PEAPACK PRIVATE
Wealth Management

NASDAQ: PGC

MARKET COMMENTS

May 20, 2022

Economic Background

U.S. Economy – The first release of U.S. gross domestic product (GDP) for the first quarter of 2022 was an annualized rate of -1.4% quarter over quarter due to negative net trade figures and lower government spending. Consumption, which makes up close to 70% of GDP, was still growing at a solid +1.8% pace. GDP is expected to rebound in the second quarter to 2.7% according to consensus estimates; however, growth rates are being revised lower for the year due to the demand destruction that is resulting from the elevated inflationary environment.

Inflation – The Fed's preferred inflation metric (core personal consumption expenditures) is up 5.2% year-over-year as of March and is running well above the Fed's long-term average target of 2.0%. Market-based inflation expectations according to the TIPS market recently peaked in late March at close to 5.0% for the 2-year tenor and have recently come down to just under 4%, indicating that peak inflation may have been reached. The main question is how quickly inflation will come down from current levels given the imbalance between aggregate supply and demand along with the tight labor market.

Employment – Over the past twelve months, nonfarm payrolls have increased dramatically at over 500,000 jobs per month. There are currently approximately two job openings for every unemployed worker. Average hourly earnings in April were up 5.5% on a yearly basis due to the tightness within the labor market. With wages rising and Covid-19 restrictions in the U.S. declining, it would not be surprising to see more people come off the sidelines and reenter the labor force. However, the labor force participation rate currently resides at 62.2% and is 140 basis points below where it stood prior to the pandemic.

Fiscal Policy – Over the course of 2020 and 2021, the Federal Government ran massive deficits that totaled over $6 trillion. Moreover, during 2021 the federal budget deficit was 12.4% of GDP. Fiscal spending is expected to decline dramatically in 2022 according to the Congressional Budget Office's most recent forecast, and the deficit is projected to be approximately 4.7% of GDP, which will be a significant headwind to economic growth in 2022.

Monetary Policy – Over the past 6 months, the Fed has switched from extraordinarily accommodative monetary policy to a neutral stance. The fed funds rate has increased 75 basis points so far this year and the Fed has utilized forward guidance to indicate that many more rate hikes are still to come in 2022. The market expects the Fed funds rate to end the year at roughly 2.75%. The Fed's balance sheet, which has expanded to almost $9 trillion, will begin to shrink in size starting in June at a pace of up to $47.5 billion per month and then double to $95 billion per month starting in September. At this point, the Fed's main priority is to fight inflation given its elevated level and the strength in the labor market. If inflation does not come down in an orderly fashion, the Fed will be forced to tighten monetary policy beyond current expectations which will lead to elevated market volatility and increase the probability that a soft economic landing will not be accomplished.

Equity Market

Market Volatility - The S&P 500 was down 4% on Wednesday which was the worst single-day selloff since June of 2020. With the equity market's dip this week, the S&P 500 is now down about 18% from its all-time high and is approaching a bear market. Bear markets are defined as a 20% market decline. The market weakness has been broad-based, and the average stock is down about 24% for the year. Meanwhile, the technology-oriented NASDAQ and small cap Russell 2000 are both in bear markets, with losses of nearly 30% each. Longer duration growth stocks have been especially punished. The Russell 1000 Growth index is down over 26% this year. Overall, the volatility has been elevated. The S&P 500 Index level has moved 2% or more in almost 40% of the trading days in 2022 – a level we have not seen since 2008/2009.

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<u>Equity Valuations</u> – Investors are requiring a substantially higher equity risk premium due to higher interest rates and heightened economic uncertainty. Higher rates are causing equities to reprice lower due to a higher equity market discount factor driving lower price-to-earnings multiples. Longer duration equities, growth companies that have more of their cash flows further in the future, have seen a sizable reduction in P/E multiples. The forward multiple on the S&P 500 Index has contracted from 21.5 times at the start of the year to 17.3 times today. Assuming no degradation in earnings estimates for 2023, and assuming that the equity market trades between a 15 to 20 price-to-earnings multiple, the range of potential forward returns would be between -9% to +22%.

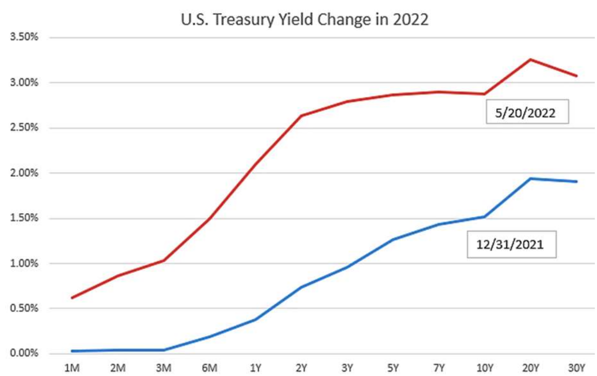
<u>Earnings</u> – Despite the prospect of a slowing economy, earnings expectations have been rock-solid for both 2022 and 2023. In fact, earnings estimates have risen modestly since the beginning of the year. Although consensus estimates are holding up in aggregate, declining expectations in areas like consumer discretion and communication services are being offset by upward revisions in energy and materials. The dynamic of rising rates, inflationary pressures and eroding consumer confidence is shifting consumption demand and impacting corporate earnings. New winners and losers are being created based on each company's ability to offset higher costs with higher pricing. Earnings reports this week from major retailers were mostly disappointing, raising questions about the strength of consumer spending and the ability of companies to offset higher costs. Ultimately, we expect some erosion in earnings expectations as the economy slows and margin pressures increase.

<u>Recession and Earnings</u> – The possibility of a recession in 2023 is increasing as the Fed takes a more aggressive stance fighting inflation. If the economy does slip into a recession, we would expect it to be relatively shallow given strong corporate balance sheets and a very healthy consumer. So, 2023 earnings estimates may likely experience a relatively modest decline of 10 to 15%. Under this scenario, the equity market drawdown could continue. We are not expecting a recession at this point, but investors need to acknowledge the possibility and be aware of the worst-case scenario.

FactSet

Fixed Income

A bevy of underlying crosscurrents have made for a volatile year in U.S. Treasury yields thus far in 2022. Year-to-date, interest rates across the Treasury curve have increased anywhere from 57.9 basis points (bps) to 185.1 bps. The dramatic move comes in the wake of historically high inflation and the Federal Reserve's pledge to combat higher prices with a series of rate hikes and balance sheet normalization. The projected pace of monetary tightening and the FOMC's hawkish rhetoric have contributed to the precipitous flattening of the U.S. Treasury curve. The 2-year and 10-year yield spread has narrowed 57.5 bps to just 20.3 bps and can sometimes be a precursor for potential economic weakness. Bloomberg's forward curve matrix is forecasting an inverted yield curve within just six months, reflecting a 2-year and 10-year spread of -6 bps.

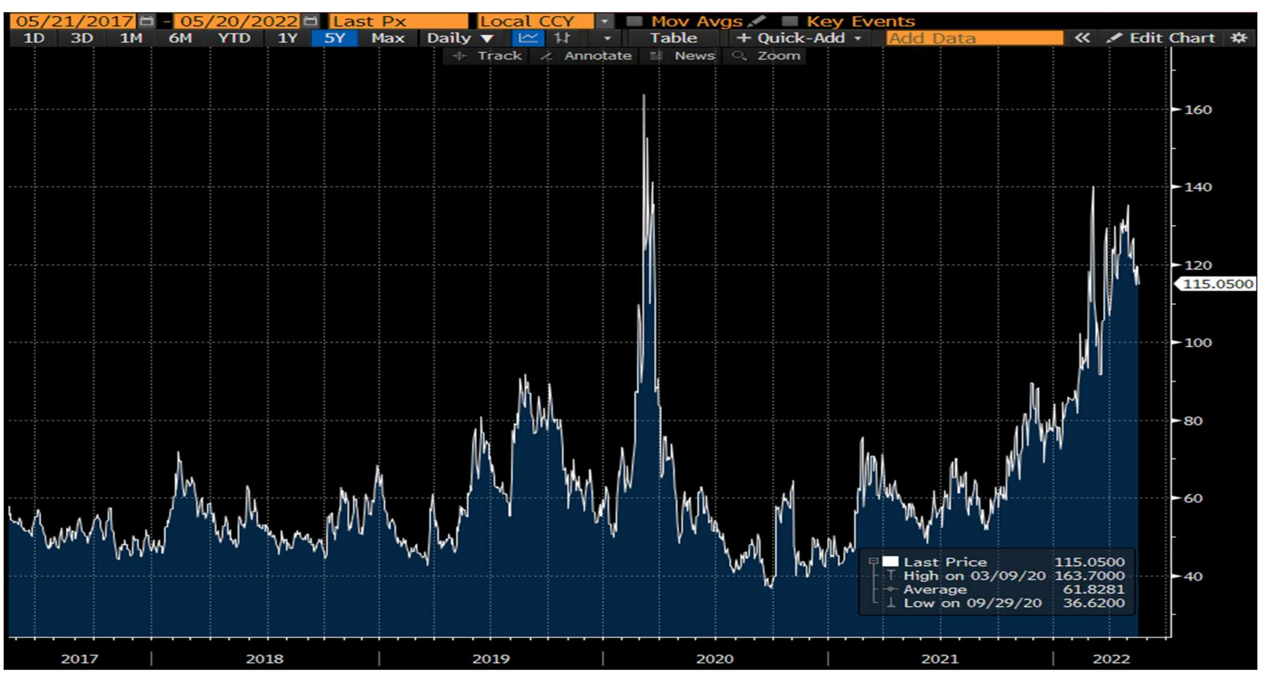


Forward Curve

Tenors	Yield	1W	3MO	6MO	1YR	2YR	3YR	4YR	5YR
1Mo	0.58	0.70	1.93	2.67	3.18	3.09	2.96	2.96	2.95
3Mo	1.03	1.15	1.98	2.69	3.17	3.08	2.95	2.95	2.94
6Mo	1.48	1.59	2.34	2.67	3.23	3.12	3.01	3.01	3.00
1Yr	2.10	2.15	2.63	2.95	3.21	3.10	2.99	2.99	2.99
2Yr	2.63	2.66	2.90	3.05	3.15	3.04	2.99	2.99	2.98
3Yr	2.78	2.80	2.96	3.05	3.10	3.02	2.99	2.98	2.92
5Yr	2.85	2.87	2.97	3.02	3.06	3.01	2.95	2.91	2.87
7Yr	2.87	2.89	2.96	3.00	3.01	2.95	2.91	3.01	3.11
10Yr	2.84	2.86	2.94	2.99	3.04	3.08	3.14	3.22	3.29
20Yr	3.22	3.24	3.28	3.30	3.30	3.28	3.27	3.26	3.25
30Yr	3.05	3.07	3.10	3.11	3.12	3.10	3.08	3.08	3.07
2/10 Spread Forecast		0.21	0.04	-0.06	-0.11	0.04	0.16	0.23	0.31

The Merrill Lynch Option Volatility Estimate Index (MOVE), which is a yield curve weighted index of volatility on1-month Treasury options, rose to 140 on March 7th. The 5-year average is just 61.8, and it peaked at 163.7 on March 9, 2020.

MOVE Index 5Y History



Bloomberg

Outlook

The overall short-to-intermediate outlook remains uncertain. Equity markets have priced in the heightened level of uncertainty with the drawdown we have experienced this year. The revaluation of equities lower will eventually draw in buyers, but this may not occur until there is greater clarity around the Fed's success in fighting inflation while maintaining economic growth. With many unresolved issues, we think the prudent course for investors is to remain focused on long-term investment objectives. For equities, high-quality companies with defendable business models and superior cash flow should be emphasized. For bonds, the focus should be high credit quality and shorter durations.

Conclusion

The S&P 500 Index has delivered superb equity returns for most of the past thirteen years. Likewise, the 10-year U.S. Treasury bond has generally delivered excellent returns for over forty years. The nature of equity and bond markets includes phases of adjustments similar to the one that we are experiencing this year. Sustained elevated inflation levels caught the Fed—and investors—off guard, and the Fed's policy shifts go a long way to explain reduced equity valuations. That process is still under way. It would not be unreasonable to expect that financial markets could decline further as the impact of higher inflation and interest rates on our economy becomes clearer. Financial markets are forward looking, and they tend to price in expectations for what is to come 6 - 12 months into the future. At the point where investors can begin to see future improvement of economic conditions, the financial markets will begin to adjust in anticipation of the next expansion phase of our economy. Until this happens, we need to remain patient.

JEC 5/20/2022