PeoplesBank
WEALTH MANAGEMENT

Economic & Market Perspectives

Summer 2022

"A nickel ain't worth a dime anymore" — Yogi Berra

Yogi Berra, an all-star catcher who played on some of the great New York Yankees baseball teams of the mid-1900s, is probably better known for his "Yogi-isms" -- witty observations, contradictions, or malapropisms on a variety of subjects.

While Yogi lived in a much different time than today, one where consumers shopped at "five and dime" stores, he certainly understood in his own unique way the value of money and the deleterious impact of inflation on its purchasing power. We can certainly appreciate Yogi's take on the loss of purchasing power every time we fill up our cars with gasoline, with the average price recently climbing to just over $5 a gallon.

Unfortunately, our experience with inflation is not limited to just the gas pump. Individuals as well as businesses are being impacted by higher prices across the board. To fight inflation, many central banks, including the Federal Reserve, are raising interest rates.

Stock and bond markets have had a historically bad first half of the year in response to tightening monetary policy and slowing economic growth, including the prospects of recession.

The Economy

The global economy has had to contend with a very dynamic and uncertain outlook in the first half of 2022. Economic growth projections for 2022 remain positive, but the economy is facing several headwinds.

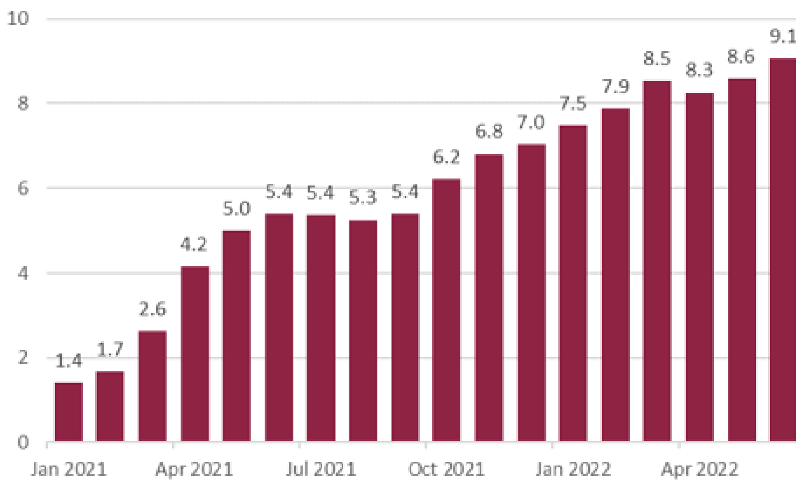
The COVID-19 pandemic's impact on the economy has lessened as restrictions have been lifted. Even though we are seeing a recent uptick in hospitalizations due to the Omicron subvariant, BA.5, the number of severe cases resulting in hospitalization or death has remained relatively low. The biggest risks to the economy are from elevated inflation, rising interest rates, and the ongoing conflict in Ukraine.

At the beginning of 2021, annual inflation as measured by the Consumer Price Index (CPI) was only 1.4%. Prices began to rise as the economy rebounded from the pandemic-related shutdowns and restrictions. Businesses struggled to keep up with demand and shortages of materials and labor added to price pressures.

Throughout 2021, Fed officials and the Biden administration kept assuring us that the higher inflation we were seeing was "transitory", but by December of 2021, the CPI reading was coming in at an annualized rate of 7% and the narrative was changing. The Fed was admitting that the price increases were "faster than expected".

Pent-up demand and supply chain-related shortages persisted into this year and Russia's war with Ukraine has exacerbated the situation and driven up the price of commodities, especially oil which has jumped 41% in the first half of 2022. Inflation is now running at an annualized rate of over 9.1%, according to the most recent data released in July. See Chart 1 below.

(Chart 1)



Source: U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average [CPIAUCNS], retrieved from FRED, Federal Reserve Bank of St. Louis.

U.S. consumers are worried about high inflation, especially higher gas and food prices, and a slowdown in the economy. Consumer confidence is at 16-month low and consumer sentiment fell to an all-time low in June. Americans' expectations for overall inflation in the next year rose to 5.4% in June. There is concern that inflation worries may lead to a pull-back in consumer spending, which is a key driver of economic growth.

Russia's war in Ukraine has intensified and is contributing to inflationary pressures and slowing economic growth. According to the Organization for Economic Cooperation and Development (OECD), global Gross Domestic Product (GDP) growth is now projected to slow sharply this year, to around 3%, and remain at a similar pace in 2023, which is well below the pace of recovery projected last December. Growth is set to be markedly weaker than expected in almost all economies. Many of the hardest-hit countries are in Europe, which is highly exposed to the war through energy imports.

The OECD now expects the U.S economy to grow at an annualized rate of 2.5% in 2022, which is down considerably from the December's projection of 3.7%. U.S. GDP growth ended 2021 on a high note, with the economy posting an annualized growth rate of 6.9%, in large part due to a build-up in inventories. However, there are signs the U.S. economy is slowing down in the first half of 2022.

U.S GDP declined at an annualized rate of -1.6% in the first quarter of 2022, driven by a large trade deficit, and the Atlanta Fed's GDPNow model estimates that the U.S economy will contract by -1.5% in the second quarter. While many would characterize two consecutive quarters of negative GDP growth as a recession, that it is not the official designation. According the Bureau of Economic Analysis:

The National Bureau of Economic Research (NBER), a private non-profit research organization, officially defines recessions based on a number of monthly indicators—such as employment, personal income, and industrial production—as well as quarterly GDP growth. While negative GDP growth and recessions closely track each other, the consideration by the NBER of the monthly indicators, especially employment, means that the identification of a recession with two consecutive quarters of negative GDP growth does not always hold.

The Fed has acted swiftly to combat inflation after what many critics consider too slow of a reaction to the rapid rise in prices over the past year. The central bank hiked the short-term federal funds rate by 75 bps to a target range of 1.50%-1.75% at its June meeting, after previously raising rates at both its March and May meetings. The June rate hike was the largest single interest-rate hike in thirty years. In a post-meeting statement, the Fed reiterated its commitment to reducing inflation to its long-term target of 2%. The Fed's June meeting minutes show that Fed officials are prepared to hike another 50 to 75 basis points in July.

There has been a lot of debate about whether the Fed can engineer a "soft landing", that is, raise interest rates enough to slow economic growth and bring down inflation without causing a recession. The probability of U.S. recession (twelve months ahead) predicted by the treasury spread is still very low at 5.9%, based on The New York Fed's model, which calculates the probability of a recession in the U.S. twelve months ahead, based on the spread between the three-month and ten-year Treasury rates. The average "10-3 spread" was 1.62% in June 2022. That spread has narrowed significantly in July, indicating that the probability of recession, based on this model, is now higher. See Chart 2 below.

(Chart 2)

Probability of U.S. Recession Predicted by Treasury Spread

Twelve Months Ahead (monthly averages)

Note: the gray-shaded areas represent U.S. recessions, as dated by NBER.

Source: Macrobond, Federal Reserve Bank of New York.

Despite signs that economic growth is slowing the labor market remains strong and consumer spending is holding up. The U.S. economy added 327,000 jobs in June and the unemployment rate remained at 3.6%, near a fifty-year low. Job openings are near record highs, with 2 job openings for every unemployed person – a sign that demand for labor is robust.

The jobs numbers and unemployment rate are coincident indicators of economic activity. Weekly jobless claims give us a better indication of emerging labor market conditions. While initial jobless claims recently hit the highest level since last November, the 4-week moving average of 237,500 is just slightly above the 2019 prepandemic weekly average of 218,000, when the labor market was also strong, according to MarketWatch.

Consumer spending, which accounts for more than two-thirds of economic output or GDP, is showing signs of resiliency despite higher inflation and plunging consumer sentiment. Although GDP growth was negative in the first quarter of 2022, consumer spending increased at an annualized rate of 1.2%. A recent report shows U.S retail sales increased 1% for June, and 8.4% above 2021. Even though higher prices for food and gas are a big part of the June increase, the number is still encouraging in the face of higher inflation.

While the focus has shifted to inflation, interest rates, and health of the economy, COVID-19 and its fast-spreading sub-variants are still a concern. The more transmissible BA.5 Omicron subvariant now represents 65% of cases in the United States, and we are seeing a 14% increase in hospitalizations based on the most recent 7-day average compared to the prior 7-day average, according to the Centers for Disease Control and Prevention.

The impact of COVID-19 restrictions, especially China's zero-Covid policy, on supply chain disruptions has been significant and is one of the key contributors to the high inflation numbers we are seeing today. Fortunately, global supply chain pressures have been decreasing over the past three months, according to the New York Fed's Global Supply Chain Pressure Index (GSCPI). The decline in June's GSCPI was mostly due to a large decrease in Chinese supply delivery times. While somewhat encouraging, supply chain pressures remain at historically high levels.

Financial Markets

Fears of recession have buffeted financial markets in the first half of 2022, and there was seemingly no place to hide -- only commodities (+18.4%) and cash (+0.2%) posted positive returns.

Stocks continued to slide in the second quarter of 2022, and U.S. stocks, represented by the S&P 500, had their worst first half in over 50 years. Tightening financial conditions in the face of increasingly high inflation data weighed on stocks. Higher interest rates have led to a repricing of equities, discounting their values lower, and there is growing concern that a slowdown in demand coupled with higher input costs could negatively impact future earnings growth and profit margins.

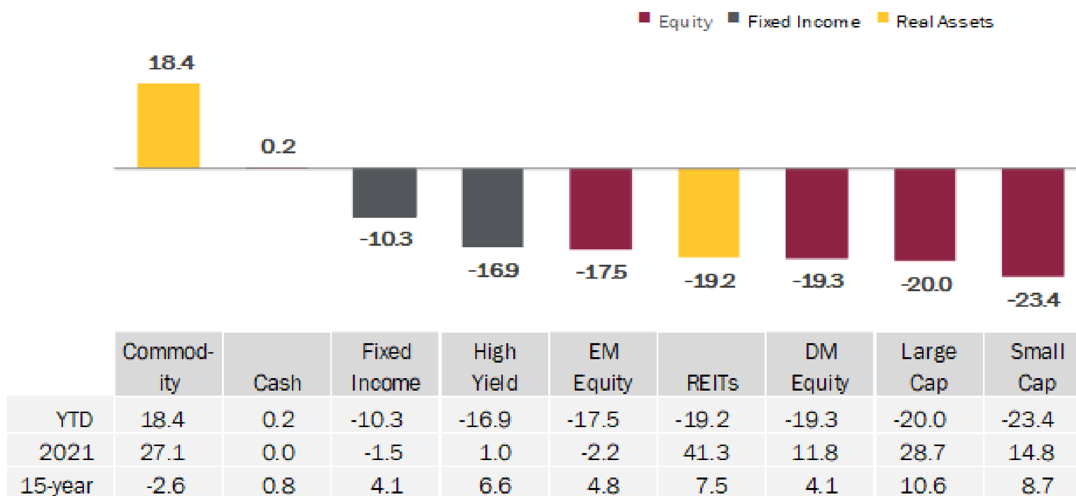
The U.S. bond market had its worst first half of the year ever as prices continued to fall with rising yields. Bonds have traditionally been a reliable diversifier, with positive returns offsetting declines in stock prices. However, we are coming off a long period of exceptionally low interest rates and a bull market for bonds. The traditional 60% stock/40% bond strategy, using the S&P 500 and Bloomberg U.S. aggregate indexes as proxies, returned -16% for the first half of 2022.

Commodities remain the top performing asset class year-to-date. Although, we have seen a recent pull-back in the price of oil and other commodities on concerns about a slowdown in global demand and growth.

For more on selected asset class returns, see Chart 3 below.

(Chart 3)

YTD RETURNS (%)



	Commod-ity	Cash	Fixed Income	High Yield	EM Equity	REITs	DM Equity	Large Cap	Small Cap
YTD	18.4	0.2	-10.3	-16.9	-17.5	-19.2	-19.3	-20.0	-23.4
2021	27.1	0.0	-1.5	1.0	-2.2	41.3	11.8	28.7	14.8
15-year	-2.6	0.8	4.1	6.6	4.8	7.5	4.1	10.6	8.7

Source: J.P Morgan Asset Management *Guide to the Markets* -U.S. Data are as of June 30, 2022.

Cash: Bloomberg 1-3m Treasury, Commodity: Bloomberg Commodity Index, DM Equity: MSCI EAFE, EM Equity: MSCI EME, Fixed Income: Bloomberg US Aggregate, High Yield: Bloomberg Global HY Index, Large cap: S&P 500, REITs: NAREIT Equity REIT Index, Small cap: Russell 2000. 15-year annualized return represents period from 12/31/2006 to 12/31/2021.

Outlook

Our long-term outlook for risk assets remains positive, but it is somewhat tempered by near-term headwinds posed by accelerating inflation, rising interest rates, and slowing economic growth.

Although equity market performance in the first half of the year has been challenging, to say the least, history shows that periods of big losses are followed by a rebound. When the S&P 500 has fallen at least 15% the first six months of the year, as it did in 1932, 1939, 1940, 1962 and 1970, it has risen an average of 24% in the second half, according to Dow Jones Market Data and The Wall Street Journal.

However, lower valuations and slowing earnings growth may put stocks under additional pressure in the near-term. The pullback in stocks this year has caused the price-earnings multiple for equities to drop significantly. For example, U.S. stocks were trading at a multiple of just over 21x (next twelve months earnings) at the end of last year compared to the current level of just under 16x, which is close to the long-term average. And non-U.S. stocks continue to look relatively inexpensive, trading at a significant discount to U.S. stocks.

Future earnings growth will be key to supporting equity prices over the next several quarters and beyond as higher interest rates will most likely keep valuations at or below current levels. Analysts are projecting high single digit earnings growth for companies both inside and outside of the U.S. in 2022, according to J.P. Morgan Asset Management. Earnings growth should moderate slightly in 2023 and then pick up in 2024. All of this assumes central banks can get inflation under control without curtailing demand too much and companies can maintain healthy profit margins.

Given these headwinds, we moved our equity allocation to neutral-weight (relative to our strategic asset allocation) back in March and recently brought our allocation percentages for U.S. and non-U.S. stocks closer to benchmark weights. We remain underweight fixed income, although bonds are looking more attractive as interest rates rise – the 10-year Treasury is currently trading around 3%, up from 1.51% at the beginning of the year. We have a tactical overweight to commodities.

Within equity, we are slightly overweight U.S. stocks and a value tilt within U.S. large cap and mid-cap. Although non-U.S. markets have attractive valuations and greater exposure to cyclical sectors than U.S markets, their economies are more exposed to the economic fallout from the Russia-Ukraine conflict, especially given the reliance of non-U.S. markets on Russia for gas and oil.

Within fixed income, we are short duration relative to our benchmark and have a tactical overweight to higher-yielding sectors such as floating rate notes and high yield bonds, which should help mitigate interest rate risk and provide additional yield. We are equal-weight cash, relative to our strategic target.

We have a tactical allocation to commodities as a hedge against inflation as well as geopolitical risk. While commodities continue to look attractive in the long-term because of supply and capacity constraints, demand may soften with a slowdown in global economic activity.

For more on our positioning, see Chart 4 below.

(Chart 4)

PBWM's STRATEGIC AND TACTICAL ASSET ALLOCATION

	Asset Class	Strategic (%)	Over/Underweight (%)	Tactical (%)
Equity	U.S. Stocks	30	3.5	33.5
	International Developed Stocks	22	-0.5	21.5
	Emerging Market Stocks	8	-3	5
Fixed Income	Core Bonds	38	-9	29
	Non-Core Bonds	0	4	4
	Cash Equivalents	2	0	2
Real Assets	Real Estate-related securities	0	0	0
	Commodity-related securities	0	5	5

PeoplesBank Wealth Management's (PBWM's) strategic and tactical asset allocation for its moderate growth total return strategy as of July 2022.

Notes

PeoplesBank Wealth Management's (PBWM's) asset allocation process develops both long-term(strategic) and shorter-term (tactical) recommendations. Strategic recommendations are based on how the Wealth Management Investment Strategy Committee (ISC) believes investment portfolios should be positioned in a generally neutral market environment over the next ten years. Tactical recommendations are based on where the ISC sees either increased opportunity or risk over the next one to two years. The ISC is responsible for developing both the strategic (long-term) and tactical (short-term) asset allocations for Wealth Management's investment management and trust relationships. The ISC is comprised of the senior members of the Wealth Management team. The ISC is also responsible for monitoring and updating strategies, managers, and funds within client portfolios. The ISC meets monthly. If you have questions or would like additional information regarding PBWM's investment process, please call or send an email to your relationship or investment officer.

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Sources: Federal Reserve Bank of New York, Federal Reserve Bank of San Francisco, J.P. Morgan Asset Management, MarketWatch, Organization for Economic Cooperation and Development. U.S. Department of Labor, and the Wall Street Journal.