August Investment Outlook 2022

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Current Market Conditions

Markets Bounce Back in July

Capital markets rebounded in July with the S&P 500 and small capitalization stocks rising 9% and 10%, respectively. Global developed markets increased 8%, while emerging markets remained unchanged due to weakness in China. While the macro-economic environment faces challenges, stocks have largely recovered from their lows, spurred on by positive corporate earnings reports and accompanying commentaries which have provided investors some short-term relief from previous low expectations.

Interest rates retreated slightly in July with the ten-year U.S. Treasury Note down to 2.6% after touching over 3%. Bond markets also saw a modest recovery with broad fixed income indices up approximately 2.5% for the month.

Commodity prices ebbed through July, with oil ending the month at $99 per barrel after touching over $111 early in in the month. The average commodity in the Bloomberg Commodity Index is down 20% from recent highs. We believe these price declines will lead to a moderation of recent inflationary data.

Geopolitical events and dynamics have remained concerning as the situation in Ukraine could easily escalate more broadly. U.S. political relations with Taiwan could create challenges and risks to our broad relations with China.

Why is this (potential) recession different from others?

Last month, we discussed historical market performance in an economic downturn, and how trying to time the market is a challenging endeavor, since missing just a small number of the best market days can often significantly erode long-term returns. This month, we look at the factors

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behind an economic downturn in general, the unique factors about the current environment, and how it may affect our investment strategy and positioning.

The National Bureau of Economic Research (NBER) defines a recession as "…*a significant decline in economic activity that is spread across the economy and that lasts more than a few months*." Another popular yardstick is two consecutive quarters of negative Gross Domestic Product (GDP) growth. Regardless of the specific metrics used, each recession has unique causes, effects, severity, and duration. As we position portfolios for the current investing environment, it is important to look beyond whether we are currently "in" a recession to understand the dynamics of the business cycle and its relationship to the current economy.

Recessions are often sandwiched between long periods of economic expansion. In the later stages of an expansion, economic activity can start to run too hot, driving up inflation and creating speculative bubbles in the capital markets. Left unchecked, these imbalances likely result in negative effects on the long run health of the economy. In some cases, central banks step in with interest rate and monetary policy changes designed to cool off the economy and inflation. Speculative bubbles can also collapse under their own weight. In either case, the impact is the same – an economic contraction or recession.

The modern global economy operates in a very lean and normally smooth-running manner, relying heavily on an efficient supply chain. COVID-19 caused a rapid halt to economic activity and threw that system into disarray, which made it particularly challenging to restart. This led to the well–documented supply chain disruptions the economy faces today. While the supply chain was sputtering, financial and monetary stimuli were injected into the economy by global governments and central banks. In the U.S., stimuli were designed to support economically stressed consumers and prevent the economy from falling into a deep recession. The excess liquidity created increased demand for goods while the economy was already struggling to keep up with supply. This resulted in a spike in inflation, which was exacerbated by the invasion of Ukraine. Further creating challenges in the supply chain, the pandemic rapidly shifted the types of products consumers sought. In the early stages of the pandemic, the work from home model created demand focused on electronics and home entertainment, while more recently, travel has taken center stage.

No two economic slowdowns are quite the same, and the current situation is particularly unique. Previous economic cycles often developed over a longer timeframe where the economy heated up on its own. The current economic path was greatly impacted by COVID-19 and accelerated by a variety of governmental actions over a relatively short period of time. In many ways, the current economic environment reflects the aftershocks of the COVID -19 induced recession. Overall demand and economic activity have shifted around much more rapidly than in previous economic cycles, and this has implications for the future economic outlook.

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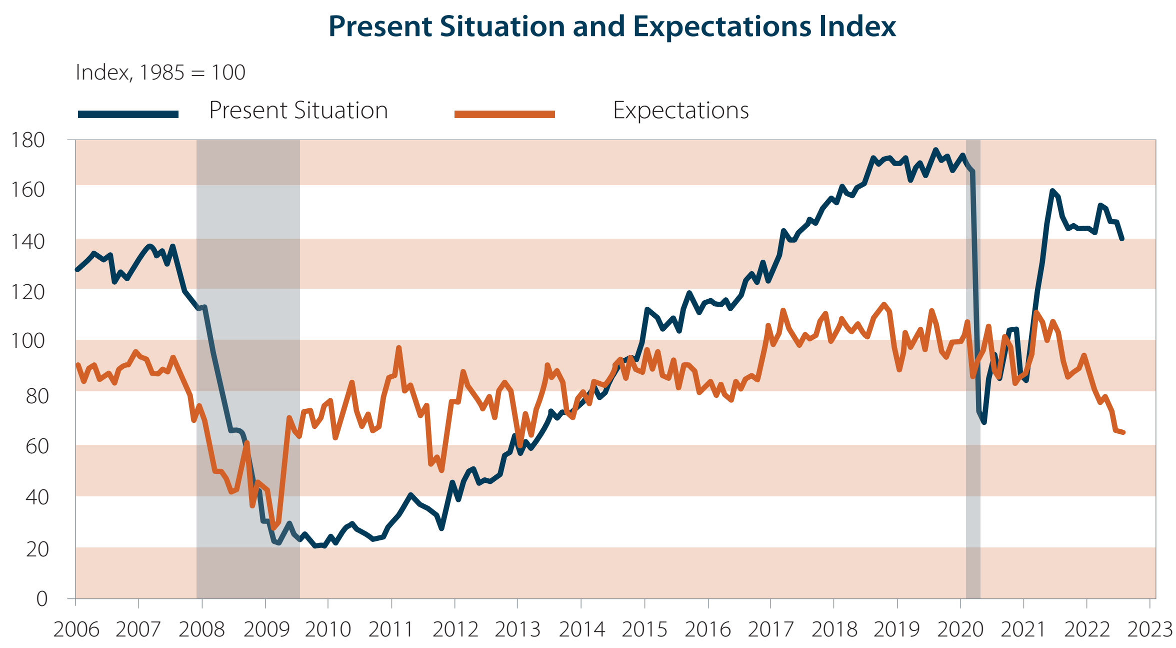
Why does this matter, and what are we seeing in the numbers?

A close examination of recent economic data suggests both increasing causes for concern over the near term, as well as encouraging signs for the longer term. Current economic activity remains positive, but indicators continue to incrementally weaken. GDP growth in the U.S. is expected to increase 2% for 2022, which is nearly half the expectation at the start of the year. Corporate profit expectations still indicate growth for 2022, but the pace of growth is slowing. Companies remain cautious in their forecasts, and many plan to slow or eliminate hiring until the macroeconomic environment improves.

High prices and a barrage of negative news on the economy have reduced consumer expectations and confidence. Consumer spending is still growing, but more recently that spending has been driven by dipping into savings and increasing indebtedness. Recent employment data is still solid, with the unemployment rate near an all-time low of 3.6%.

Shown below is The Conference Board's survey of consumers. The chart highlights consumers' expectations six months from now versus their view of the present situation. The deteriorating expectations are, of course, concerning, although the view of the present situation is constructive. Consumers appear to view the economy as currently acceptable but seem concerned about the economy's direction. Consumers are a key part of economic activity, so this relative caution and uncertainty is an important factor to consider.



**Shaded areas represent periods of recession.*

*Sources: The Conference Board; NBER *

While the jury is still out as to whether we are "officially" in a recession, we believe in large measure that is not the most relevant question when it comes to investment strategy. Irrespective of whether we are in a recession, economic activity has been clearly slowing. The market's performance through June 30th reflected those concerns, and despite the recent equity market rally, there are still some clouds on the horizon. We also remain concerned that some of the more positive data points to date, such as employment, could also see negative shifts.

Investment Approach and Strategy

Nevertheless, in looking at the current data, coupled with the discussion above of how we got here, we do not believe that a prolonged severe economic contraction provides the most likely outcome. We believe there is a strong possibility that slower, but still positive, rates of growth for the next few years may occur. Considering these factors and our recent analysis of the negative long-term impact of missing out of the best days of the market, we are not making any significant changes to our investment policy. We do, however, expect volatility to continue and at times be significant, as the market continues to struggle with both positive and negative economic data. We continue to use the current capital market dislocations to invest in quality companies and managers at reasonable prices.

Things We are Watching

The key factors we evaluate remain Federal Reserve Board (Fed) policy, economic and corporate profit growth, inflation and interest rates, and geopolitical stability. Recent data have shown some incremental economic weakness, which could result in the Fed taking a less aggressive path than previously expected. The Fed's policy decisions and how they react to the changing environment remain a key dynamic. For their part, Fed officials insist they are "nowhere near" being done in terms of fighting inflation, but this depends a great deal on the path the economy takes. We believe they will be thoughtful and circumspect with respect to any changes in the environment and their impact on policy decisions. As evidenced by the recent market moves, both up and down, the investing environment remains in flux, and we are closely watching the aforementioned factors as we evaluate potential future changes to our investment policy.