Legacy Trust

Investment Perspectives

Mid-Year Market & Economic Update

July 2022

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Key Takeaways

- The first half of the year brought selloffs in both stocks and bonds as investors focused on inflation, Federal Reserve actions, and slowing economic growth
- The Federal Reserve, following months of criticism for a slow response, has since acted decisively in a series of aggressive rate hikes
- While economic growth is slowing, we recommend investors stay committed to equities as recession risks are already priced in

The first half of 2022 brought a prolonged market downturn across most asset classes, as investors shifted focus from the pandemic to worries about persistent inflation and its impact on the economy. Multiple interest rate hikes from the Fed appear to be having the desired effect of cooling economic growth, although the labor market remains historically tight. Both stocks and bonds have shown improvement in recent weeks as the risk of recession appears to now be priced in.

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The first half of 2022 brought a prolonged market downturn across most asset classes, as investors shifted focus from the pandemic to worries about persistent inflation and its impact on the economy. Inflation readings have been coming in persistently high with the latest CPI headline reading at 9.1% (ex food and energy 5.9%). Economic imbalances that emerged during the pandemic years are slowly unwinding and, while prices are not likely to decline to previous levels, we do not expect ongoing persistent jumps in prices either. As a result, we continue to expect inflation readings to begin to come down in the latter half of the year and into 2023.

The Federal Reserve, following months of criticism for a slow response, has since acted decisively in a series of aggressive rate hikes. The Fed Funds Rate was increased by 0.25% in March, 0.50% in May, and 0.75% both in June and again in July. This has brought the rate up from effectively zero, where it has sat since the beginning of the pandemic, to 2.25% - 2.50%. The Federal Open Market Committee has three more meetings scheduled from September through December which will be opportunities for additional increases, but we believe there is more uncertainty about the Fed's path going forward as economic and inflation numbers will likely be showing signs of weakness by then.

There are clear signs that the economy is already slowing. Data has been softening for several weeks as businesses and consumers adapt to higher rates and more persistent inflation. Both the ISM Manufacturing and Services indexes show meaningful declines since the beginning of the year, although they are still in expansionary territory. American consumers have largely spent through their savings that were accumulated during the pandemic and there are indications that household debt is beginning to increase, although levels remain reasonable for now.

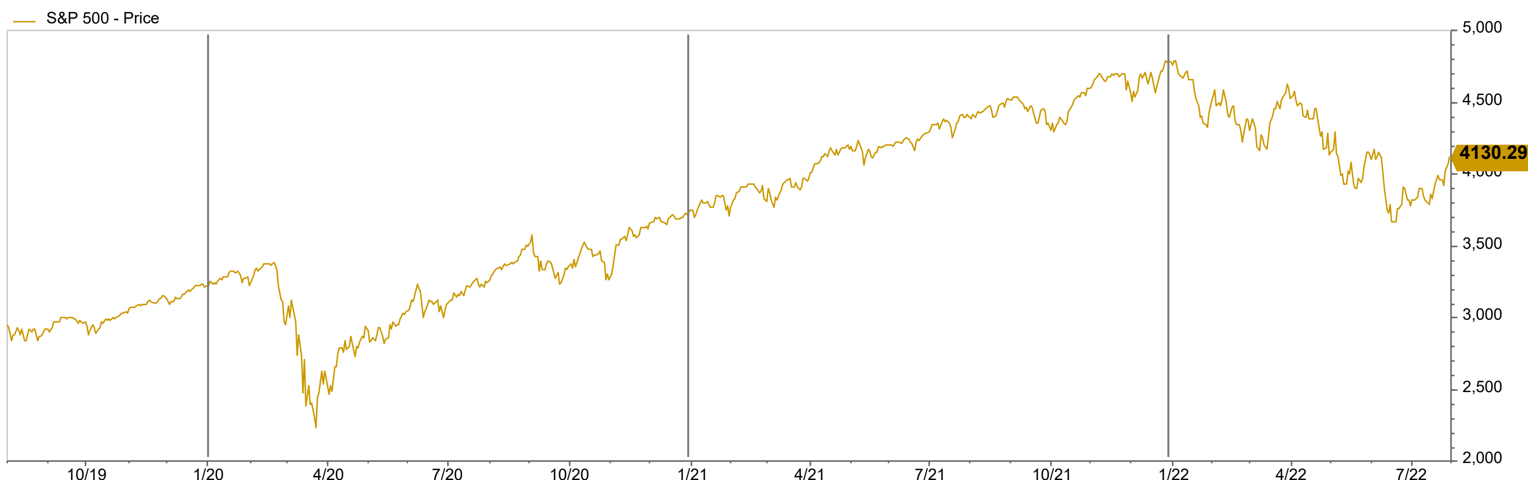
In contrast, unemployment remains very low at 3.6%, although we are starting to see anecdotal reports of numerous companies laying off workers or pausing hiring. The number of job openings has begun to come down from its peak but there are still nearly two open jobs for every one unemployed person seeking work. We are watching weekly jobless claims closely for signs of softening, but for now, the jobs market is very tight and is putting significant pressure on wages.

With heightened uncertainty around the future path of inflation, interest rates, and economic growth, stocks around the globe sold off in the first half of the year. Bonds, which can usually be counted on to offset stock market losses during times of volatility, experienced losses of their own as fixed income investors scrambled to price in the rapid path of Fed rate hikes. The 10-Year Treasury yield more than doubled during the first half of the year. We believe the Fed's path of anticipated rate hikes has now been priced into the bond market, so we expect that most if not all of the pain for bond investors has been felt at this point.

The S&P 500 experienced a -24% decline from its January 3rd peak to its June 16th low. It should be noted that this equity market selloff has so far been purely valuation-driven rather than a fundamental decline prompted by lower earnings. In fact, company earnings have continued to grow year-over-year. There may be softening in the latter part of the year as economic growth slows, but nevertheless, we do not believe a recession is guaranteed. We expect that if a recession does become reality, it is likely to be fairly mild. Consumer spending behavior still remains reasonably solid and the labor market is historically tight.

Despite economic worries, we recommend clients remain invested. Remember that equity markets are forward-looking and typically bottom well before the economy does. The stock market already appears to have priced in a significant risk of recession, and equities typically rally by double-digits in the year following a bear market.

S&P 500 – Prior Three Years Ending July 31, 2022



Source: FactSet Research Systems

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