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Definitions

***Large Cap:** are defined as the group that account for the top 70% of the total market capitalization of the US equity market.*

***Small Cap:** are defined as the group that account for the bottom 10% of the total market capitalization of the US equity market.*

***Value Stock:** is a stock with a price that appears low relative to the company's financial performance, as measured by such fundamentals as the company's revenue, dividends, yield, earnings and profit margins.*

***Consumer Price Index (CPI):** Measures the average change in prices over time that consumers pay for a basket of goods and services.*

***Buffet Indicator:** a valuation multiple used to assess how expensive or cheap the aggregate stock market is at a given point in time.*

***10-year US Treasury Yield:** used as a proxy for mortgage rates. It's also seen as a sign of investor sentiment about the economy.*

****Russell 1000 Index:** The Russell 1000® Index measures the performance of the large-cap segment of the US equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000® represents approximately 92% of the U.S. market.*

****Russell 2000® Index:** measures the performance of the small-cap segment of the US equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.*

****Russell 3000 Index:** The Russell 3000® Index measures the performance of the largest 3,000 US companies representing approximately 98% of the investable US equity market.*

****S&P 500 Index:** S&P (Standard & Poor's) 500 Index: a market-capitalization-weighted index of the 500 largest US publicly traded companies.*

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ECONOMIC OUTLOOK 2022

2nd Quarter Update

An Indepth Forecast Of The Year 2022

jamesinvestment.com

First Half Recap

Four-decade high inflation and an increasingly hawkish Federal Reserve (Fed) response have created havoc in the financial markets.

Driven by higher consumption demand, rising commodity prices, and supply chain bottlenecks, the May Consumer Price Index (CPI) number came at 8.6% from a year earlier, the highest since 1981.

The Federal Reserve's most recent response was more aggressive than anticipated, raising interest rates by 0.75%, the most significant hike in 28 years. In normal times, the Fed hikes by 0.25%.

Stubborn inflation readings and the wFed's reaction pushed the major equity indexes into bear market territory (defined as a fall of 20% or more from a recent peak).

The Russell 3000 Index (a broad measure of the stock market) lost 21.1% year-to-date. The tech-heavy NASDAQ Index lost 29.2%. Both the small companies of the Russell 2000 Index and the larger ones of the Russell 1000 Index lost more than 20%. The S&P 500 had its worst half-year performance since 1970.

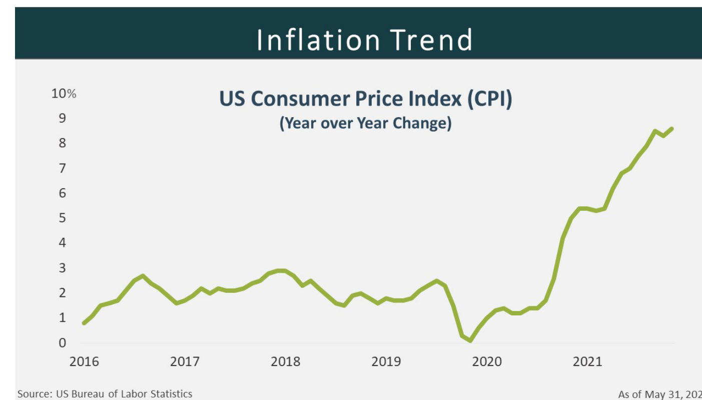
All sectors have lost money during the first half of the year except Energy. Rising oil prices propelled the Energy sector to an impressive gain of 34.2%. The Consumer Discretionary sector was the laggard losing 31.5%.

Inflation

The most prevalent story in today's news is inflation. Higher prices are all around us, whether food prices at the grocery store or the dreaded higher gas prices. As of 6/23/22, the national average for a gallon of regular grade gas was $4.93. Premium grade and diesel, which is used to ship goods across the country, were even higher at $5.56 and $5.82, respectively. It is no wonder consumers are beginning to feel the pinch. This is especially important regarding consumer sentiment, or how shoppers feel about their current situation and wealth. The University of Michigan Consumer Sentiment readings recently fell to a new cycle low level, 50.2 in June, indicating shoppers across the country are beginning to question their financial strength. Should consumer spending take a hit as shoppers change their habits, corporate profits and stock prices could take a hit as well.

What a turn of events we have seen this year regarding inflation and how it is viewed.

At this point in time, during 2021, the Federal Reserve continued to talk of inflation as 'Transitory' or, in other words, temporary. At that time, their view was



prices would fall due to outside factors which would not cause them to make rapid changes in monetary policy.

While the overall inflation rate is important to watch, let's look at the individual components that make up consumer prices. As of late, increases in oil, wheat, corn, and rent have been drivers of these increases. Oil, wheat, and corn price increases may have more to do with lack of supply. The Ukraine War with Russia can be seen as one major issue that continues to keep supply constrained. The global impact of these trade restrictions has put a crimp on supply throughout Europe.

Higher oil prices have a trickle-down effect on the prices of many other goods and services worldwide. The cost of shipping goods has increased and the companies paying for this service have done their best to pass those costs on to the end user.

One additional leading factor is wage inflation. After the COVID-19 lockdowns, we witnessed what has been called the 'Great Resignation'. An instance where employees throughout the United States either quit their jobs to stay home or conversely found an alternate career that paid higher wages. Wage increases directly impact the bottom line of corporations throughout the U.S.

However, there are a couple of things in our favor regarding inflation. The recent Michigan inflation survey indicates consumers feel the Federal Reserve's moves will have a positive impact. Respondents indicated they feel inflation will fall to 5.3% by the end of June. However, it will dissipate to a lower average rate of closer to 3% over the next five years. In addition, inflation breakeven rates, which are the rates on a Treasury Inflation-Protected Securities (TIPS) minus the rate on a nominal Treasury, have been falling. Just two months ago, investors expected over 3% of protection from a 10-year TIPS; now, they are only settling for 2.5%.

Fed Tightening

The Fed, the central bank of the United States, has been set up with a dual mandate to maximize employment while providing price stability. As of late, however, with CPI, PCE (Personal Consumption Expenditures), and PPI (Producer Price Index) at elevated levels, the objective of price stability has taken the lead.

The Federal Reserve began its rate increase program by initially increasing the Fed level by a mere 25 basis points (bps) (0.25%) in March of this year. In early May, due to high inflation numbers, they were forced to double the rate of their increase to 50bps.

Expectations were that inflation would begin to subside, and it could move back down to slower, more typical increases. Unfortunately, inflation continued to rise, and a 75 bps increase was enacted in mid-June.

Immediately following the announcement of the June rate increase, the Federal Reserve held its quarterly press conference. The Fed Chair Jerome Powell said the Fed anticipates the Federal Funds rate target to be 3.4% at the end of 2022.

What may be most concerning to bond investors is not the current rate but rather how we get there. In order to reach that 3.4% level, we may need to see a series of 50 bps hikes along with a smaller 25 bps or even a larger 75 bps rate hike in the earlier months, which allows for a smaller increase towards the end of the year.

Many economists think the Fed should do more earlier and allow the rate increases some time to work, rather than gradually increasing rates bit by bit over a slower period.

In addition to the ability to adjust the Fed Funds rate as an inflation-fighting tool, the Fed can also impact the money supply by allowing bonds they hold in the Fed's portfolio to mature, i.e., not to be reinvested. This process, which began in June, has been dubbed Quantitative Tightening. By shrinking the Fed's balance and decreasing the money supply, the Fed hopes will it bring down inflation as the number of dollars floating through the economy is reduced.

It would be a small miracle if the Fed could bring down inflation while not stalling the economy. Such a feat is commonly referred to as a soft landing. A hard landing, on the other hand, is not so pleasant. That would entail a situation where the Fed raises rates so aggressively the economy moves into a full-blown recession. Admittedly, this is a potential outcome Fed Chair Powell has admitted may happen.

The worst possible scenario would be an instance where the Fed raises rates, which severely slows the economy while inflation remains high. Like the 1970s, this would be referred to as Stagflation.

It looks like the fate of the US economy may be in the hands of the consumer. Whether on large ticket goods like refrigerators, washers, and dryers, or services and travel, if spending continues, we may be able to escape unscathed. However, if consumers worry about an impending recession and save for a rainy day, we may see a slowdown in spending, triggering a downturn in the later months of the year.

Business Cycle

Are we still in the mid-cycle expansion phase? What are the implications of the tightening on the cycle?

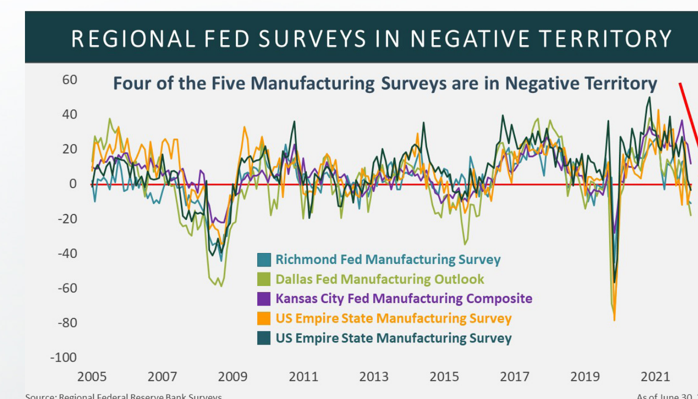
We began the second quarter concerned economic growth would weaken as we unexpectedly saw what happened in the year's first quarter. The Balance of Trade (Exports minus Imports) significantly contributed to the weak Gross Domestic Product (GDP) growth during that period. The impact of inflation, the conflict between Russia and Ukraine, and rising interest rates continue to be a primary concern here and abroad.

As we progressed through the second quarter, the concerns surrounding the consumer, inflation, and the possibility of a recession have stolen the headlines. We have seen weakening growth throughout several segments of the economy, and forecasts for GDP continue to get cut. Some of our business cycle indicators point to mid-cycle growth. However, we are seeing some indications we are nearing the end of the mid-cycle and might be further into the late part of the business cycle.

Manufacturing

The manufacturing industry is one area showing growth despite the slower pace. The latest reports for Industrial Production have been solid and have posted gains in the first five months of the year.

Durable Goods also show shipments and orders have been higher as inventories are rebuilt. The improvement in the supply chain has been helpful and should help alleviate some of the pricing pressure in the future. The hard data remains robust, but the softer survey data is slowly fading and could indicate a more challenging road ahead. Regional Fed Surveys are pointing to a slowdown. The good news for investors is the surveys have not reached levels often associated with recessions. This could also indicate the economy might still be able to avoid a recession in the quarters ahead.



Labor

The labor market continues to show signs of strength despite weakness in other areas, such as housing and overall demand. The US Employees on Nonfarm Payrolls has grown over 300,000 in each of the last 13 months, helping the unemployment rate drop below 4%. Jobs openings remain near record levels giving workers leverage when bargaining for wages. As we move into the third quarter, we will be watching the reports about initial jobless claims. The data is a leading indicator for the labor market and the past several weeks have shown a slight increase in claims. If the jobless claims trend continues higher, this could indicate the best for the labor market is behind us.

Housing

The Fed's tightening has significantly impacted the housing market. Rapidly rising home prices and mortgage rates are slowing demand as affordability tumbles for homebuyers, significantly affecting new home sales and the sale of existing homes. Existing home sales dropped 3.4% Month-over-Month (MoM) in June. However, new home sales rose 10.4% MoM in June, surprising economists who collectively looked for a drop of 0.2%. Still, new home sales are well off their high of over 1 million in August 2020. A broad measure of home prices still shows a 20.4% increase Year-over-year (YoY), which should shore up consumer confidence.

The slowing demand and supply chain issues are not helping home builders. The last data shows the National Association of Homebuilders Market Index has tumbled, now down 26% from its high last November. With the rising probability of a recession around the corner, it is less likely the housing industry will rebound anytime soon as buyers wait to see if the buying conditions improve. The housing sector traditionally has a multiplier effect on the economy. Therefore, slowing housing activities will be felt in almost every industry, another headwind for GDP growth.

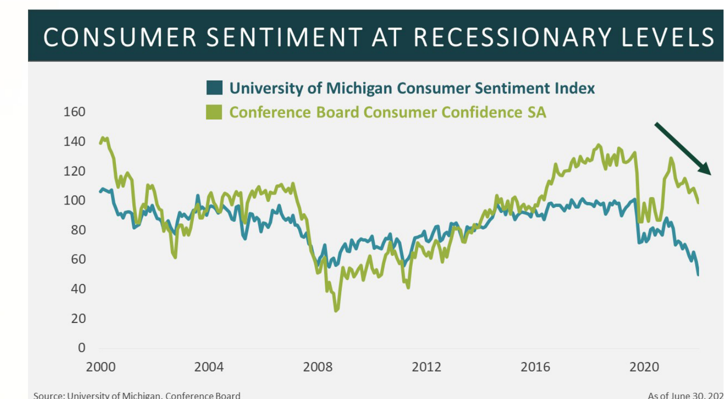
Retail / Consumer Demand

Despite the strong labor market, some cracks are appearing in retail sales as consumption slows. Reports from several retailers indicate the strong demand over the past year is waning, and some indications that businesses might struggle to reduce excess inventory in the near term. Many companies are concerned their profit margins will be difficult to maintain as transportation costs rise and the excess inventories are discounted to hopefully revive revenue growth. Currently the demand is still enough to keep the economy from sliding into a recession in the near term. If demand slips and higher prices change consumer habits, it could be a turning point for the economy and signal a recession is here.

Consumer Confidence / Sentiment

Similarly, consumer confidence remains weak and has yet to find solid ground. The University of Michigan Survey of Consumers indicates inflation is a primary concern. The rise in costs is being felt almost everywhere, from food and gas to goods and services. Many have seen their financial conditions deteriorate and do not expect them to improve anytime soon.

Furthermore, nearly half of the Michigan Confidence Survey respondents don't expect their incomes to rise more than inflation. Negative growth in real income (income growth after inflation) leads to depleted savings and, eventually, less spending. The impact is being felt first by lower income groups, which often spend a very high part of their income on food and energy. Households have shown they still have excess cash available, but it will likely fall as inflation slowly eats away at their savings.



Impacts On The US Economy From Weak Trading Partners

The probability of a recession in Europe is higher than in the US as the Ukraine war effects are more pronounced there. An energy crisis this fall and winter is the wildcard and could have devastating effects on the European economy. Currently, consumer confidence in the Eurozone is near the lowest level since the 2008 Financial Crisis. However, business confidence is still surprisingly resilient. The Eurozone Purchasing Manager Index (PMI) for the manufacturing and services sectors is steady at the 50 to 55 area. PMI reading greater than 50 indicates expansionary conditions. On the other hand, Eurozone May inflation is running hot at 8.1%, and neither the headlines nor the core items are expected to peak anytime soon.

Our other major trading partner is China, which is held down by its zero-COVID-19 policy, a favorite tool for President Xi to curb COVID-19 before the national election later this year. A critical difference between the US and China is the Chinese central bank is easing monetary policies, which may bode well for their economy and Chinese equities. However, the uneven recovery is hurting the global economy and exacerbating supply chain problems as China is the manufacturing plant for the world.

There will be continuous spillover effects from any weakness in Europe and China, which could keep the US dollar stronger, hurting exports. The optimistic take is low import prices should help lower inflation. It is important to keep an eye on Energy prices as we move toward the fourth quarter.

Equity Market

The first half of 2022 was a time for the records books. Approximately $15.5 trillion of wealth between equities and bonds (60% of GDP) has disappeared. Will the second half be better? To answer this question, we need to think in a distribution framework: bull case, base case, and bear case scenarios.

Our Bull Case

The bull case is that the Fed achieves a soft landing where they tighten policies just enough for inflation to come down to an acceptable level, say 3%, without damaging the labor market and economic growth to the point of a recession. This is the most bullish scenario for equities.

There's a chance of this happening, but history indicates the Fed has a bad record of achieving a soft landing. Out of 13 tightening cycles since 1954, the Fed achieved a soft landing only in 2 in the 1966 and 1994 cycles. It is important to note inflation was not rampant in both cycles, and oil prices were not skyrocketing. Second, the Fed was proactive in raising rates before inflation materialized instead of reactive to inflation data, as is the case now.

Our Base Case

Our base case, which we define as the most likely scenario, looks like this: The Fed was late to raise rates and is reactive to lagging inflation data resulting from last year's expansionary fiscal and monetary policies. As a result, the most likely scenario, in our view, is that both inflation and growth will decelerate. The already enacted Fed tightening may slow economic growth in the second half of 2022, leading to slower aggregate demand and lower inflation. This will put downward pressure on equity prices.

The following four indicators support lower equity prices. First, the ratio of Purchasing Manager Index Manufacturing New Orders to Inventories indicates inventories are building, and new orders are dwindling. Historically, these series lead S&P 500 earnings by 12 months. Second, the Conference Board Leading Credit Index, which is a good measure of the economic credit cycle, is deteriorating. Third, regional Fed surveys are pointing to a significant slowdown. For example, Philadelphia Fed Future Activity Index is negative and at its lowest since May 2020. Fourth, the New York Fed's forecast for GDP in 2022 and 2023 is negative (-0.6% for 2022 and -0.5% for 2023). They cite tighter monetary policies' drag on real activity over the next few quarters.

A Fed tightening into a significant slowdown or potentially mild recession is a bearish setup for equities. We believe investors should maintain a reasonable equity level per their plan and continue maintaining a defensive tilt as we recommended in March, favoring Healthcare, Consumer Staples, and Utilities, the traditional bear market portfolio.

Our Bear Case

Our bear case is a stagflation environment where inflation remains elevated while the economy grows below trend. In such a scenario, equities suffer as top line growth is sluggish, while cost-push inflation pressure margins, leading to lower earnings. Additionally, in such cases, bonds do not act as a buffer to declining equity prices as inflation continues to be elevated. This is the worst scenario for asset prices. We believe the current inflation burst is mostly cyclical cost-push inflation and not driven by changes in structural forces. Technological advances, aging demographics, and a mostly still-globalized world are some major lasting deflationary forces that should keep a lid on long-term inflation trends.

In sum, you should expect volatility in the third quarter of 2022 as the Fed and other central banks continue tightening their monetary policies and withdrawing market liquidity through Quantitative Tightening programs.

Earnings

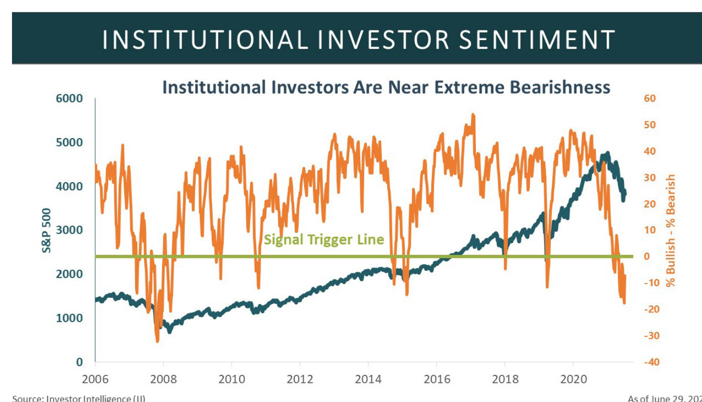
With our base case stated above for the economy, companies will get hurt from slowing revenue and rising costs, leading to a potentially significant decline in the bottom line. The analysts have not adjusted their earnings estimates to align with the weakening GDP growth and the elevated inflation environment ahead.

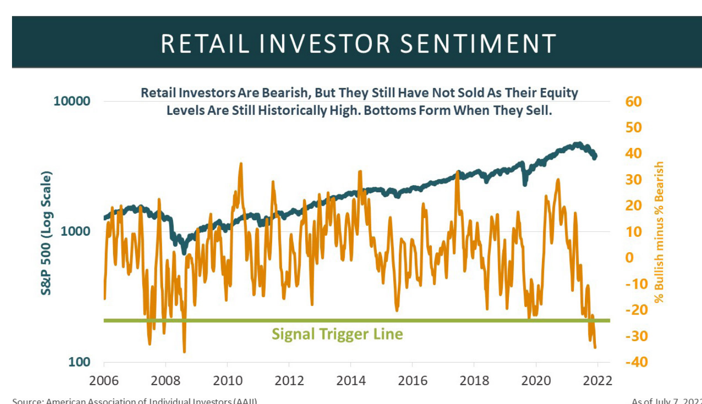
We believe earnings estimates from analysts are still too high. In fact, if you take energy earnings out of the S&P 500 as an outlier sector benefiting from an outsized move in oil price, S&P 500 ex-Energy earnings have been revised down by only 4.3% for the second quarter and 1.5% for the 2022 calendar year. So, growth estimate revisions have been trending downward in the past three months.

As second quarter earnings are announced in the coming weeks, we expect analysts to downgrade their previously optimistic estimates as they heard from company management teams. This will be the next driver for another leg down in the equity market.

Investor Sentiment

Historically, it pays off to buy when everyone is bearish. Retail and institutional investor sentiment indicators got to the most bearish level in this bear market on the week ending May 18th. Charts 5 and 6 show how bearish sentiment got for both institutional and individual investors. Bearish sentiment has already reached prior selloff levels, including COVID-19, 2018 Fed Tightening cycle, 2015/2016 earnings/energy recession, and 2010/2011 Europe debt crisis, but not yet the same pessimism as in the deep part of the 2008 great financial crisis.





However, it would be best to watch what investors do, not what they say. The sentiment data should be combined with asset flows and equity allocation data.

According to the Bank of America Global Fund Manager Survey, institutional investors have been selling market rallies. They are underweight equity. In contrast, retail investors have not sold yet. The American Association of Individual Investors (AAII) data shows their equity levels are still historically high. Until the retail group sells, it is hard to see the ultimate bottom for this market selloff, as historically, their selling marks significant market bottoms.

Fixed Income

In the bond market, the steep rise in the bond yields continues unabated causing a historical bond market selloff (bond prices and yields move in opposite directions). The 10-year Treasury yield saw a two-fold increase from 1.52% on December 31, 2021, to 3.01% on June 30, 2022, sending almost all bond market sectors down. The Bloomberg US Aggregate Bond Index, a broad-based measure of the bond market, lost 10.2% year-to-date.

In this round of declining markets, bonds have not provided their traditional diversification benefit, and balanced portfolios have declined substantially.

However, the higher interest rates should provide investors with more attractive yields. In addition, the rising interest rates make the bond market more attractive as the earnings yield gap between investment grade bond yields and the equity market is narrowing.

Rising inflation, higher recession risk, increasing interest rates, and Fed balance sheet normalization have been the main drivers of the bond market.

Rising inflation is detrimental to bondholders because it erodes the purchasing power of the fixed payments they receive and lowers the price of their bonds as the Fed raises interest rates to tame inflation. There is an inverse relationship between interest rates and bond value.

A higher risk of recession is favorable for bonds because the Fed is likely to start lowering interest rates to jump-start economic growth. Lower interest rates are good for bonds but not part of an inflation-fighting strategy.

Today there is a tug of war between fear of a recession and fear of the Fed tightening, giving rise to a new mantra in the market: "Bad news may be good news." The bad news is a recession, and the good news is the Fed will stop or moderate its aggressive tightening policy to avoid a recession. But Fed Chair Powell has said often and publicly that he will bring inflation down.

This tug of war is increasing the volatility of the bond market. The ICE Move Index - a measure of bond volatility- has been rising faster than the VIX Index – a measure of equity volatility.

However, we should remember that the Fed is raising rates from a very low level, and corporations and homeowners have already locked in lower rates for many years to come. Additionally, we believe a strong labor market, a consumer with a healthy balance sheet and ample savings, corporations flush with cash and low debt, and a resilient financial market are likely to keep the economy from tipping into a recession.

Conclusion

With signs of slowing consumer demand and weaker global growth, the risk of a recession is on the rise. Fortunately, we don't see a recession in the coming months. The strong labor market and the consumer should keep the economy growing in the months ahead.

However, we do see some early recession signals rising, and the probability of a recession is higher than a quarter ago. If the labor market weakens, consumer demand will most likely slow, and the likelihood of a recession will increase significantly.

The two wild cards that may upend our expectations are the trajectory of COVID-19 in the coming months and the Russian war on Ukraine.

For Investors:

Economy

- The economic outlook has dimmed over the last quarter
- Fed tightening has worsened financial conditions
- Higher inflation and weaker consumer confidence are disrupting the recovery
- A significant slowdown in domestic and global growth is underway
- Interest-sensitive sectors like housing may see substantial slowdowns
- US manufacturing activity is weakening as the economy loses momentum
- A strong dollar is hurting the US trade balance and emerging markets
- Strong consumer and corporate balance sheets are still strong tailwinds keeping the economy afloat

Stocks

- Expect a continually hawkish Fed until inflation shows signs of easing
- Expect market volatility to continue into Q3
- Analysts' earnings estimate may be too high, expect earnings revisions in the next two quarters
- Higher inflation will increase revenue growth but lower profit margins
- Both retail and institutional investors' sentiment indicators show excessive pessimism
- Large Cap stocks have the potential to do better than Small Caps
- Continue to favor defensive sectors and underweight cyclicals as the economy slows
- Stick with your long-term plan and have realistic market expectations
- Favor strong balance sheet companies with pricing power

Bonds

- Economic growth worries and sticky inflation are opposing forces, keeping bond market volatility high
- Risk/Reward for long-term bonds is becoming more attractive
- In Q3, continue to favor shorter duration bonds over long-duration bonds
- Investors should look to floating rate bonds as the Fed continues to raise rates
- Continue to favor high-quality bonds over high-yield bonds