICS

The Fed believed—erroneously, with the benefit of hindsight—that goods inflation would prove to be transitory, as supply increased to meet demand. But supply chain challenges have been persistent, and hopes for a recovery in labor market participation have been met with disappointment.

That brings us to 2022, whose dominant feature is the withdrawal of stimulus in the face of yet higher inflation. On the fiscal front, government tax receipts are at record high levels (up 29% versus prior year), reflecting a strong economic recovery and full employment. At the same time, government outlays are down significantly—19% year-over-year, as pandemic-related expenditures are greatly reduced. This constitutes the most contractionary fiscal policy since the years following the end of World War II.

As for the monetary policy front, the Fed has begun quantitative tightening—shrinking its balance sheet by not reinvesting proceeds of maturing Treasury bonds. More visibly, it is lifting interest rates, with three increases thus far this year, totaling 1.50%.



SOURCE: TRADING ECONOMICS, FEDERAL RESERVE

The Fed is forecasting further rate increases of 1.25% this year and an additional 0.4% in 2023.

BEARING IT ALL

Little bear, little bear
You sit on my right, right there…
-Stephen Sondheim

The Fed's new-found toughness, first in words and then in deeds, resulted in painful declines in asset prices.

Asset Class	Index	2nd Quarter Returns	Year to Date Returns
US Large Cap Stocks	S&P 500 Total Return	-16.1%	-20.0%
US Small Cap Stocks	Russell 2000	-17.2%	-23.4%
International Developed Markets Stocks	MSCI EAFE	-14.5%	-19.6%
Emerging Markets Stocks	MSCI EM	-11.5%	-17.6%
Real Estate Securities	MSCI US Real Estate	-17.0%	-20.3%
Commodities	Bloomberg Commodities Futures	-5.7%	18.4%
Bonds	Bloomberg Barclays US Aggregate	-4.7%	-10.4%
Cash	FTSE 1-Month US Treasury Bill	0.1%	0.1%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

As the Fed signaled higher interest rates to come, investors recalibrated securities valuations. Higher interest rates lower stock prices because stock valuations reflect future earnings expectations discounted back to today, and a higher discount rate results in lower valuations. Similarly, prices of bonds fall when rates rise and newly issued bonds feature yields above existing levels.

All asset classes except cash lost value in the second quarter. Across the board, equities turned in double-digit negative returns, and bonds also fell in value.

For the year to date, US equities entered a new bear market, with declines of 20% or more. International equities fared only modestly less poorly. Commodities were the only stand-out, with solid double-digit returns, while cash held value.

THE FED HIGH WIRE ACT: STAGFLATION, SOFT LANDING, OR RECESSION?

I'm just a little black rain cloud, hovering under the honey tree.
-A. A. Milne, Winnie the Pooh

The Fed has laid out a clear strategy. It cannot bring demand and supply back into balance by raising supply. It can't drill for more oil, or clear port backlogs, or coax people back into the workforce. Lacking tools to address supply shortfalls, the Fed is focused on tamping demand, in order to slay the inflation dragon. Its time-tested tool to do so is to raise interest rates, reducing the affordability of housing, automobiles, and other expenditures that are financed. It is also deploying a tool it has used only once, reducing its balance sheet.

1974 inflation fighting strategy.

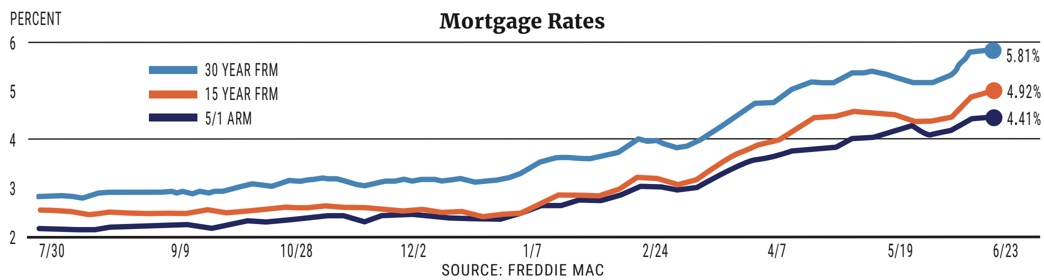
A more restrictive monetary policy is designed to reduce demand, slow economic growth, and thereby alleviate inflationary pressures. Ideally, the Fed achieves this objective without endangering economic growth. This is the proverbial soft landing, a unicorn-like rarity that even Fed chair Powell acknowledges will be tricky to achieve.

The Fed could err in a couple of ways. It could act too aggressively, curtailing economic activity so much that a recession ensues. Or it could continue to be 'behind the curve,' slowing the economy but not bringing inflation down to acceptable levels, resulting in stagflation.

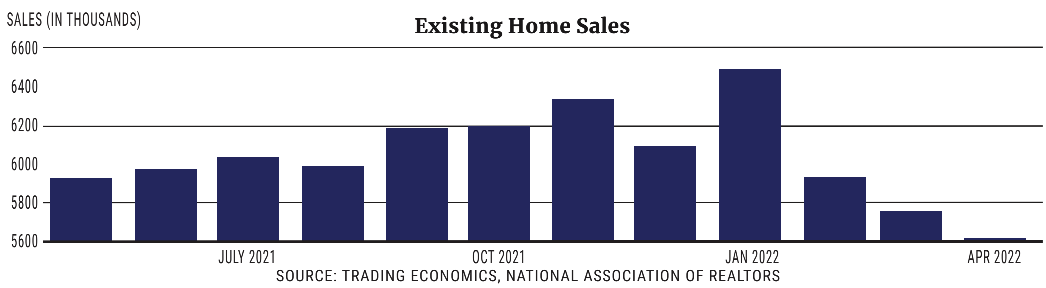
It is an accepted truism that monetary policy operates with a long and variable lag, yet there is growing evidence that higher rates are already affecting demand and slowing economic growth. The Atlanta Fed produces a real-time measure of the economy, GDPNow, and this measure indicates the US economy shrank by 2.1% in the second quarter. When viewed in the context of the first quarter's GDP decline of 1.6%, an argument can be made that the US may already be in a recession.

Here are additional indicators of economic softness:

• **The housing market is one of the most interest rate-sensitive sectors, and it is already exhibiting a downturn as a result of higher interest rates.** With 30-year fixed mortgage rates now approaching 6%, the highest level in 13 years and up from 3% at the start of the year, there should be little surprise that housing has cooled.

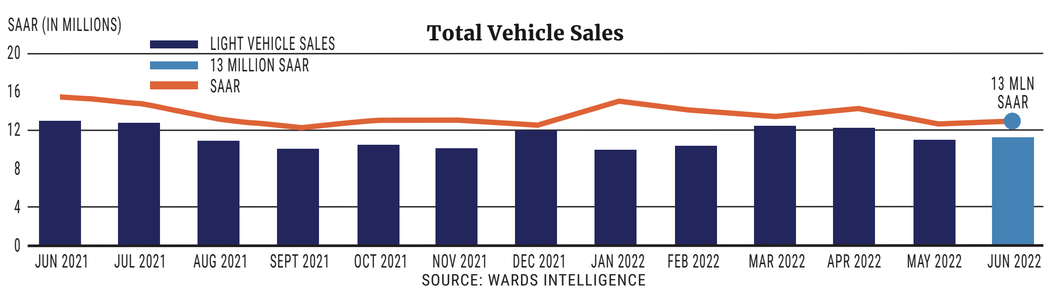


• **Year-over-year existing home sales have declined for the past three months.** Housing affordability, already reduced by two years of high price appreciation, has been hurt further by elevated mortgage rates.

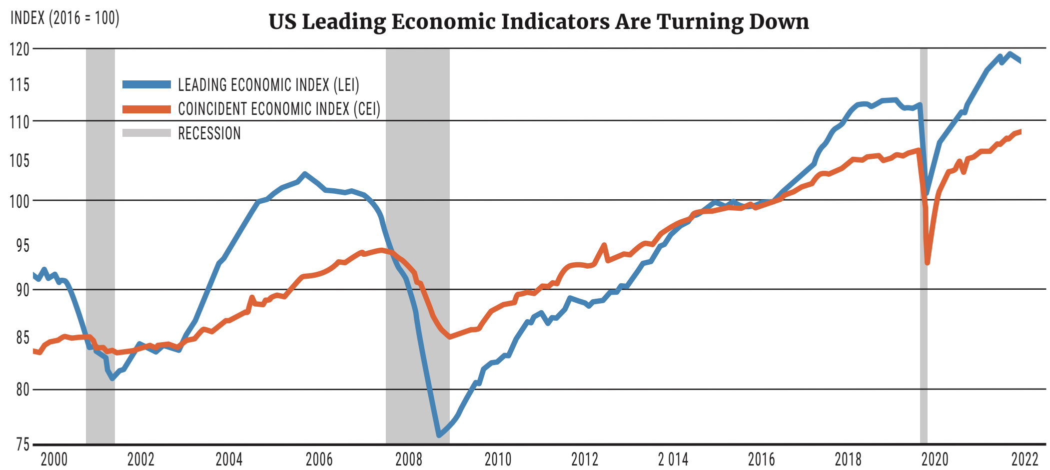


• **May data from the US Census Bureau for new home construction reflects new permits down 7% from the prior month, and new starts down 14%—the lowest level since April 2021.**

• **Vehicle sales, battered by supply chain constraints, dramatically higher prices, and increased auto loan rates, have fallen for most of this year.**



• The Conference Board's US Leading Economic Index has turned down for the past two months.



SOURCE: THE CONFERENCE BOARD

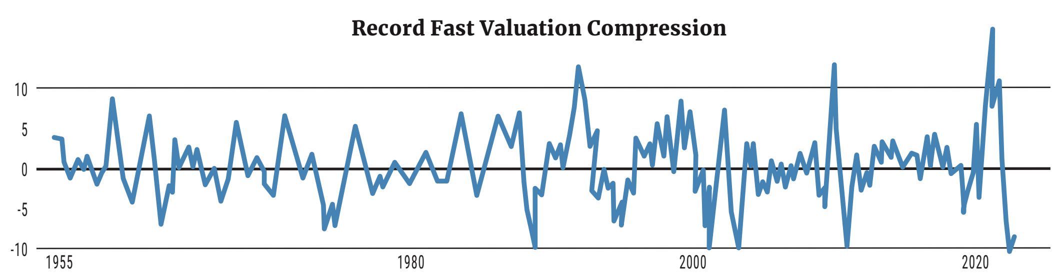
Other examples of a slowing economy: the University of Michigan Consumer Sentiment is at the lowest level since the series began in 1978; weekly new jobless claims have risen for three consecutive months; and consumer credit is growing rapidly—suggesting consumers are burning through pandemic era savings.

We are, thus, on heightened recession alert—notwithstanding that recessions are officially declared by the National Bureau of Economic Research (NBER)—as their determinations are made a number of months after recessions have occurred.

MARKETS UNDER THE SWAY OF THE FED

I'm so rumbly in my tumbly.
-A. A. Milne, Winnie the Pooh

Market indigestion at the start of the second quarter was brought on by high and rising inflation and the unsettling thought that the Fed was behind the curve. However, when May CPI failed to confirm investors' hopes that inflation had peaked, and the Fed responded with a bold three-quarters percent interest rate increase, market participants turned their anxiety to the increased possibility of a recession.

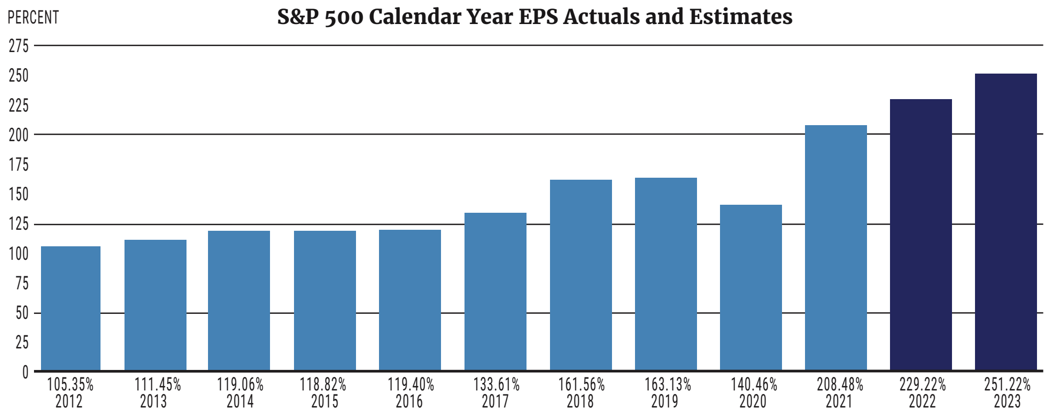


YEAR-ON-YEAR CHANGE IN PRICE EARNINGS MULTIPLE OF THE S&P 500 | SOURCE: BLOOMBERG

Either concern warrants a recalibration of stock valuations, and that's just what happened. At the start of this year, the S&P 500 traded at a multiple of 22 times expected 2022 earnings. As the Fed's commitment to fighting inflation grew and investors priced in multiple upcoming rate increases, valuations compressed to a recent level of 15.8 times expected earnings. As this chart reflects, market valuations spiked in the 2020-2021 period of maximum Fed accommodations, and have been plummeting this year in the face of Fed accommodation removal.

The current market valuation is modestly below average levels over the past decade. Of course, market multiples could shrink further, to well below average levels. While a substantial portion of the valuation reset has occurred, we could see investors reduce further how much they are willing to pay for future earnings if the Fed is forced to raise rates more than currently anticipated.

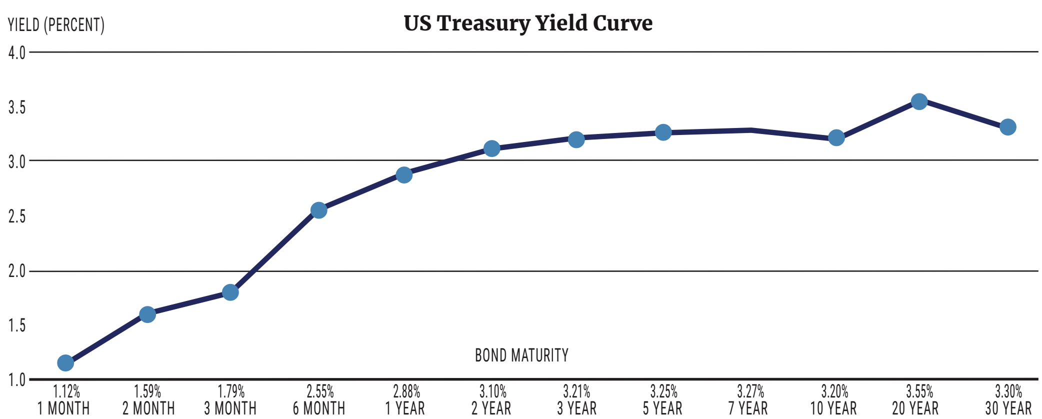
While it is true that market forecasters have stared down valuations, they have not yet made any adjustments this year to earnings expectations. Analysts have consistently estimated that earnings for the S&P 500 will grow 10% this year.



SOURCE: FACTSET

There are substantial headwinds to achieving these ambitious earnings targets. Cost pressures from higher input costs, shipping and transportation expenses, and wages will challenge record profit margins. Supply chain disruptions, inventory adjustments, and the strength of the US dollar add to the downside risk to earnings estimates. We will be carefully scrutinizing second quarter earnings reports for indications of pricing power.

Bond investors have also suffered stomach upset this year, as rising rates depress bond prices and changing perceptions of risk have widened spreads. Across the yield curve, rates are higher by approximately 150 basis points (1.50%) from the start of the year.

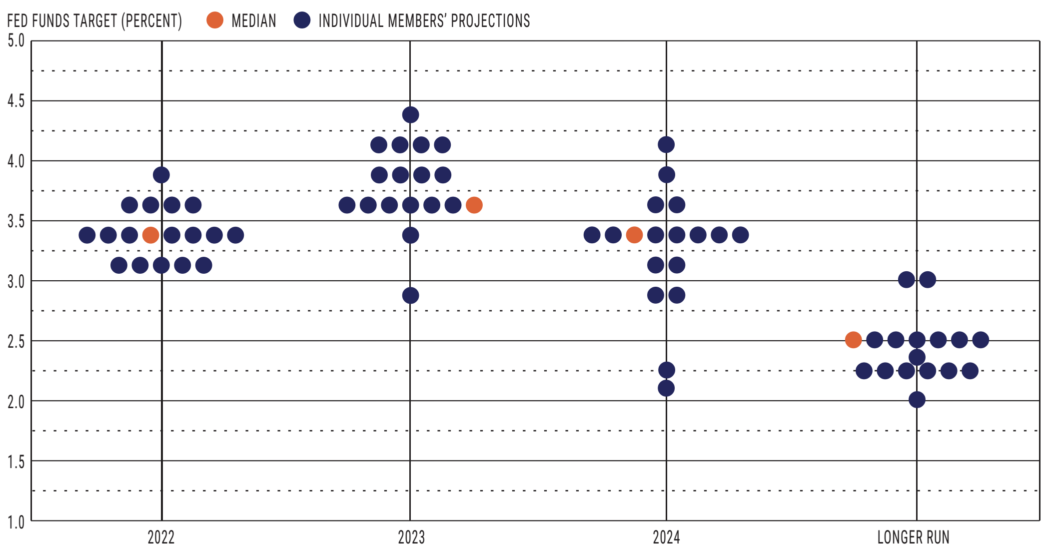


SOURCE: U.S. DEPARTMENT OF THE TREASURY

Note in this chart how rapidly rates rise in the one-month to one-year maturity range, and how flat or constant rates are from two to thirty years (other than the 20-year maturity). This term structure reflects expectations of substantial increases to come in the Fed funds (overnight) rate, cresting in the 3% range before eventually coming down again as inflation subsides.

The FOMC's closely followed 'dot plot,' its own projection of the future direction and level of interest rates, is somewhat more aggressive than this market view.

FOMC Fed Funds Forecast



SOURCE: FEDERAL RESERVE, SUMMARY OF ECONOMIC PROJECTIONS (SEP)

The Fed sees its benchmark policy rate at 3.4% at the end of this year, and 3.8% next year, before falling back in 2024. (Of course, the Fed has a less than perfect record forecasting interest rates and other economic variables.)

THE FED GIVETH, AND THE FED TAKETH AWAY

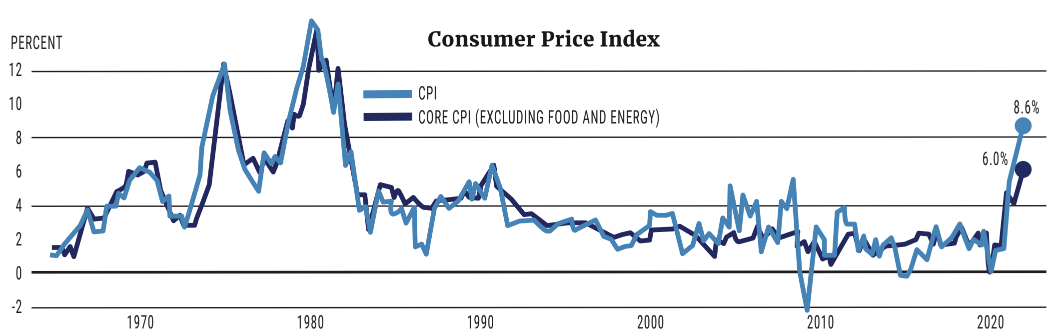
I did mean a little larger small helping.
-A. A. Milne, Winne the Pooh

Inflation. The Fed. Inflation. The Fed. The entire investment narrative boils down to this. It's like that scene in *Chinatown* where Faye Dunaway's character explains to naïve private eye Jack Nicholson that her daughter and her sister are one and the same.

We cannot get away from the inflation conversation because of its profound effect, not just on Wall Street but, more broadly, on Main Street. Thus, it's a political issue as well as an economic issue.

And no wonder. The May CPI reading of 8.6% was the highest in 40 years. It indicated to investors, the Fed, and mere citizens that inflation has not peaked and that more forceful action will be required to corral inflation.

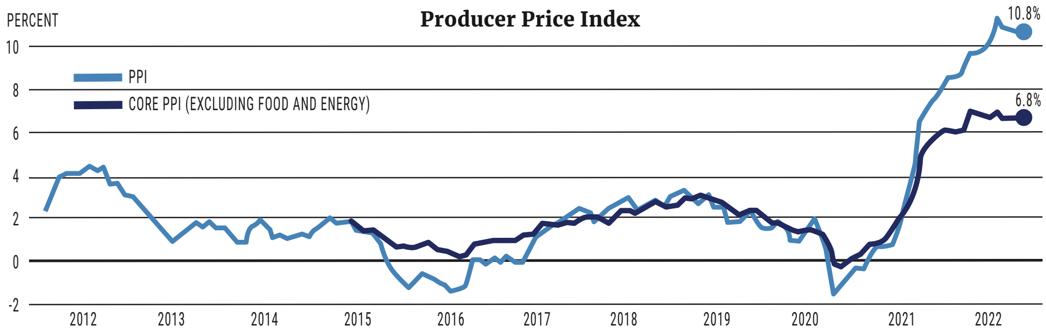
Consumer Price Index



YEAR-OVER-YEAR PERCENTAGE CHANGE | SOURCE: U.S. BUREAU OF LABOR STATISTICS

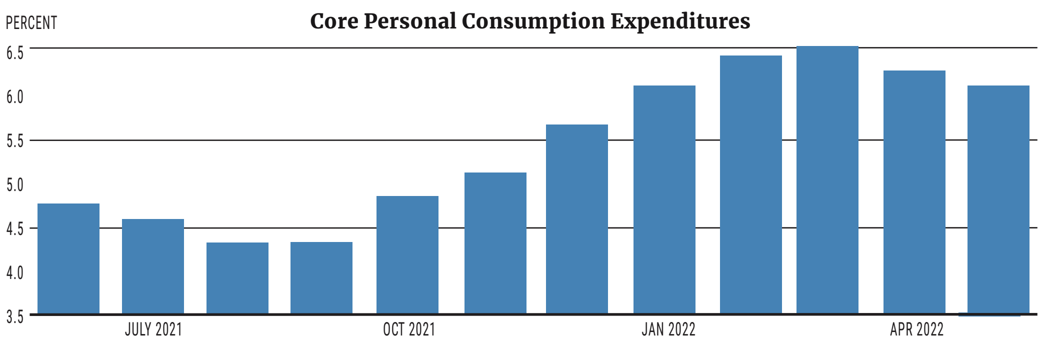
The Fed is fearful that long run inflation expectations will become unanchored, and that its inflation fighting credibility is on the line. This goes a long way to explaining the Fed's surprise three-quarters of a percentage point rate increase in June, its most aggressive hike since 1994—a Winnie-like 'larger small helping.'

Yet there are some indications that inflation has, in fact, summited and is coming down the mountain. The Producer Price Index (PPI) may have already peaked: PPI year over year was up 11.5% in March, 10.9% in April, and 10.8% in May.



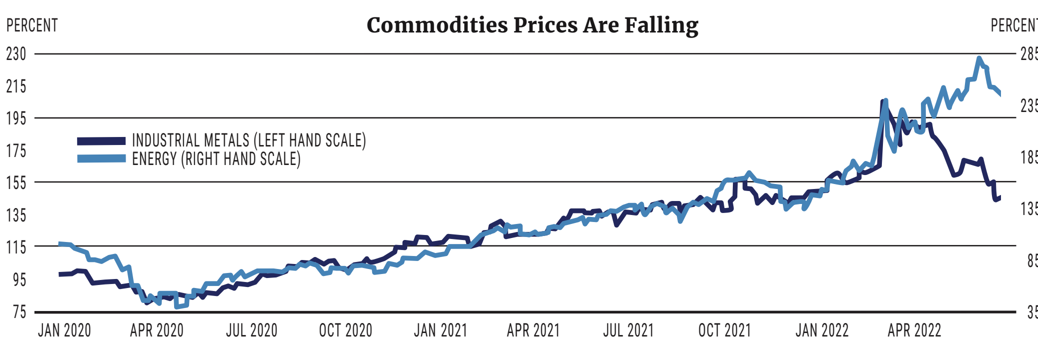
YEAR-OVER-YEAR PERCENTAGE CHANGE | SOURCE: U.S. BUREAU OF LABOR STATISTICS

And the Fed's preferred inflation gauge, Core PCE, appears to have peaked in March and has fallen since then.



SOURCE: U.S. BUREAU OF LABOR STATISTICS

Commodities prices, too, appear to have topped out in the spring:

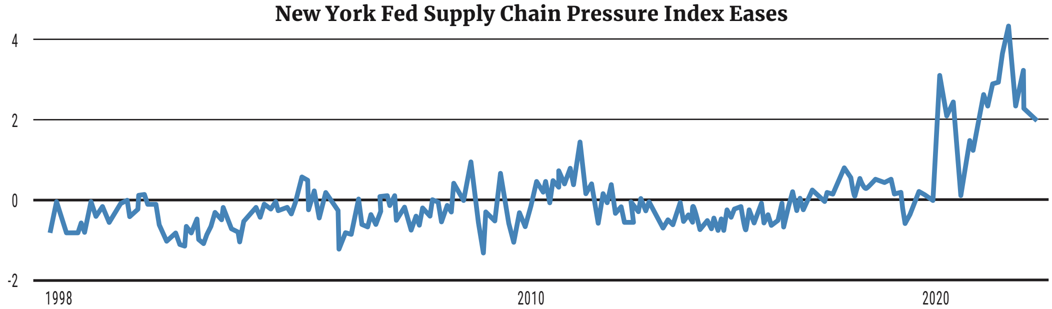


EQUAL WEIGHTED PRICE INDEXES | SOURCE: TOPDOWN CHARTS, DATASTREAM

Copper prices have fallen almost 30% from their peaks; other industrial metals including aluminum, nickel, and tin are also down sharply from March levels. The Food and Agriculture Organization of the United Nations' food price index has dropped for three successive months. And lumber has fallen 58%.

Lastly, supply chain bottlenecks are improving, as can be seen in the New York Fed's measure.

New York Fed Supply Chain Pressure Index Eases



SOURCE: BLOOMBERG

HOW LONG WILL THE BEAR HIBERNATE?

Think, think, think.
-A.A. Milne, Winnie the Pooh

Worshipping at the altar of the Fed, historically, may not offer much spiritual salvation, but it has often been rewarding as an investment strategy. After all, the old saw goes that investors should not fight the Fed—that is to say, when the Fed's policy path is clear, resistance is not merely futile but harmful to one's financial health and well-being.

Photo: Federal Reserve Bank headquarters, Washington, DC.

But the distinguished men and women who toil at the Fed are not gods, but fallible human beings capable of error and misjudgment. While the Fed's policy prescription has been clearly articulated, we are left to contemplate the likely consequences, and devise appropriate portfolio positions.

There is reasonably convincing evidence that the US economy is experiencing distinct deceleration, and nascent evidence that inflation is on the right road to decline. There are sound empirical examples of the effectiveness of higher interest rates to diminish demand, and the increases already in place and those that have been projected are likely to achieve their targeted aim. Quantitative tightening is likely to also be constructive in reducing inflationary pressures. Inflation is likely to fall—the only questions are how much it will fall and how long it will take.

The prescription for inflation of higher interest rates, however, may have regrettable side effects. The most consequential, and perhaps the most likely, is a recession. With unemployment at a remarkably low 3.6% and 11 million unfilled jobs, it may seem odd to speak of a recession. (Note, however, that most labor market data are, at best, coincident indicators.) But interest rates are a notoriously blunt instrument, and the Fed's track record is less than stellar in engineering a soft landing as it seeks to abate inflation. And the health of the labor market frees the Fed to focus entirely on wielding its interest rate and balance sheet tools to fight inflation.

A late cycle economy which may be flirting with recession is not a set-up for over-weighting equities. It is, however, an appropriate backdrop for a focus on high quality stocks—those with defensible economic moats, solid balance sheets, steady earnings growth, and strong free cash flow generation. Value stocks continue to be more attractively priced than growth stocks. Small cap stocks are particularly attractively valued, though they are also less defensive than better capitalized companies.

International equities—both developed and emerging markets—sport modest valuations, too, but face challenging inflation and growth dynamics.

In the fixed income arena, the rise in absolute interest rates has increased the attractiveness of the asset class. Further, if current trends of slowing economic growth persist, and early signs of inflation easing prove durable, the Fed may well not need to raise rates as much as currently forecasted. These features of the current fixed income landscape suggest modest duration extension into intermediate term bonds. At the same time, potential future economic weakness warrants a cautious approach to credit quality and inclines us to focus on stronger issuers.

This is a challenging juncture for investors, who have experienced portfolio declines and are understandably concerned about further bear market weakness. (Of course, upside surprises—resolution of war in Ukraine, supply chain restoration, COVID trailing away—are possible.) In times of heightened uncertainty, it's helpful to turn to well established words of wisdom to see yourself through such periods. Who better than Winnie the Pooh, who reminds us that "You're braver than you believe, stronger than you seem, and smarter than you think." Long-term investors who are brave enough and strong enough to stay the course will prove to be smart enough, too.

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