Market Update and Outlook

June 17, 2022

As we approach the midpoint of the year, uncertainty has rattled the markets and much has changed in a short six months. From a business cycle perspective, we are either in a mid-cycle slowdown digesting the normalization of interest rates, or we are approaching a contraction in economic activity. Our market cycle dashboards remain in positive territory, but we are closely monitoring trends and probabilities that might cause them to turn bearish. So much uncertainty persists that one must carefully weigh the probabilities of each outcome. Given the datapoints we received from the Fed this week, we are re-underwriting our Stress Test Scenarios to be able to explain better the potential outcomes from here and to determine appropriate portfolio positioning and action. You should expect to hear from your advisor with more details in the coming weeks.

The Fed, Inflation, and Interest Rates

The Federal Reserve announced its decision to increase the Fed Funds rate by 75 basis points ("0.75%") at the conclusion of their June meeting. As a result, the upper end of the Fed Funds range is now 1.75%, still quite low by historical standards. Chairman Powell confirmed that the American economy remains very strong. Nonetheless, the Fed took the more aggressive step this meeting because inflation has remained more resilient than they had hoped. They shared an update to their economic projections highlighting more moderate expectations for GDP growth in 2022-2024, a slightly higher unemployment rate, but also a belief that inflation (Personal Consumption Expenditure or "PCE") can drop to 5.2% by year-end 2022 and 2.6% by the end of 2023 on its way to the Fed's target of 2%. The Fed also ratcheted up its expectations for the Fed Funds rate to levels more in-line with what the market was already expecting (3.4% in 2022, 3.8% in 2023 and 3.4% in 2024).

The Business Cycle

Rolling back to 2019, pre-pandemic, the economy was growing, but not much above a stall rate. The pandemic hit and drove the global economy into recession. Fiscal and Monetary policy unlike any we have seen before quickly sedated the economy to prevent more serious complications. The treatment was sufficient to bridge the gap and give the economy a firmer foundation from which to bounce back. We had a significant recovery led by financial markets with economy following in its footsteps. Whatever the cause, whether the stimulus, supply-chain disruptions, geopolitical events, or something else, we have now found ourselves caught in the vice of inflation.

Home prices and rents have increased dramatically, we cannot find enough people to fill the roughly eleven million job openings, wages have shot up significantly as a result and demand for goods still outstrips supply. All signs of a strong economy, but also factors that the Fed is trying to slowdown as it tries to tame inflation by raising interest rates and reducing its balance sheet. The risk is that they do not just slow the economic momentum but bring it to a stop. We put a roughly equal weight that this will just be a mid-cycle slowdown versus a recession.

Market Outlook

Stocks and bonds have significantly repriced since the beginning of the year. Equities have reached bear market territory (down 20%+) and bonds have not been spared either with one of the worst drawdowns on record. Equities are fairly valued today if not undervalued in some cases as forward Price-to-Earnings multiples for the S&P 500 Index sit in the 16x range,

comparable to the average over the last 25 years. A brighter future for returns awaits, assuming we do not experience a contraction in earnings. In the bond market, we have seen quite an adjustment, but note that we do not currently see yields reflecting much in terms of future inflation expectations, nor concerns about future credit risk via credit spreads.

The entirety of the Pathstone team continues to work diligently to assess new data as it comes in and to proactively communicate our views. Times like these are where discipline and sound process can make the most difference in your future financial outcomes. We encourage you to reach out with any questions in the meantime.

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