MARKET UPDATE

Economic Market Update – Midyear Overview, 2022

August 3, 2022

After a historically challenging start to the year, join us as we provide our outlook for the remainder of the year for the economy and markets and lay out the most important risks and opportunities in the back half of 2022.

- The year has been difficult for investors, with heavy losses in both equity and fixed income markets
- The Fed has turned to a much more aggressive policy stance to combat persistently high inflation
- Supply-side challenges present risk inflation remains elevated despite Fed efforts
- Current sell-off is cyclical in nature; cyclical bear markets historically turn when Fed shifts policy stance

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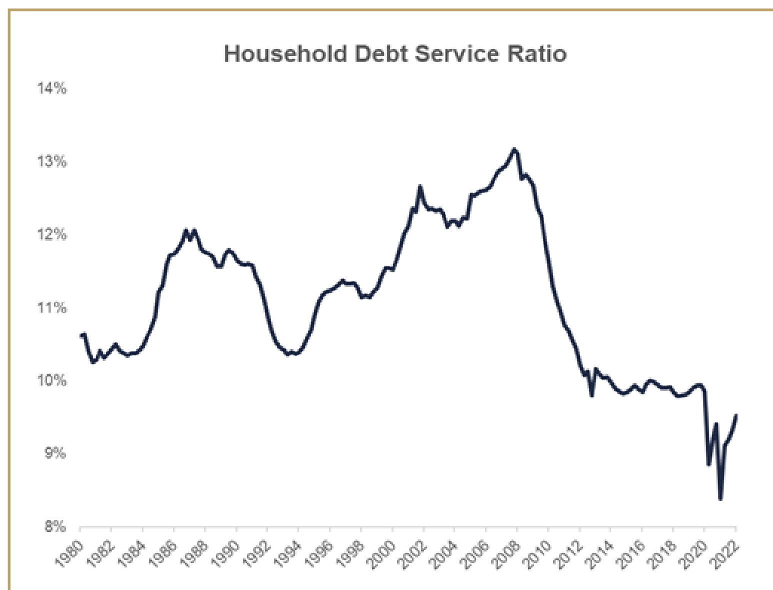
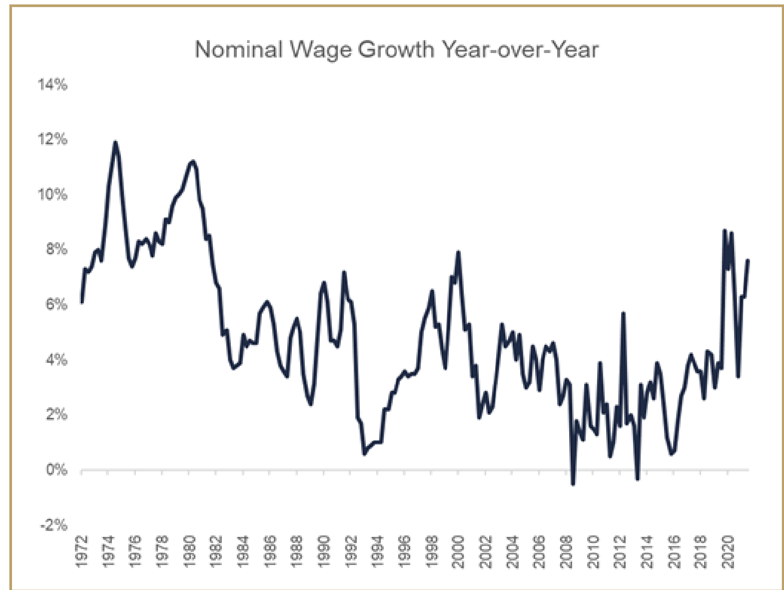
The first half of 2022 was filled with a number of shocks creating headwinds for the economy, which entered the year with incredibly strong fundamentals. Another wave of COVID hit the United States and abroad. China doubled down on the CCP's zero-COVID policy, sharply curtailing output in the first half of the year and creating a dilemma going forward. Inflation continued to accelerate, hitting a 40-year high. The Russian invasion of Ukraine shocked both the post-WWII European security order and commodity prices, further boosting inflationary pressure. Markets experienced an incredibly rare "bear market in everything," with both equity and fixed income markets seeing historical declines.

Though the economy began the year on strong footing, signs that economic growth is faltering have been rising. In our 2021 annual outlook, we noted the elevated risk that this cycle could burn hotter but ultimately be shorter, bucking the trend of lengthy economic expansions experienced for the last several decades. The current environment suggests that is precisely what is playing out for the economy and markets, as a rapid recovery gives way to higher inflation, slowing economic growth, and market declines. Most professional forecasters see the risk of recession over the next 12 months at 35% or higher – an uncomfortably high level relative to the unconditional norm of 15%. **The key question from here is how the slowdown plays out – will it be a moderate, garden-variety recession or something more severe? The evidence is weighted toward the former, given the underlying economic fundamentals leading to the deceleration in economic growth.**

What separates a mild downturn from a severe recession historically has been the state of financial conditions heading into the slowdown. Private sector balance sheets remain unusually robust, the labor market remains strong, and despite the scale of some of the price declines across equity and fixed income markets, there has not been a systemic shock, and credit markets remain orderly. Severe recessions have historically always been the result of significant imbalances in the economy, often amplified by excess leverage – either households, corporations, or both spending more than they were bringing in, ultimately leading to a reckoning. Fortunately, this is not the case in 2022. While concerns are rising that debt obligations could start to become restrictive as monetary policy normalizes, corporate and household balance sheets remain extremely healthy. While leverage has increased in recent months, the U.S. household sector has only just now returned to the level seen pre-pandemic – and that does not factor in income, which has risen substantially over the last few years. Current household debt as a share of income is 92.4%, a two-decade low, and the current household debt service ratio stands at 9.5%, close to the all-time low. Corporations are in a similarly healthy position. While rising inflation has crimped spending for households, prices have generally run well ahead of inflation, leading to record-high profit margins for companies. While we expect these margin levels are unlikely to be sustained, a return to the long-run average from these elevated levels should allow corporations to bend but not break.



The Fed is currently attempting to thread the needle by slowing the economy enough to lower inflationary pressures, particularly in the wage channel, but not so much that the economy falls into contractionary territory. The Goldman Sachs' proprietary wage tracker is currently running at 5.4%, in line with recent data reports. This level of wage growth is significantly higher than the pre-pandemic average of around 3%, and far too high to be consistent with the Fed's 2% inflation target. So how much must the Fed knock off the current underlying growth in wages to see inflation move back to target? In theory, over the long run inflation should trend towards the difference between wage growth and productivity growth on average over time. Practically speaking, inflation has run about 0.9% higher than this gap historically. The most popular measures of productivity growth fall within a range of 1.5%-2%, meaning the Fed will need to see wage growth cool to around 3%-3.5% to reach a level consistent with its goals for price stability. GDP growth relative to potential GDP tells a similar story. Persistent growth above potential is by definition inflationary. Prior to Q1 2022, economic growth averaged 5.6% per quarter in 2021[1] and an astonishing 10.1% since the recovery took root in Q3 2020. The COVID crisis left us with a huge output gap, which is the difference between actual and potential GDP. That gap has now closed, and economic growth has to decelerate to lower inflation. Estimates for potential GDP vary, but are generally around 1.75%-2.25%, and thus the Fed needs to decelerate economic growth to around this level in order to stabilize prices. Mark Zandi, chief economist for Moody's Analytics, recently analyzed the relationship between the labor market and potential GDP – defined as the level of growth consistent with enough job creation to maintain stable unemployment – and he estimates potential growth is currently 2.2%. Using this calculation of potential GDP as the growth target, he estimates that the jobs target for the Fed should be around 100,000 a month going forward, substantially below the average of 456,000 or so seen in 2022 thus far. The Fed thus faces the unenviable task of slowing economic growth and likely raising the unemployment rate in the process while avoiding an outright contraction. Given this challenge, the economy is highly vulnerable to anything else that may go wrong in the back half of the year.

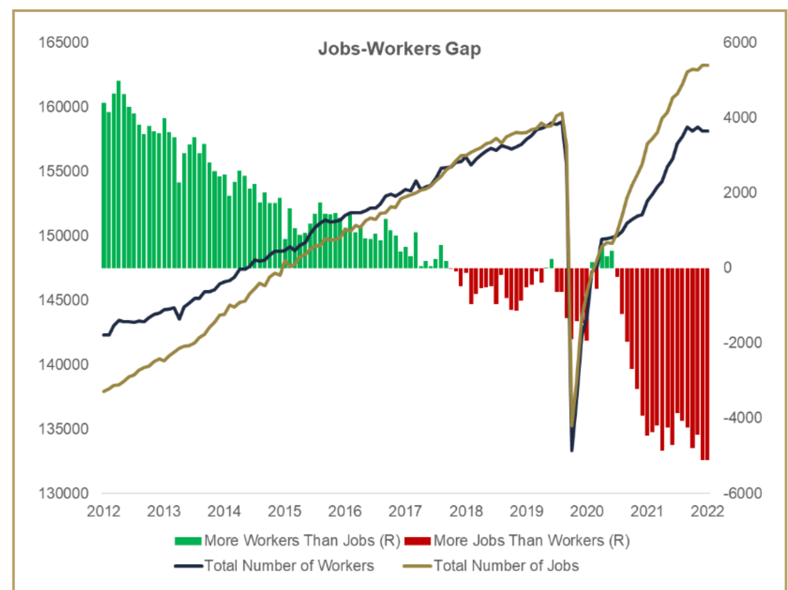


The major risk for the Fed is that, despite their best efforts, inflation remains elevated even as economic growth (i.e., consumption demand) comes down. We see three risks in the current environment driving this possibility. The tools at the Fed's disposal act on aggregate demand and have relatively limited effect on supply-side issues, which are the key drivers of the inflation we are seeing today. There is risk that inflation remains elevated due to three supply-side shocks that are all hitting the economy at once. How these challenges evolve will be crucial to the trajectory of the economy in the back half of the year. **First**, the world is lurching closer towards a global food crisis. Food exports have been

[1]Quarter-over-Quarter Seasonally Adjusted Annualized Rate

virtually halted out of Ukraine due to the impact of the Russian invasion, and poor weather conditions have weakened the output of grains in the United States and China, the world's next biggest producers after Russia and Ukraine. Ukraine will also see significantly less acreage planted this year due to the effects of the war. We can't harvest crops that were never planted – meaning there is no immediate way to remedy the current situation. Demand for food remains relatively stable regardless of price, so as prices rise, consumers around the world will have fewer discretionary dollars to spend. Higher food costs are expected to decrease overall consumer consumption by about 1% in developed markets like the United States and by 3%-4% in emerging markets as consumers increasingly find themselves spending money they otherwise would have spent on goods and services on food.

The **second** challenge is energy costs. Oil prices have receded from their highs in recent weeks, but gasoline costs have decoupled from crude prices and have not declined to the same magnitude. Current gasoline prices are more than $1 above the peak hit the last time oil prices were this high, back in 2011. Gasoline prices are so much higher on a comparable oil price because refining capacity today is substantially lower – about 5.5 million barrels less than capacity a little over a decade ago and with more declines expected ahead. This decline in refining capacity is driven by several structural challenges with no quick fixes. The last decade has seen a secular decline in investment in the energy industry as companies "right-size" to expectations for future demand, which is expected to peak in about five years. Refineries damaged in hurricanes were permanently shuttered, as were some that shut down due to declines in consumption during COVID. More are scheduled to shut down in the near future as a result of long-term strategic plans. Refining capacity takes time and more importantly significant investment to build out, and given the secular decline in demand, no incentive exists to increase capacity, despite current refineries operating at all-time high utilization rates. Sanctions against energy exporters like Iran, Syria, and Venezuela exacerbate the capacity shortage. Around 1 million barrels a day of capacity in Russia and China remain offline, and neither country has an incentive to restart production. Much like with food production, little can be done to immediately remedy the supply-side situation and bring down the cost of retail gasoline and diesel fuel significantly. Increased energy costs are expected to reduce consumption by about 1% in the United States, in line with the expected hit due to higher food costs. Additionally, higher energy costs will also bleed into food costs, since transportation and energy costs account for around 10 cents of every dollar spent on food.



The **third** risk stems from the labor market, which continues to exhibit near-record levels of tightness. The demand for labor far outstrips supply. This supply-demand mismatch between potential employers and those available to fill job openings has driven the high level of wage growth experienced recently. Should the labor market continue to remain resilient in the face of rising rates, wage pressures will persist. A key metric to monitor going forward will be the jobs-workers gap, a measure introduced by economists at Goldman Sachs to serve as a simple measure of labor market tightness. The

jobs-workers gap compares the number of workers available to fill positions (the total labor force) minus the total number of jobs available (current employment plus job openings) and has been found to be a statistically significant predictor of wage growth, both within a single country and in cross-country comparisons. Logically, that makes sense – when there are more jobs than workers to fill them, prospective employers must entice people already employed to switch jobs. How do companies do that? By paying someone more than they earn in their current role. As of June, there were 5.1 million more jobs available in the U.S. than people in the labor force to fill them, making the U.S. labor market the most imbalanced it has ever been. This imbalance can be corrected either through an increase in size of the labor force, a decline in job openings, a decline in employment, or any combination of the three. Given the size of the gap today, there is the potential for this imbalance to persist for quite some time, despite the Fed's efforts. There are some signals that the labor market is beginning to moderate (mostly through a decline in job openings), but it has a long way to go to return to balance, continuing to add to inflationary pressure. The Fed has no real ability to increase the size of the labor force, which is the supply side of the labor market; their toolkit is targeted at demand, which means the Fed must aim to decrease the number of open and/or filled jobs in the economy – which also increases recession risk.

Given that the current risk of recession is elevated, if the economy does slip into contraction territory, what might it look like? With no major imbalances to unwind outside of the labor market, history tells us a recession caused by moderate overtightening by the Fed would most likely be shallow, but not without some pain. Even shallower recessions have seen the unemployment rate increase by about 2.5% on average. One additional concern this time is that the fiscal and monetary policy response might be more limited than usual, given that many governments around the world are still hungover from the unprecedented amount of stimulus provided during the COVID crisis. But a repeat of the type of downturn seen during the Great Financial Crisis is highly unlikely given the lack of private sector imbalances. The risk to economic growth is skewed to the downside, however, and as such, a degree of caution is still warranted. Financial conditions globally and in the U.S. are tightening at a much faster pace than at any other time in the last two decades.

So what does that mean for markets over the remainder of the year?

As the first half of the year came to a close, most major equity markets fell into official bear market territory. The decline was nearly entirely due to multiple compression for most markets, with investors digesting the impact of the higher cost of capital and rising recession risks; earnings actually continued to grow in the first half of the year, though at a lower rate than 2021's torrid pace. Where markets go from here depends on the type of bear market in which we currently find ourselves.

Going back to the early 1900s, we can identify three types of bear markets in equities – **structural, event-driven, and cyclical. Structural bear markets** are triggered by structural imbalances in the economy and bubbles in financial assets – the Great Financial Crisis is a textbook example. They often entail a price shock, such as deflation, that follows and tends to be protracted, with the recovery process taking years, not quarters. While cryptocurrency mania certainly fits the mold of a historical asset bubble, the deflation of that bubble poses little risk to the broader financial system and the economy at large, which is on far firmer footing than in previous structural bear markets. **Event-driven bear markets** are triggered by a one-off shock to the system that often does not even lead to a sustained domestic recession – historical examples include war, oil price shocks, financial crises in emerging markets, and

technical market dislocations. The COVID crisis in 2020 is a prime example. While some of these elements are certainly present in the current environment, none was the trigger for the market sell-off. The culprit was monetary policy tightening by the Fed. **That suggests the current bear market is cyclical in nature.** Cyclical bear markets are a function of rising interest rates, impending recessions, and declining profits in the private sector. In short, they are a function of the economic cycle. The evidence suggests we are currently in the midst of a cyclical bear market, with **stronger private sector balance sheets and negative real interest rates cushioning against the systemic risks that result in longer, deeper, and more painful structural bear markets.**

So what does the typical cyclical bear market look like? On average, historical cyclical bear markets have declined around 30% from peak to trough and can have some staying power, lasting up to two years or more. A key feature of cyclical bear markets is that they bottom out ***before*** earnings and the economy reaches their troughs. Historically, cyclical bears hit their bottom around six to nine months before earnings bottom and a quarter or two before economic activity hits the trough and reverses. Missing out on the market recovery, which occurs when economic and market fundamentals appear to be deteriorating, can be devastating for investors. Examining market returns around recessions going back to 1957, the stock market rallied 19.3% on average between the time equity markets bottomed and when GDP hit its nadir. Returns were even higher between the time when markets bottomed and GDP started to grow again, at 31.7%. “That’s all well and good,” you may think, “but when will we hit the bottom in the equity market? Are we there yet, or even close?” The history of cyclical bear markets provides some clear guidance. Downturns sparked by a Federal Reserve hiking cycle have historically bottomed out when the Fed shifts its monetary policy stance. This does not mean an outright reversal from tightening monetary policy to loosening monetary policy. 2018 provides an excellent corollary, when markets bottomed after the Fed softened its previously hawkish commentary without an actual shift in the direction of rates. In the current environment, the Fed moving to a 25-basis-point hike, indicating a softening policy stance relative to the 75-basis-point decision in June and the 50- to 75-basis-point hike signaled for July, could likely be the trigger.

Given the high degree of uncertainty in the current environment, however, a slightly more defensive tilt in portfolios is warranted. Regardless of whether the economy falls into recession or not, we expect margins to decline from current record-high levels. As previously highlighted, the decline this year has been driven by multiple compression; that leaves room for the uncertain path of earnings going forward with rising borrowing costs also likely to crimp profitability. Such an environment increases the value of earnings safety – i.e., firms with stable earnings history relative to those with highly variable earnings patterns. Such an environment argues for a tilt towards firms with stable growth, which are frequently found in the consumer staples, utilities, and health care sectors. Health Care in particular provides a margin of safety for investors, with the sector’s earnings continuing to grow in each of the last several recessions.

The current environment has produced a level of uncertainty rarely seen before. Our base case is split between U.S. economic growth slowing but avoiding recession and a technical recession that is relatively shallow and short-lived. With many recession prediction models approaching a 50% chance of recession in the next 12 months, a neutral risk stance is warranted. With nearly all markets now at valuation levels below their 10-year average and the knowledge that equity market rallies occur well before economic metrics hit their troughs, the months ahead should provide an opportune time to rebalance portfolios to

neutral strategic asset allocation targets, with a focus on the long term. The situation remains fluid, and our investment team is monitoring the situation daily and is prepared to take further action in portfolios should developments necessitate such moves. Since the onset of the COVID crisis, the markets have not been for the faint of heart. Investors have seen both significant market declines and huge rallies over the last two and a half years. We remain committed as always to focusing on your long-term financial goals and priorities and constructing portfolios designed to reach those goals while minimizing risk. Should you wish to have a more in-depth conversation about the current environment and its impact on your portfolio and long-term financial plan, please reach out to your Fulton team.

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