2022 Q2 Commentary – The Cure and the Ailment

- In 1977, the Congress mandated the Federal Reserve ("Fed") to "promote effectively the goals of maximum employment, stable prices, and moderate long term interest rates". This is referred to as the Fed's "dual mandate." Since the unemployment rate reached double-digits as a result of the self-imposed Covid economic shutdown, the Fed and the Congress have been focused on supporting the economy from falling into a depression and have focused on stabilizing the labor economy.
- Since the Global Financial Crisis ("GFC") through most of 2021, we have witnessed the Goldilocks situation with low unemployment and low inflation. The uber accommodative monetary policies of zero interest rate, the ever-expanding Fed balance sheet, and the Fed's ever readiness to step in to rescue the financial markets with more liquidity ("Fed Put") to maximize financial conditions ("Extraordinary Fed Policies") gave rise to inflated financial markets of stocks and bonds.
- The massive monetary and fiscal support unleashed sowed the seeds for the escalating inflation that we are experiencing today. At 3.9% headline unemployment ("U3") rate and 5.5% real GDP, the Fed was ready to turn its attention to the second mandate of price stability. At the headline inflation rate of 7.09% in December 2021, the Fed's posture was deemed to be "behind the curve" in controlling inflation when the Fed's neutral inflation is at or slightly above 2%. It is also unfortunate that, on August 27, 2020, the Fed announced its new monetary policy framework[1]. Among other things, the Fed seeks to achieve inflation that averages 2% over time, and therefore judges that, following periods when inflation has been running persistently below 2%, appropriate policy will aim to achieve inflation moderately above 2% for some time. This shift from an *ex ante* (taking steps in anticipation of) to an *ex pose*[2] approach (taking steps with clear evidence) means the Fed would be late in responding to inflation.
- With a strong economy and low unemployment, "price stability" becomes the Fed's sole focus beginning this year. The urgency to take action was elevated with new supply shocks in energy and agricultural products from Russia's invasion of Ukraine and China's zero-Covid policy that extended the supply chain dislocation.
- In order to maintain the Fed's credibility, it is "frontloading" rate hikes as well as starting to shrink its balance sheet (Quantitative Tightening or "QT"). This complete reversal of policies implies the Fed is willing to slow the economy, increase unemployment and reverse the wealth effect from financial markets (i.e. no more Fed Puts and allow markets to fall). This is the Cure to slay the inflation Ailment.
- The market is increasingly concerned that the very reversal of policies to bring inflation back to the 2% target requires bringing down the economy so much that we end up in a recession. But, the alternative is worse as the economy has begun to slow while inflation is at 1980's levels. This high inflation (driven by non-substitutional energy, food and shelter prices) is particularly devastating to the bottom half of workers and families. However, a recession will cause higher unemployment and spells devastation as well. Perhaps the worst is stagflation.

[1] https://www.federalreserve.gov/monetarypolicy/guide-to-changes-in-statement-on-longer-run-goals-monetary-policy-strategy.htm
[2] https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/ex-ante-vs-ex-post/
3 https://ihsmarkit.com/research-analysis/ukraine-agriculture-exports-what-is-at-stake.html

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A Self-Imposed Slowdown – Soft or Hard Landing?

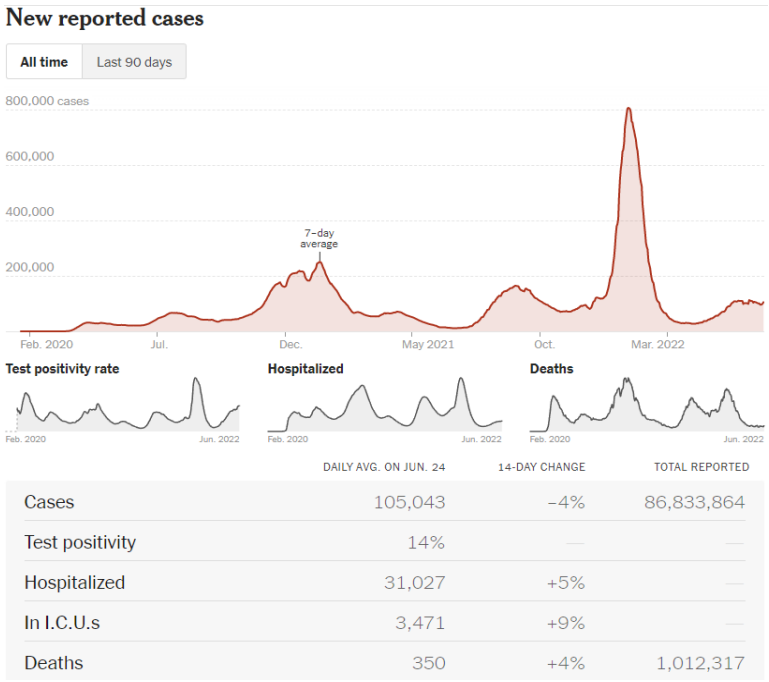
- In 2020, we did a self-imposed shutdown of the U.S. economy which led to a hard landing or recession, even though it was followed by a super fast recovery. Today, the Fed is engineering a self-imposed economic slowdown to rein in an escalating inflation. The result can be no recession (soft landing), a recession (hard landing) or stagflation (high inflation and slow growth).
- In a May 12, 2022, Marketplace interview with Chair Powell[1], he stated "What we can control is demand, we can't really affect supply with our policies." He also told Marketplace host Kai Ryssdal, "*And supply is a big part of the story here. But more than that, there are huge events, geopolitical events going on around the world, that are going to play a very important role in the economy in the next year or so. The question whether we can execute a soft landing or not, it may actually depend on factors that we don't control.*"
- According to the New York Fed's dynamic stochastic general equilibrium (DSGE) model. The June outlook is "considerably more pessimistic than it was in March. It projects inflation to remain elevated in 2022 at 3.8%, up a full percentage point relative to March, and to decline only gradually toward 2% thereafter (2.5% and 2.1% in 2023 and 2024, respectively). This disinflation path is accompanied by a **not-so-soft landing**: the model predicts modestly negative GDP growth in both 2022 (-0.6% versus 0.9% in March) and 2023 (-0.5% versus 1.2%). According to the model, the probability of a soft landing—defined as four-quarter GDP growth staying positive over the next ten quarters—is only about 10%. Conversely, the chances of a hard landing—defined to include at least one quarter in the next ten in which four-quarter GDP growth dips below -1%, as occurred during the 1990 recession—are about 80%."[2]
- If the Fed "blinks" (i.e., pauses restrictive monetary policies) before inflation is fully or truly contained, defined as 2% or around the 2% anchor, we will experience higher inflation and slower growth with higher unemployment – the worst of all worlds. Soon or later, if inflation persists under this scenario, the Fed will need to hikes rates and cause a hard landing so the business cycle may restart anew. Some observers suggest that we are already in a stagflation and moving to a hard landing.

[1] https://www.marketplace.org/2022/05/12/fed-chair-jerome-powell-controlling-inflation-will-include-some-pain/
[2] https://libertystreeteconomics.newyorkfed.org/2022/06/the-new-york-fed-dsge-model-forecast-june-2022/

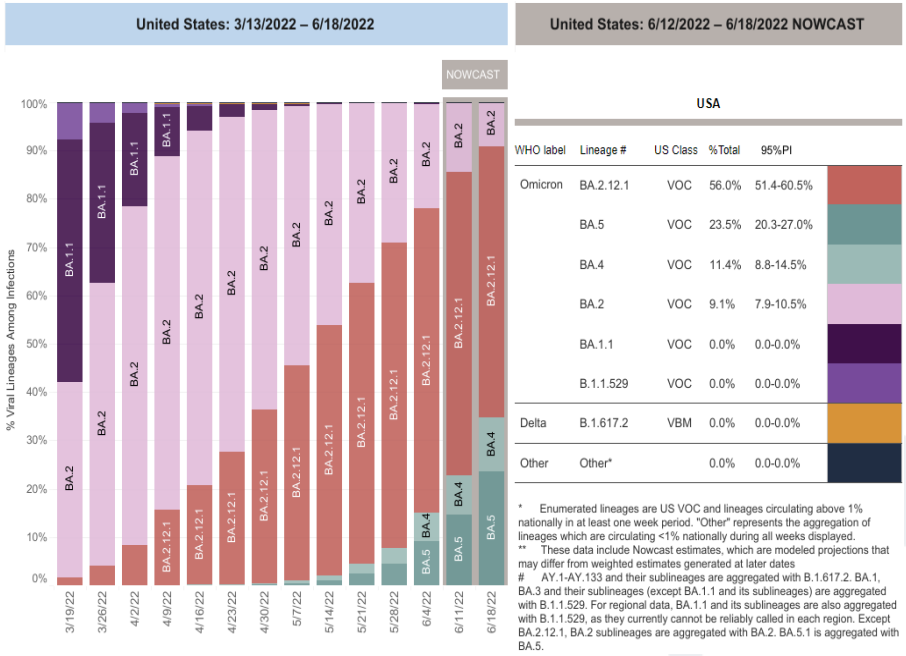
Powell Statement – Senate Banking Committee

- This is a summary of Chair Powell's 06/22/2022 written statement.
  - The economy is very strong and well positioned to handle tighter monetary policy (i.e., front loading rate hikes).
  - Improvements in labor market conditions have been widespread, including for workers at the lower end of the wage distribution as well as for African Americans and Hispanics (i.e., front loading rate hikes).
  - Aggregate demand is strong, supply constraints have been larger and longer lasting than anticipated, and price pressures have spread to a broad range of goods and services (i.e., inflation is also rising for the core).
  - High inflation imposes significant hardship, especially on those least able to meet the higher costs of essentials like food, housing, and transportation. The Fed is highly attentive to the risks high inflation poses to both sides of its mandate and is strongly committed to returning inflation to its 2% objective. The Fed has both the tools needed and the resolve it will take to restore price stability (i.e., restore confidence in the Fed).
  - Consumption spending remains strong. In contrast, business fixed investment appears to be slowing, and activity in the housing sector looks to be softening. The tightening in financial conditions that we witnessed in recent months should continue to temper growth and help bring demand into better balance with supply (i.e., economy is slowing and helps to contain inflation).
  - Russia's invasion of Ukraine is boosting prices for gasoline and fuel and is creating additional upward pressure on inflation. And COVID-19-related lockdowns in China are likely to exacerbate ongoing supply chain disruptions (i.e., factors that are out of Fed's control).

Cases, Hospitalization, Death and the Future



https://www.nytimes.com/interactive/2021/us/covid-cases.html



https://covid.cdc.gov/covid-data-tracker/#variant-proportions

As of 06-17-2022,

- With daily cases largely flat throughout the month of June, the national outlook remains stable in the United States, though there are fluctuations attributable to delays in Covid reporting over summer holidays.
- Many states did not report Covid data over the Juneteenth holiday weekend. Still, the number of new known cases announced each day in the U.S. remains close to 100,000.
- The country's cases have remained relatively steady even as some regions have seen increasing caseloads and others have seen conditions improve.
- Covid hospitalizations have remained steady in recent weeks. Around 30,000 people are in hospitals on an average day.

SARS-CoV-2 virus is constantly changing and accumulating mutations in its genetic code over time. New variants of SARS-CoV-2 are expected to continue to emerge. Some variants will emerge and disappear, while others will emerge and continue to spread and may replace previous variants. To identify and track variants, the CDC uses genomic surveillance. Virus genetic sequences are analyzed and classified as a particular variant.

Nowcast is a model that estimates more recent proportions of circulating variants and enables timely public health action. The CDC is providing weekly Nowcast estimates which will be updated every Tuesday.

https://www.nytimes.com/interactive/2020/us/covid-19-vaccine-doses.html

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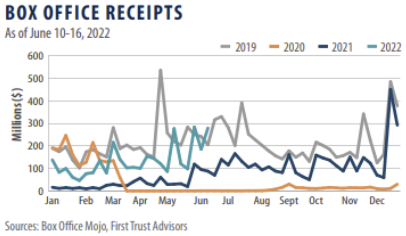
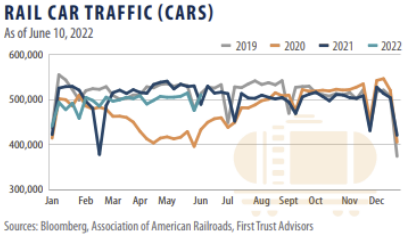
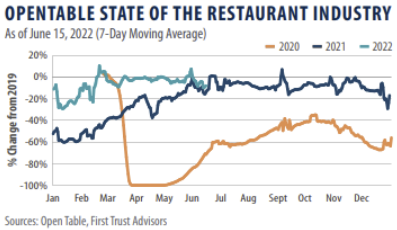
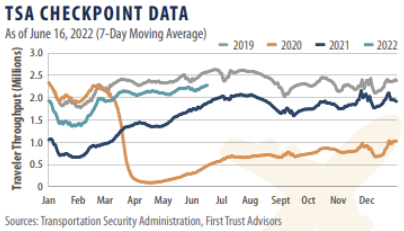
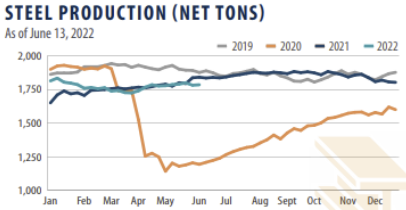
High Frequency Economic Data

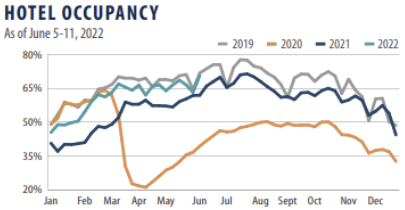


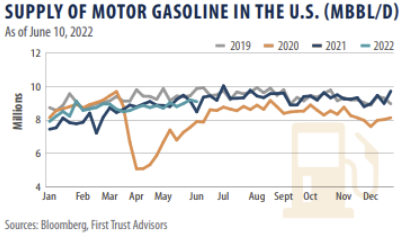


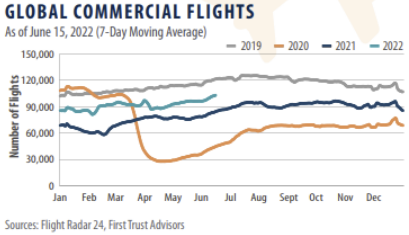


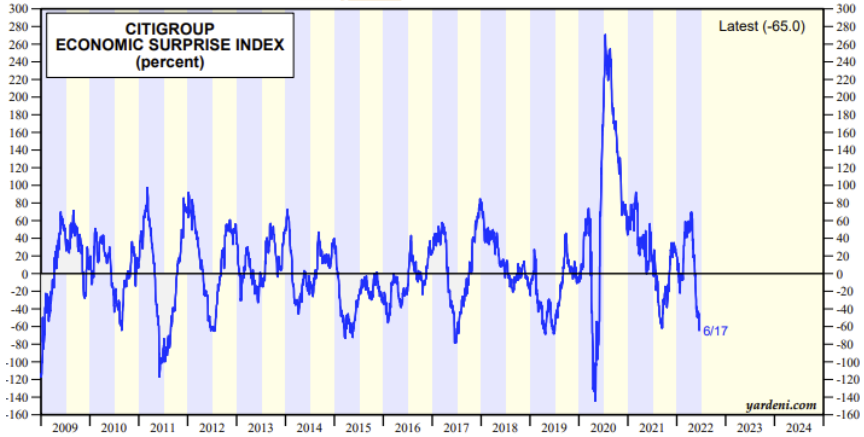








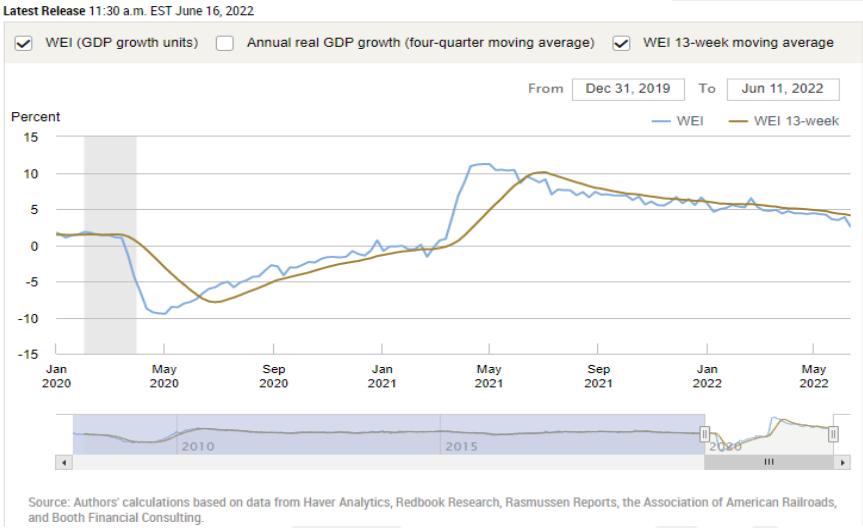




Note: Blue shaded areas are first half of each year.
Source: Citigroup.

https://www.yardeni.com/pub/citigroup.pdf

Citi's Economic Surprise Index, which measures the degree to which economic data is either beating or missing expectations, continued to positively improve in the first quarter. The current downside surprise continues to be the impact on the stock market under significant inflation, interest rate and geopolitical risks.



The New York Fed's Weekly Economic Index shows ten daily and weekly indicators of real economic activity. Since its peak in May 2021, the index continues to fall even as the U.S. continues its economic recovery from Covid.

https://www.newyorkfed.org/research/policy/weekly-economic-index#/interactive

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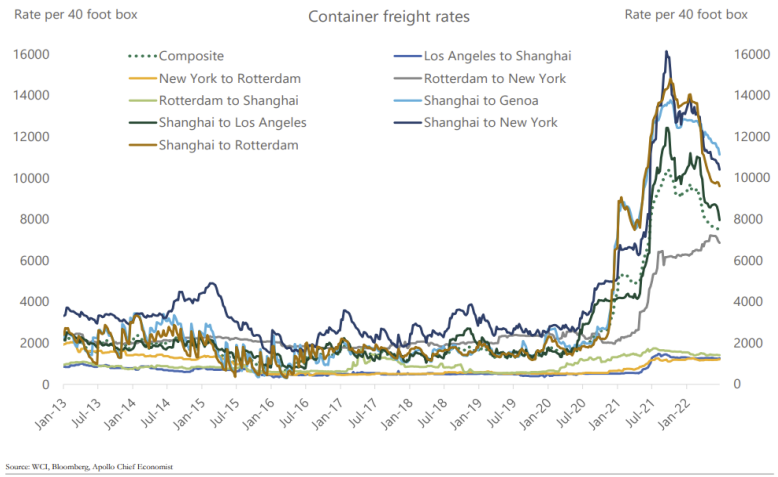
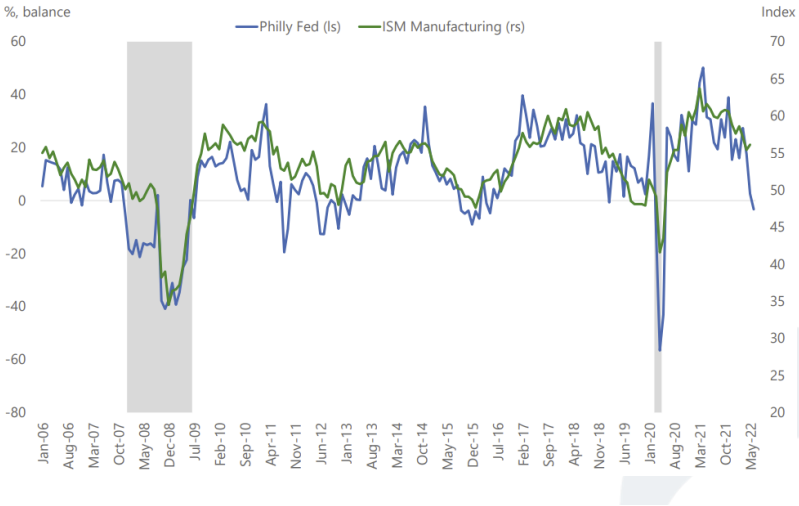
High Frequency Economic Data

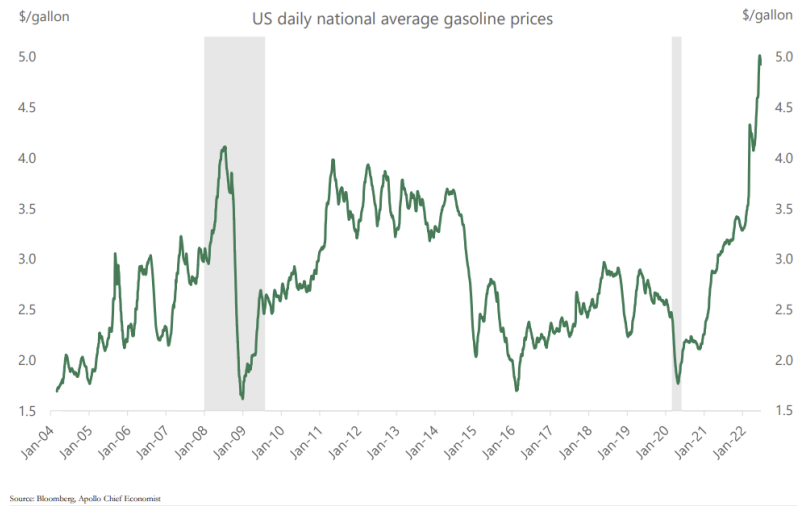
Container freight rates falling: Inflation pressures are easing



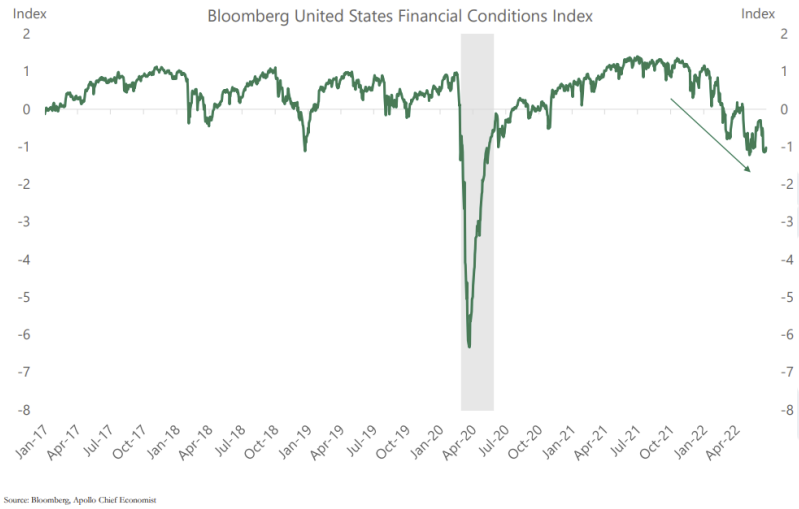
Manufacturing slowdown is coming



US retail gas price at record-high levels: $5 per gallon



Financial conditions tightening



Courtesy: Apollo, 2022 06 24

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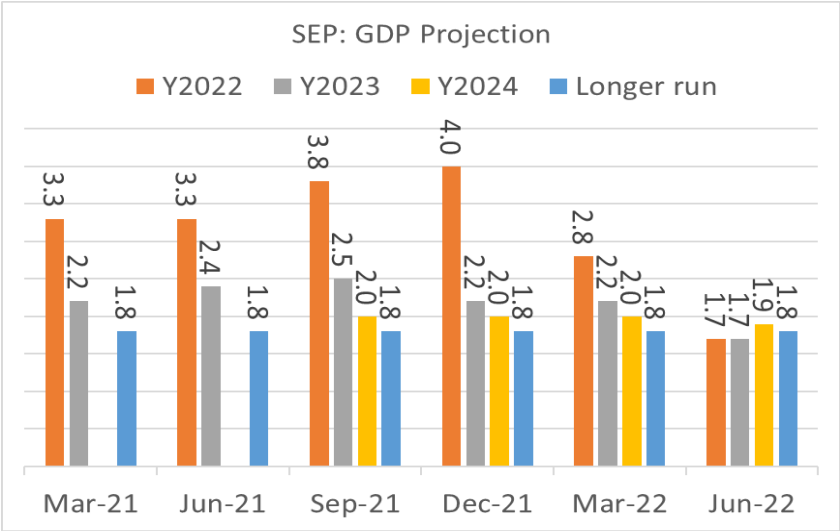
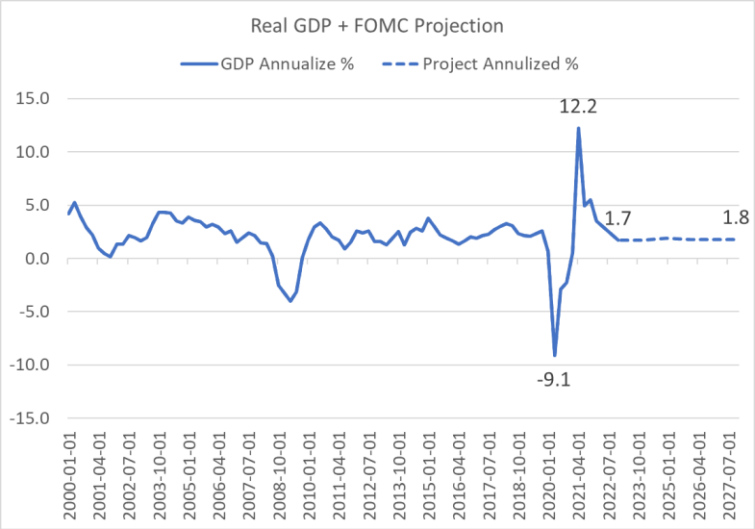
Summary of Economic Projections - GDP



https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20220615.pdf



https://fred.stlouisfed.org/series/GDP

At its June meeting, the Federal Open Market Committee (FOMC) released its quarterly Summary of Economic Projections (SEP). FOMC participants submit their projections of the most likely outcomes for real gross domestic product (GDP) growth. Participant projections are based on information available at the time of the meeting together with their assessment of appropriate monetary policy and assumptions about other factors likely to affect economic outcomes. The SEP should NOT be relied upon as the official position of the FOMC. Clearly, the FOMC has revised downward again its 2022 economic growth projection. This is in recognition of the need to tighten financial conditions to fight persistent above trend inflation.

Based on historical real GDP date, since the 1970's, the U.S. has been in a flat to downward growth rate, ending in the last 10-years through 2021 at an average of 2.1%. The latest SEP projects the longer run real GDP after 2024 to remain at 1.8%. This suggests the Federal Reserve expects the U.S. economy to reverse back to trend at 1.8% as the long-term trajectory for economic growth. With the flat projection over the next 3 years and beyond, the FOMC is expecting a soft landing (i.e., controlling inflation without causing the economy to dip into a recession).

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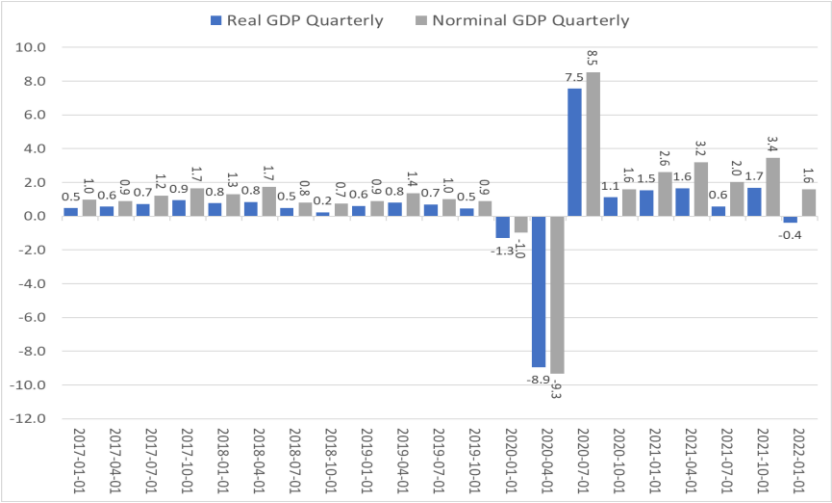
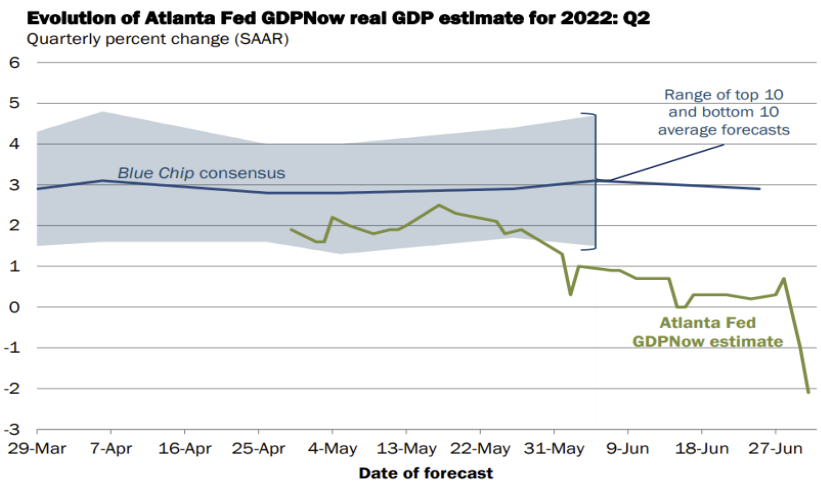
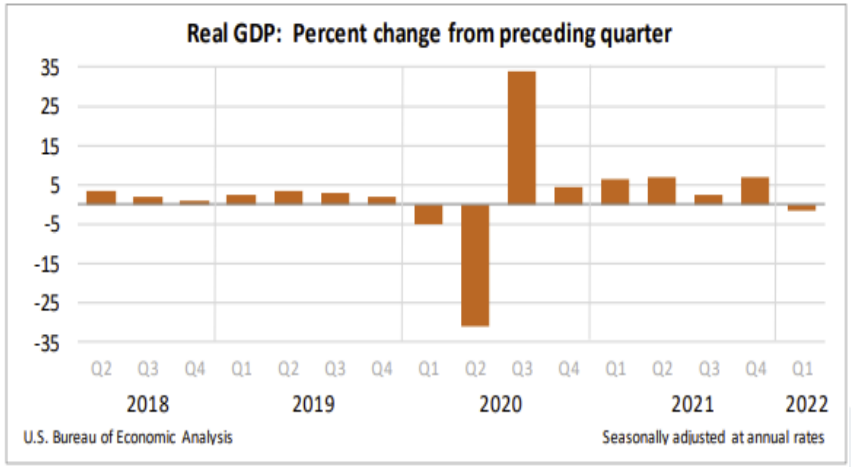
The U.S. Economy – GDP – Slowing as expected



https://www.bea.gov/news/2022/gross-domestic-product-fourth-quarter-and-year-2021-advance-estimate



https://www.atlantafed.org/-/media/documents/cqer/researchcq/gdpnow/RealGDPTrackingSlides.pdf



Real GDP **decreased** at an annual rate of **1.6%** in the first quarter of 2022, following an increase of 6.9% in the fourth quarter of 2021. In the first quarter, there was a resurgence of COVID-19 cases from the Omicron variant and decreases in government pandemic assistance payments. On a month-by month basis, the first quarter decrease in real GDP reflected decreases in inventory investment, exports, federal government spending, and state and local government spending, while imports, which are a subtraction in the calculation of GDP, increased. Consumer spending and business investment increased.

A committee at the National Bureau of Economic Research (NBER) declares an economic recession when GDP has declined for two consecutive quarters. There is a chance that the U.S. is in a recession during the first half of the year.

The Atlanta Fed's GDPNow model estimate for real GDP growth (seasonally adjusted annual rate) in the second quarter of 2022 is -2.1% on July 1, down from -1.0% on June 30.

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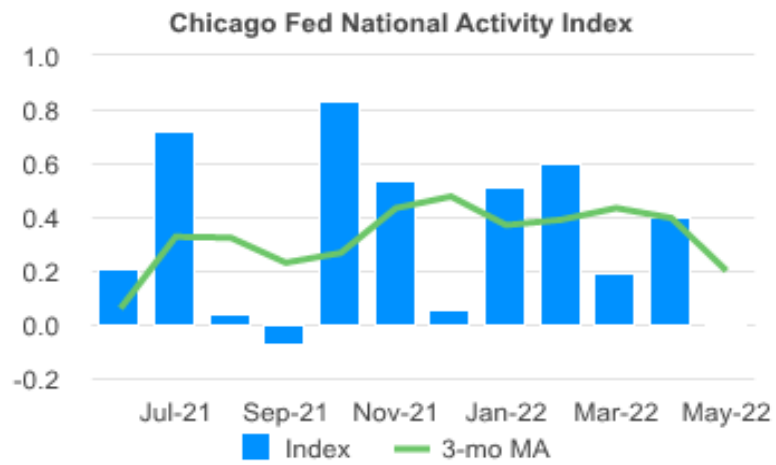
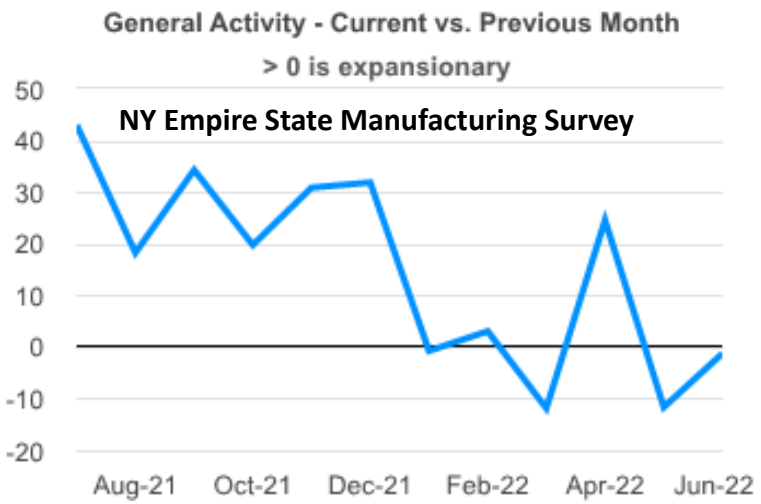
Signs of rapid economic slowdown

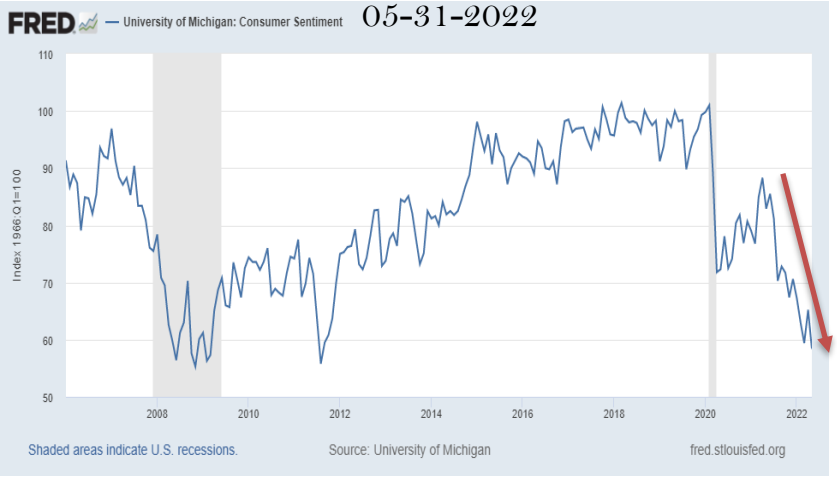




The U.S. ISM manufacturing index fell more than expected in June to its lowest level in two years. The index dropped from 56.1 in May to 53. Despite the decline, the index remains above its neutral threshold, signaling expansion in manufacturing for the 25th month in a row. However, the employment index fell further below its neutral threshold of 50 in June. New orders also sent a negative signal dropping almost 6 points to fall below 50 for the first time since May 2020. Meanwhile, production and inventories ticked slightly higher. NY Empire State Manufacturing Survey shows top-line conditions have held steady this month, according to the Empire State Manufacturing Survey, marking a continuation of the weakness in May and March. The Chicago Fed National Activity Index fell in May to 0.01, the lowest reading since September. The decrease from 0.40 in April indicates a slowdown in U.S. economic growth last month. Two of the four broad categories of indicators used to construct the index weakened from April, dropping into negative territory. The other two components improved slightly.

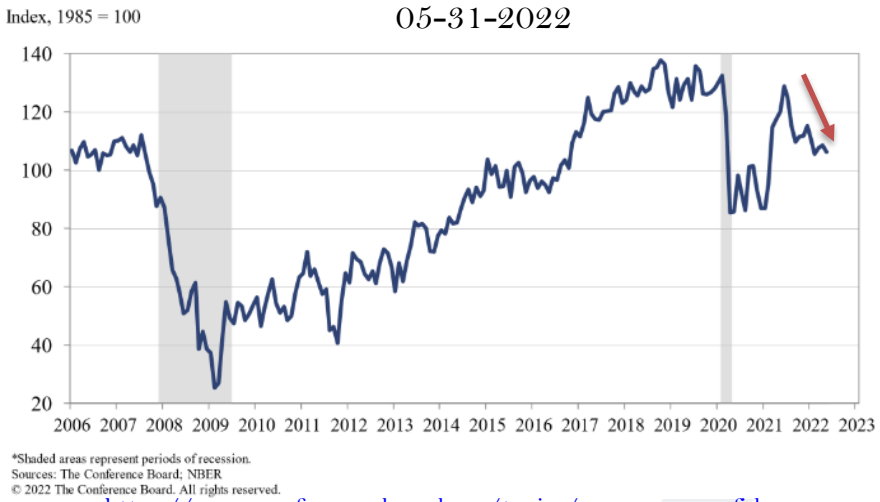
Consumer & Business Confidence

UMich Consumer Sentiment



https://fred.stlouisfed.org/series/UMCSENT#

Conference Board Consumer Confidence Survey



https://www.conference-board.org/topics/consumer-confidence

Moody's Business Confidence

https://www.economy.com/economicview/indicator/usa_dsbc/5ACCE990-B6C9-4E5D-A4FA-14B8A15F6A13/World-Moodys-Analytics-Survey-of-Business-Confidence

Moody's: Some two-thirds of survey respondents say that current business conditions are weakening, and a similar percentage say that they don't expect conditions to get any better for the remainder of the year. Also disquieting is the percentage of businesses that say present business conditions are improving remains below 20% for the second week running. Historically, this has been a key threshold for recession. Weighing on business sentiment are the ongoing COVID-19 pandemic, Russia's invasion of Ukraine, and, most recently, higher interest rates, which are set to increase substantially more given guidance from the Federal Reserve. As has been the case so far this year, sentiment is consistent with a global economy that is struggling to avoid recession.

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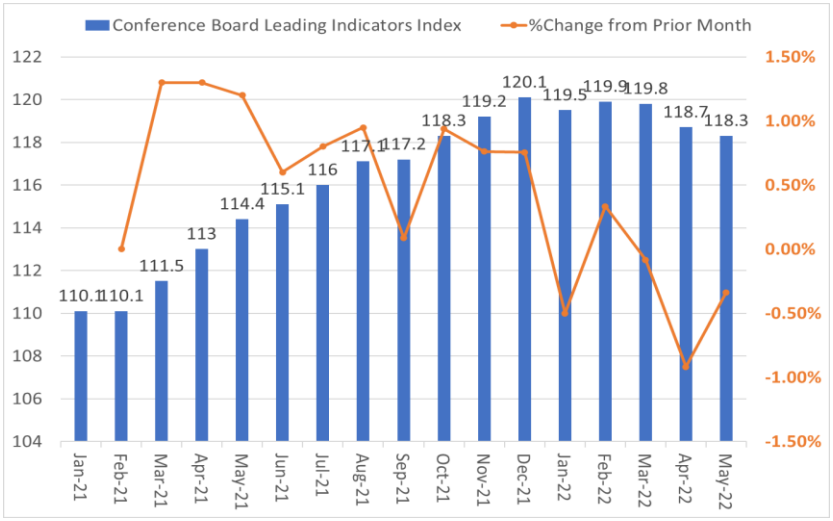
Leading Indicators and Financial Conditions – a mixed bag



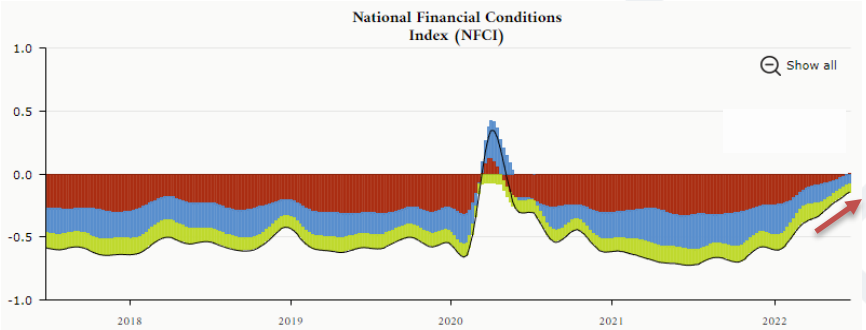
Source: Conference Board, Moody's

The Conference Board Leading Indicators Index intends to forecast future economic activities. The Index decreased by 0.4% in May 2022 to 118.3 (2016 = 100), following a 0.4% decline in April 2022. The LEI is now down 0.4% over the six-month period from November 2021 to May 2022. This is fueled by tumbling stock prices, a slowdown in housing construction, and gloomier consumer expectations.

The St. Louis Federal Reserve Bank's Financial Stress Index continues to remain supportive. (Negative is accommodative.) This index measures the degree of financial stress in the markets and is constructed from 18 weekly data series.

The Chicago Fed's National Financial Conditions Index (NFCI) provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets, and the traditional and "shadow" banking systems. The NFCI ticked up to –0.18 in the week ending June 17. Risk indicators contributed –0.02, credit indicators contributed –0.09, and leverage indicators contributed –0.07 to the index in the latest week. All these signals indicate the financial conditions remain supportive to the economy. However, the direction is moving towards zero – suggest less accommodation.

Source: St Louis Fed https://fred.stlouisfed.org/series/STLFSI3



https://www.chicagofed.org/publications/nfci/index

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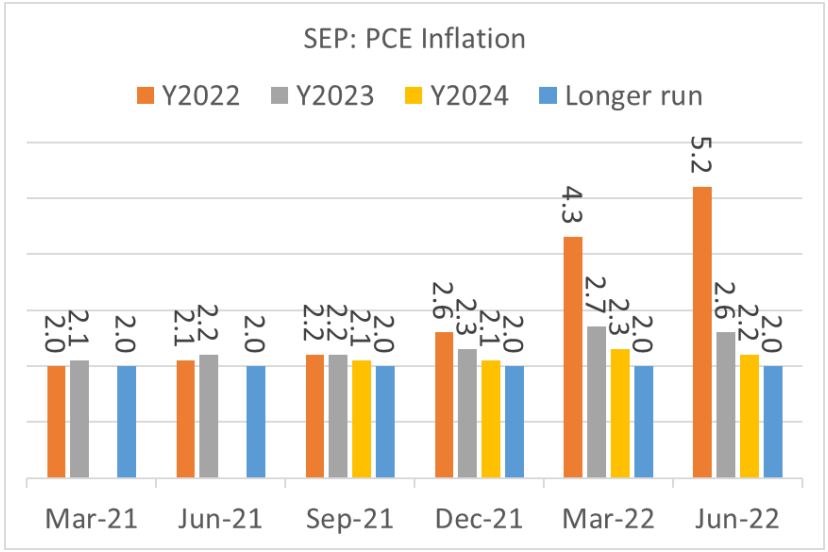
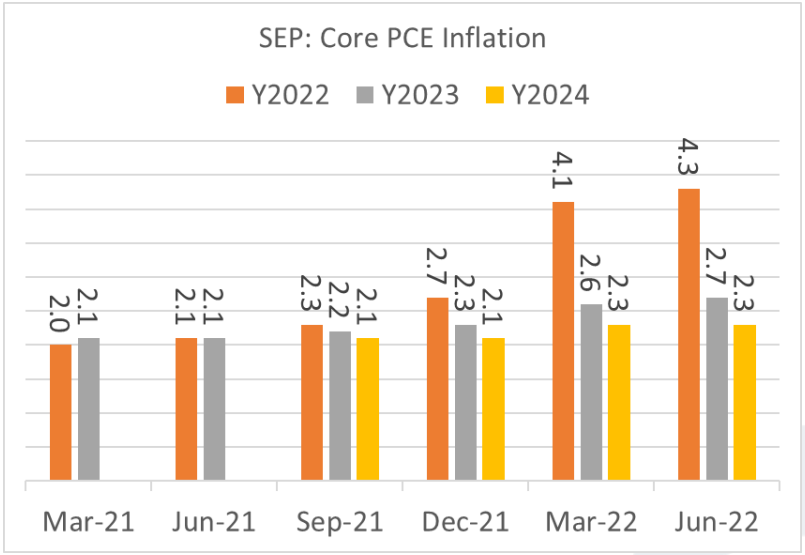
Summary of Economic Projections –Inflation (Core PCE)





https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20220615.htm

In the latest SEP, it is clear that FOMC members continue to see inflation moving higher, For 2022, the projected annual PCE moved up from March's meeting at 4.3% to the June meeting at 5.2%. The projection also suggests that the Fed's current hiking in rates and QT will be successful as the projected PCE for next year moved down from 2.7% in March meeting to 2.6% in the June meeting. At the same time, projections for Core (ex-food and energy) PCE inflation mirror those of PCE projections – slightly higher projection in June at 4.3% from March at 4.1% and 2022 June meeting is projecting 2023 to be 2.7% versus 2.6% projection in March meeting.

Although Core PCE is the Fed's preferred inflation gauge, the headline PCE and CPI are likely to play a more dominant role as the Fed is sensitive to the rising costs of food and energy. These, along with housing costs, are the main drivers to current inflation and thus are experienced by American consumers daily. These three components cannot be deferred by consumers. Further, to combat and bring down inflation rates, food and energy prices must come down as well. Chair Powell acknowledged that monetary policy does not have a direct impact on supply shocks, and therefore, more must be done to dampen or slow economic growth and possibly increase unemployment to drive down enough demand to make a difference. This means even higher rates and a more severe impact on the economy is needed.

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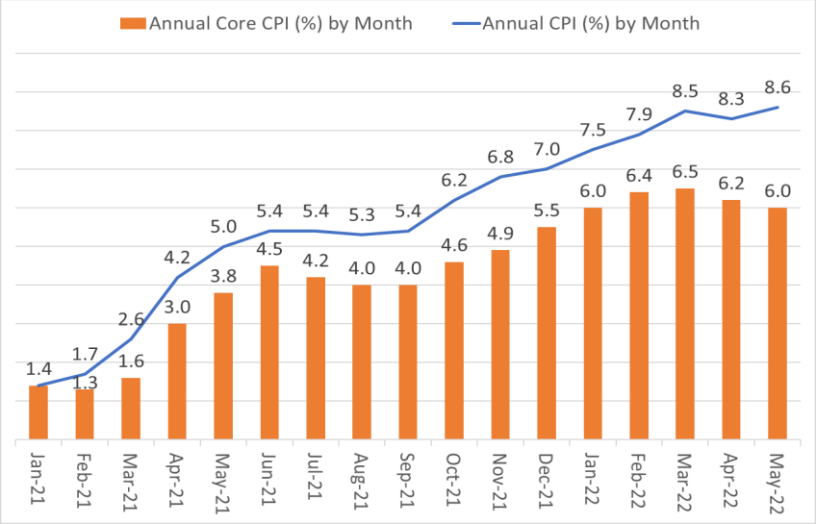
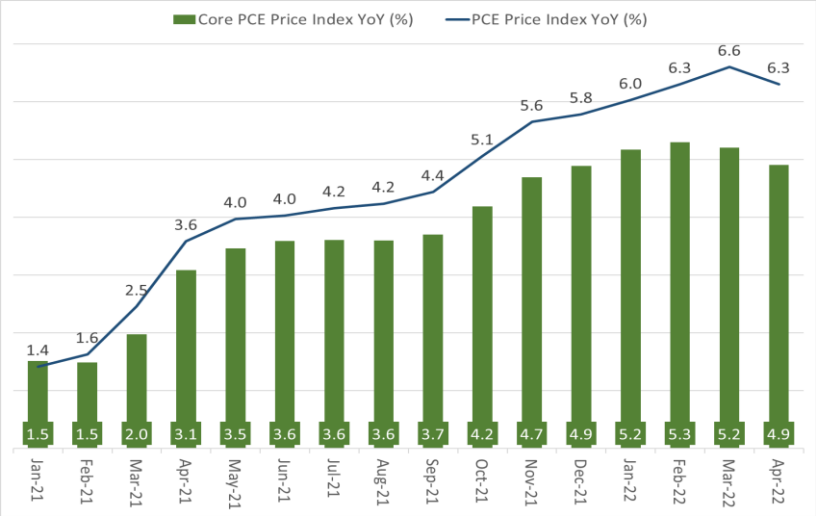
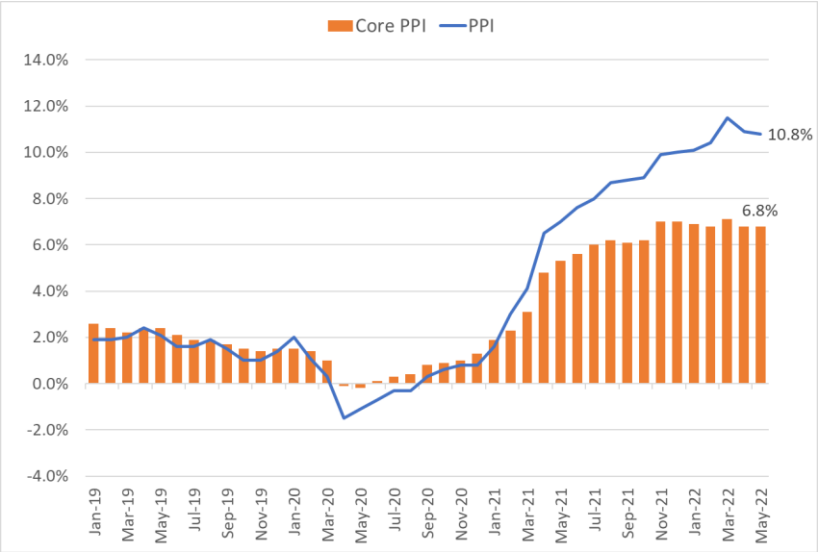
Inflation – CPI, PCE and PPI



https://www.bls.gov/cpi/



https://www.bea.gov/data/personal-consumption-expenditures-price-index



https://www.bls.gov/ppi/

The CPI increase was broad-based, with the indexes for shelter, gasoline, and food being the largest contributors. After declining in April, the energy index rose 3.9% over the month of May with the gasoline index rising 4.1% and the other major component indexes also increasing. The food index rose 1.2% in May as the food at home index increased 1.4%. The Core CPI index rose 0.6% in May, the same increase as in April. While almost all major components increased over the month, the largest contributors were the indexes for shelter, airline fares, used cars and trucks, and new vehicles.

The PCE price index for April increased 6.3% from one year ago, reflecting increases in both goods and services. Energy prices increased 30.4% while food prices increased 10.0%. Excluding food and energy, the PCE price index for April increased 4.9% from one year ago.

Producer prices for final demand increased 11.2% during the 12 months ended in March 2022, the largest increase since 12-month data were first calculated in November 2010. The index for final demand less foods, energy, and trade services increased 7.0%.

The Producer Price Index for final demand increased 0.8% in May, seasonally adjusted. This rise followed advances of 0.4% in April and 1.6% in March. On an unadjusted basis, final demand prices moved up 10.8% for the 12-months ended in May (a precursor for CPI).

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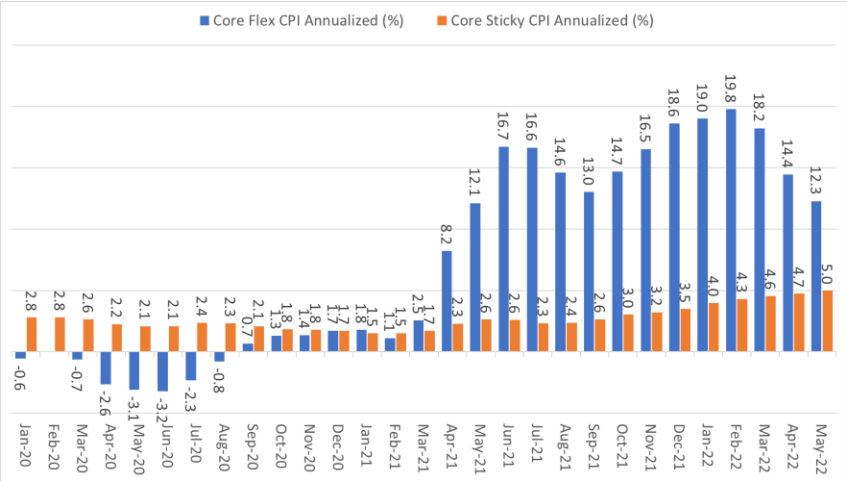
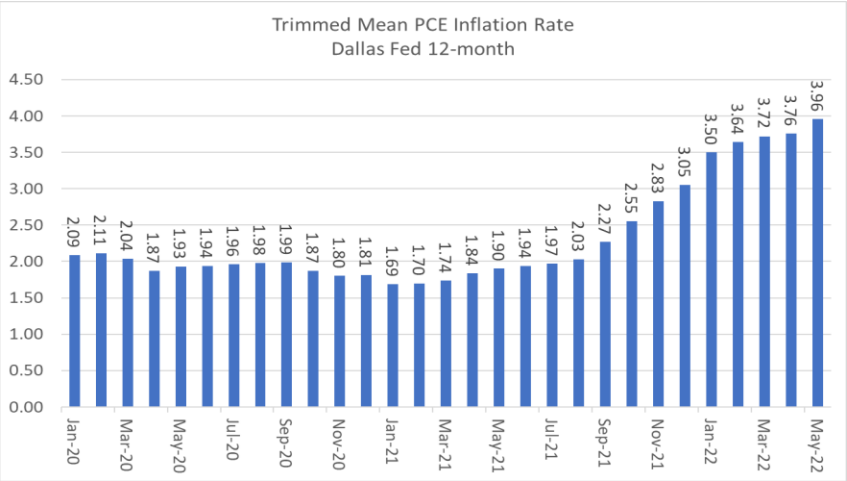
Alternative Inflation Measured



https://www.atlantafed.org/research/inflationproject/stickyprice

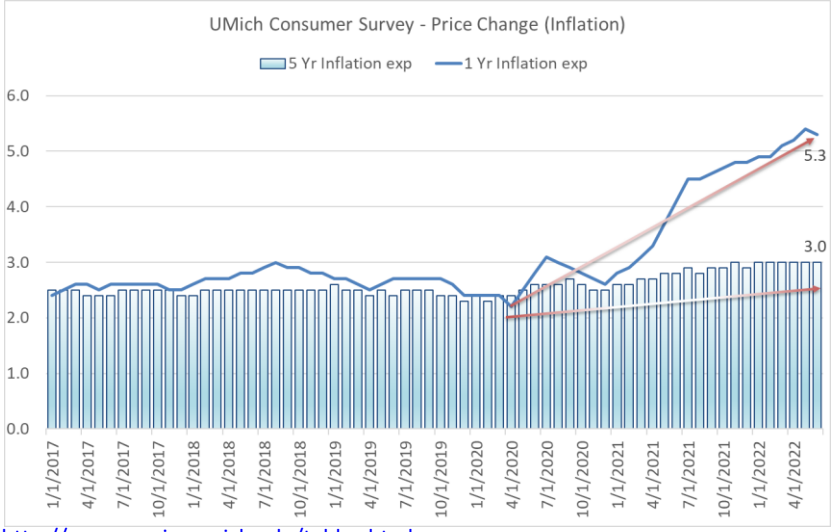


https://www.dallasfed.org/research/pce#data

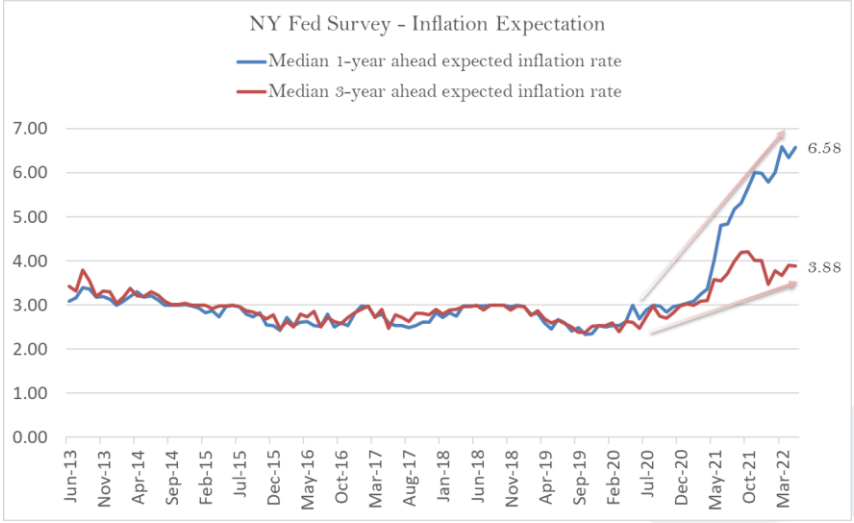
Flexible-priced items (like gasoline) are free to adjust quickly to changing market conditions, while sticky-priced items (like rent) are subject to some impediment or cost that causes them to change prices infrequently. As research shows, sticky prices appear to have an embedded inflation expectations component that is useful in forecasting future inflation. The Atlanta Fed calculates these two types of inflation indexes each month. The latest figures show a reduction in Core (exclude energy and food) Flex CPI and an upward trend for Core Sticky CPI. This is a worrying sign because it means that the current inflation may be harder to combat and may cause expectations to be unanchored.

The Trimmed Mean PCE inflation rate produced by the Federal Reserve Bank of Dallas is an alternative measure of core inflation in the price index for personal consumption expenditures (PCE). Calculating the trimmed mean PCE inflation rate for a given month involves looking at the price changes for each of the individual components of personal consumption expenditures. The individual price changes are sorted in ascending order from "fell the most" to "rose the most," and a certain fraction of the most extreme observations at both ends of the spectrum are thrown out or trimmed. The inflation rate is then calculated as a weighted average of the remaining components. The trimmed mean inflation rate is a proxy for true core PCE inflation rate. The May report continues its upward trajectory for PCE inflation.

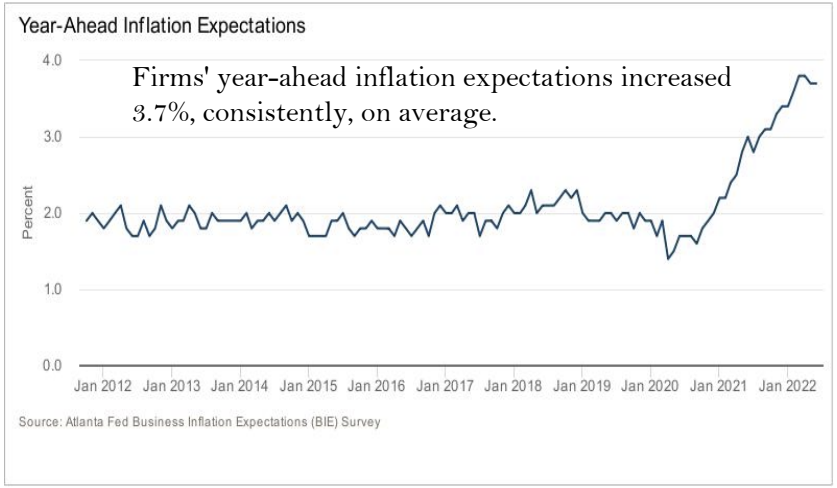
Inflation Expectation – Survey-Based



http://www.sca.isr.umich.edu/tables.html



https://www.newyorkfed.org/microeconomics/sce#/inflexp-1



https://www.atlantafed.org/research/inflationproject/bie

Inflation expectation is an important indicator for future inflation. Thus far, survey-based data suggest that the near term or 1-year inflation expectations have jumped as the CPI hits another high. Although the longer 3- and 5-year expectations remain more subdued, the trends are moving upward.

According to the New York Fed, the median one-year-ahead inflation expectation increased to 6.6% in May, up from 6.3% in April. At the three-year horizon, inflation expectations were unchanged at 3.9%. The median one-year-ahead home price expectation came in at 5% - down from 6.0% in April but still elevated relative to pre-pandemic levels. Household spending expectations over the next year rose by 1% to reach 9%, a new series high.

Every short-term indicator suggests inflation expectation is moving higher and the Fed hopes that, through its aggressive actions, the longer-term expectation will remain anchored.

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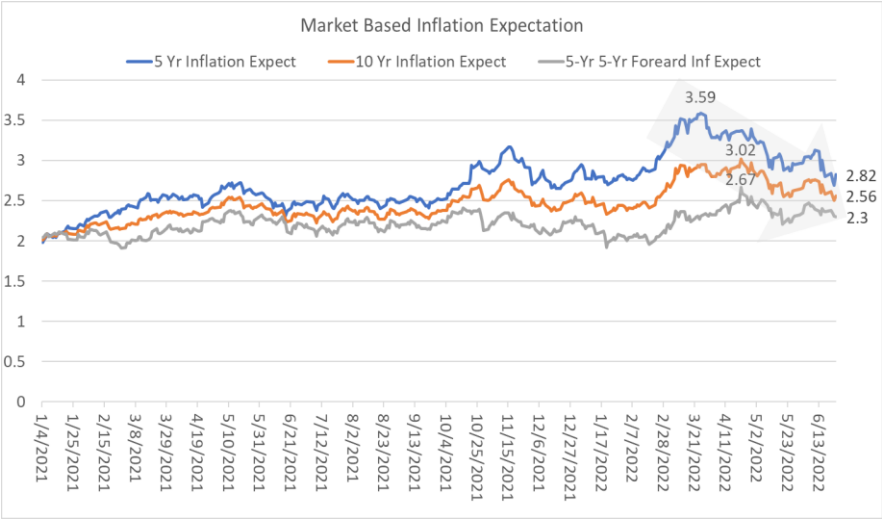
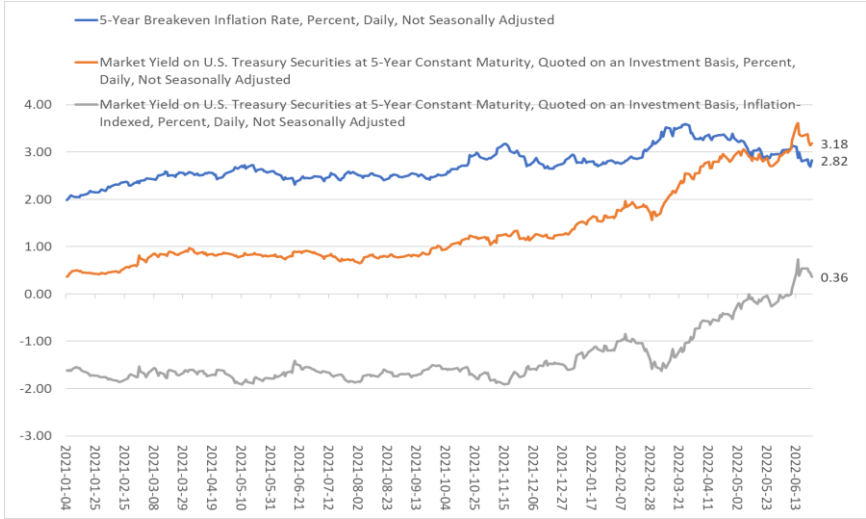
Inflation Expectation – Market-Based





5-Year, 5-Year Forward Inflation Expectation Rate is a measure of expected inflation (on average) over the five-year period that begins five years from today - **@ 2.3%**

10-Year Breakeven Inflation Rate is a measure of expected inflation derived from 10-Year Treasury Constant Maturity Securities and 10-Year Treasury Inflation-Indexed Constant Maturity Securities. The latest value implies what market participants expect inflation to be in the next 10 years, on average - **@ 2.56%**

5-Year Breakeven Inflation Rate is the measure of expected inflation derived from 5-Year Treasury Constant Maturity Securities and 5-Year Treasury Inflation-Indexed Constant Maturity Securities. The latest value implies what market participants expect inflation to be in the next 5 years, on average - **@ 2.82%**

5-Year Constant Maturity Rate is the nominal rate of the 5-Year U.S. Treasury. The latest value is the current yield on the 5-Year Treasury - @ **3.18%**

5-Year Constant Maturity, Inflation-Indexed Rate is the current yield on the 5-Year TIPS - @ **0.36%**

5-Year Breakeven Inflation Rate- @ 2.82%

These expectations have all increased since January. The most recent yields have turned down a bit. This may suggest that the market is expecting a sufficient economic slowdown and that the Fed no longer needs to be aggressive in its monetary policies.

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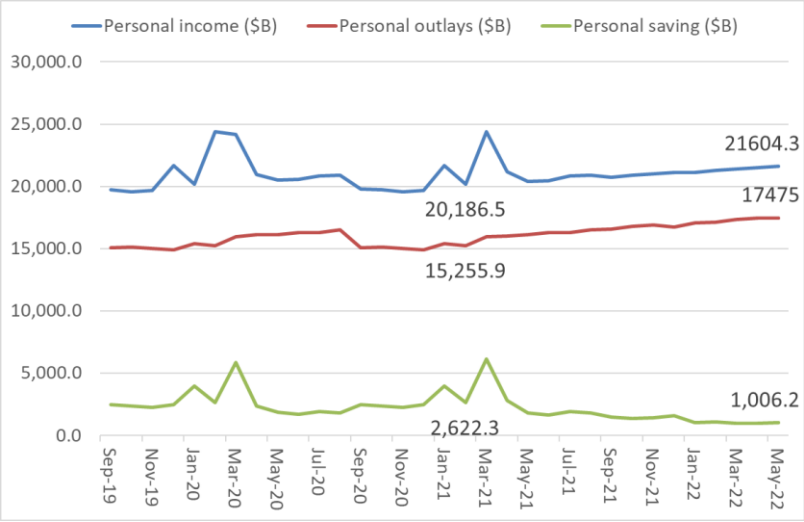
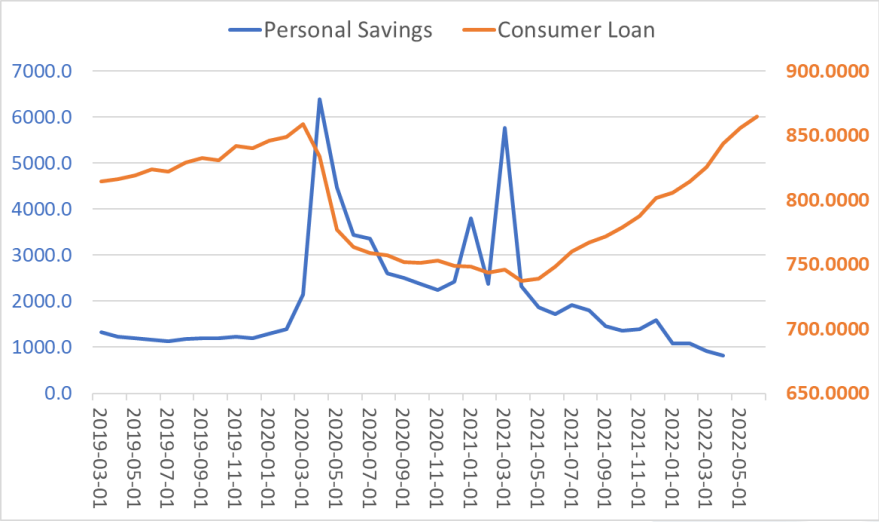
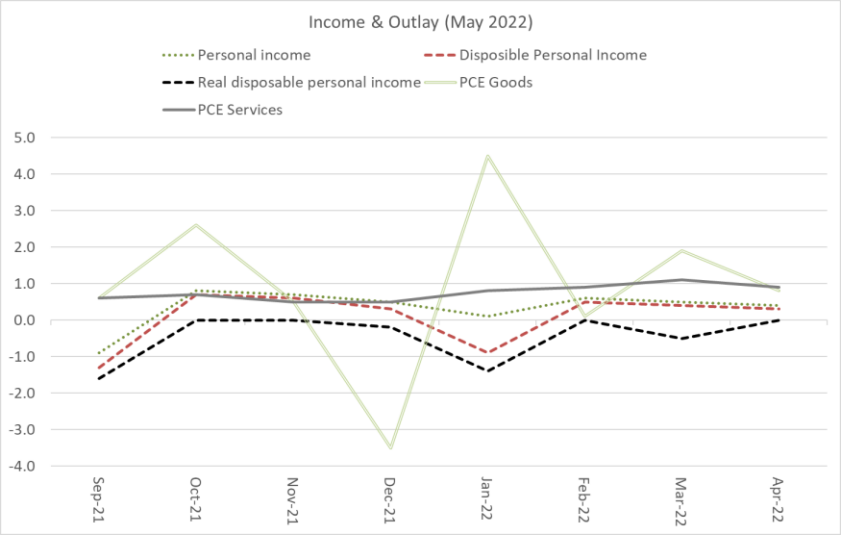
Savings and Spending





https://www.bea.gov/sites/default/files/2022-05/pi0422.pdf



Source: BEA Data

According to the May 2022 (latest data) BEA Personal Income and Outlays data, Personal Income continues to rise as does personal outlay. At the same time, Personal Savings continue to trend down. On a percentage basis, spending on goods has been coming down (rate of change from prior month) while spending on services has continued to hold steadily upward. The lower left graph shows that, although the nominal rate of change for Personal Income is trending down on a monthly basis, the Real (inflation adjusted) Disposable Personal Income is a 0% increase from the prior period. This means that, after adjusting for inflation, disposable income stayed flat. Separately, the latest Fed data on consumer loans as compared to personal savings is clear that Americans are spending down their savings and, with rising prices, making up the difference with new debt (defending one's lifestyle for now).

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The Consumer Is Still Spending, for Now

Mastercard SpendingPulse™
U.S. Snapshot – April 2022

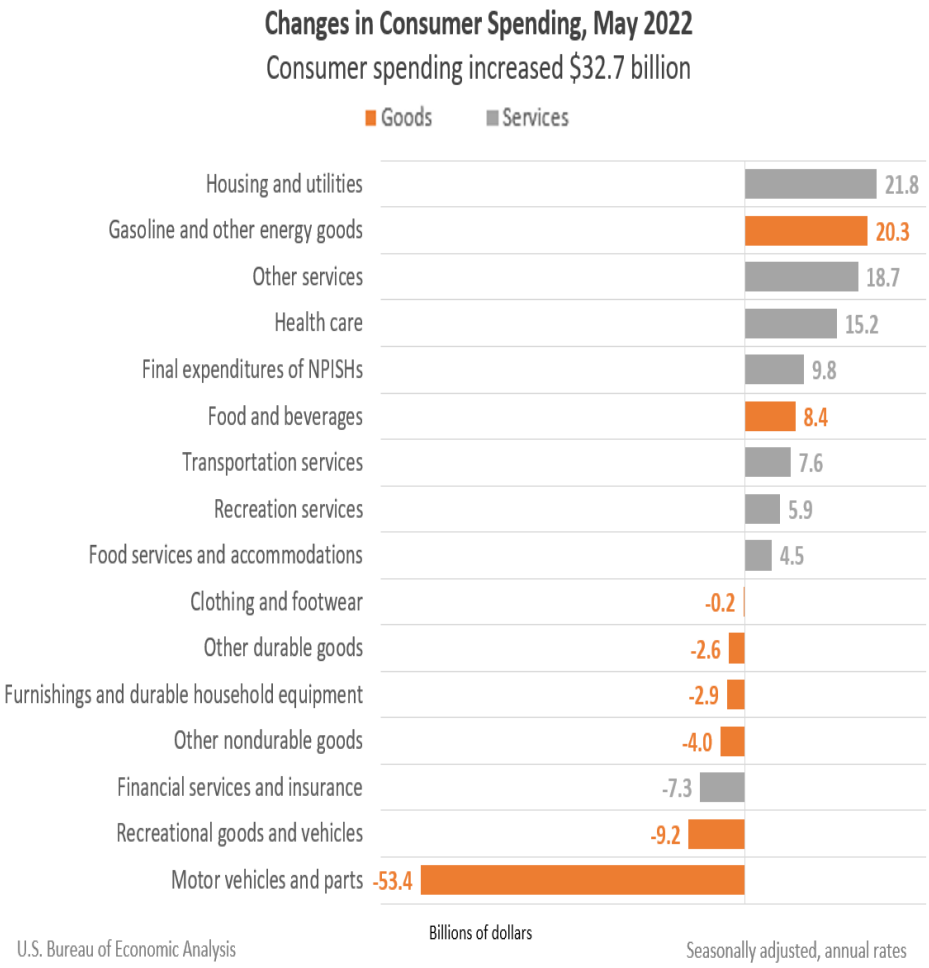
	Sales Growth Year-Over-Year **April 2022 vs. April 2021**	Sales Growth vs. Pre-Pandemic **April 2022 vs. April 2019**
Total Retail (ex. Auto)	+7.2%	+15.3%
E-commerce	-1.8%	+92.0%
In-Store	+10.0%	+5.2%

By Sector	Sales Growth **April 2022 vs. April 2021**	Sales Growth **April 2022 vs. April 2019**
Apparel	+10.8%	+8.4%
Department Stores	+15.7%	+22.3%
Electronics & Appliances	+4.6%	+36.2%
Grocery	+12.4%	+22.1%
Furniture & Furnishings	+3.8%	+25.7%
Jewelry	+33.3%	+51.8%
Luxury (ex: jewelry)	+26.0%	+60.1%
Restaurants	+9.4%	+15.6%

SpendingPulse™

Source: Mastercard SpendingPulse, which measures in-store and online retail sales across all forms of payment.

*Excluding automotive sales.



https://www.mastercard.com/news/press/2022/may/mastercard-spendingpulse-april-u-s-retail-sales-remain-steady-up-7-2-year-over-year/

https://www.bea.gov/data/income-saving/personal-income

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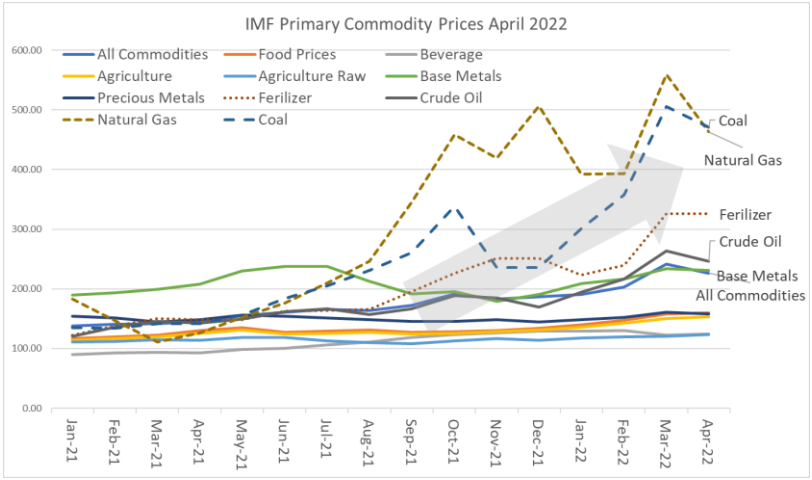
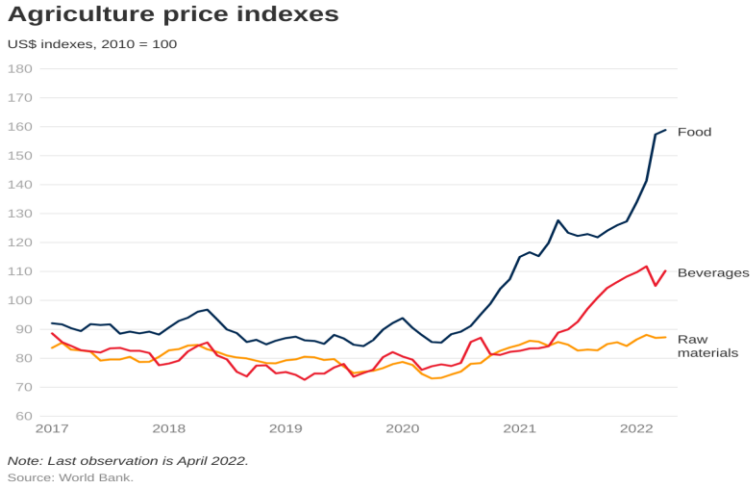
Russia and Ukraine are still fighting.

For now, commodity prices continue to be elevated.



https://www.imf.org/en/Research/commodity-prices



https://blogs.worldbank.org/opendata/food-prices-continued-their-two-year-long-upward-trajectory

https://blogs.worldbank.org/opendata/food-prices-continued-their-two-year-long-upward-trajectory

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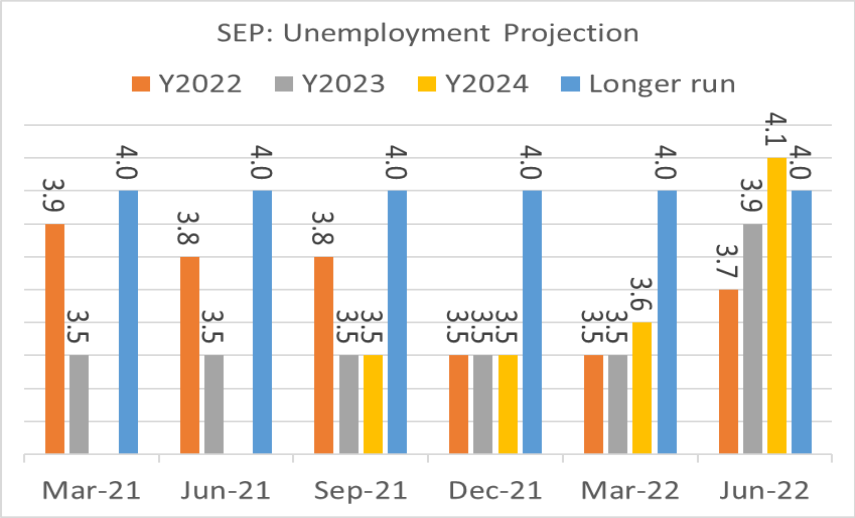
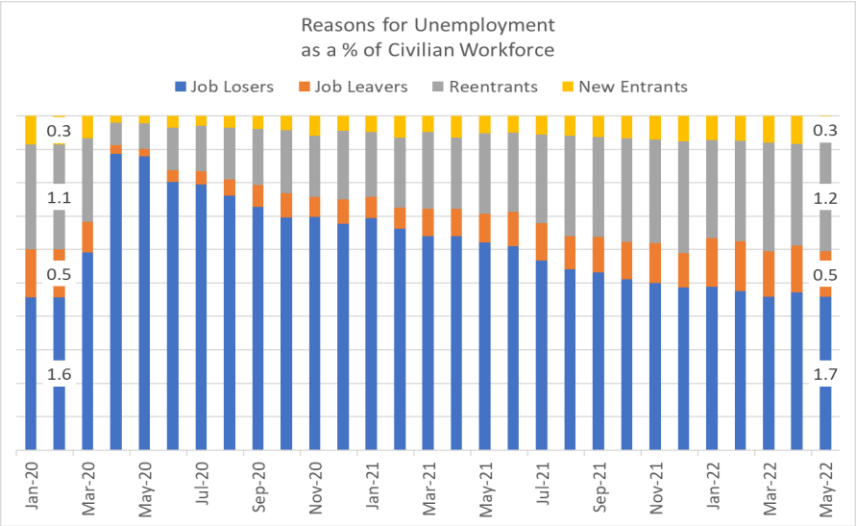
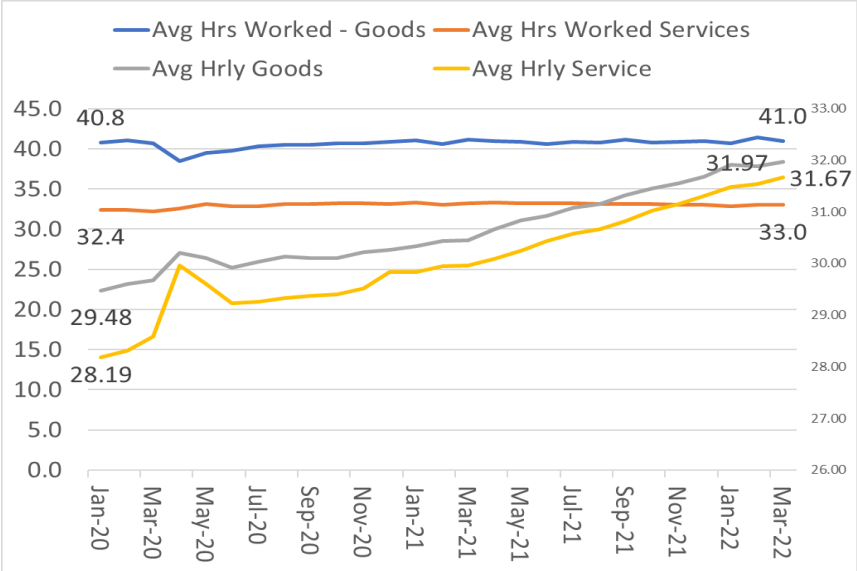
Summary of Economic Projections – Unemployment (U3)



https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20220316.pdf



https://www.bls.gov/webapps/legacy/cpsatab11.htm



https://www.bls.gov/ces/data/employment-situation-table-download.htm

The Federal Reserve expects the U.S. to return to its pre-Covid low of 3.5% unemployment by 2022, a speedier rate than March's SEP projection. The March U3 unemployment is at 3.6%, a continuing improvement, and is quickly reaching the 3.5% pre-Covid rate. This is the lowest since the pandemic. Naturally, "Job Losers" continue to come down. The number of hours worked for both services and goods producing workers have returned to pre-Covid levels. The hourly wage for the services and the goods producing sectors have also both exceeded the pre-Covid levels.

Job Losers continue to shrink while Job Quitters continue to increase - signs of a better job market and more workers reentering the job market. These are all good indicators of a strong and growing labor market.

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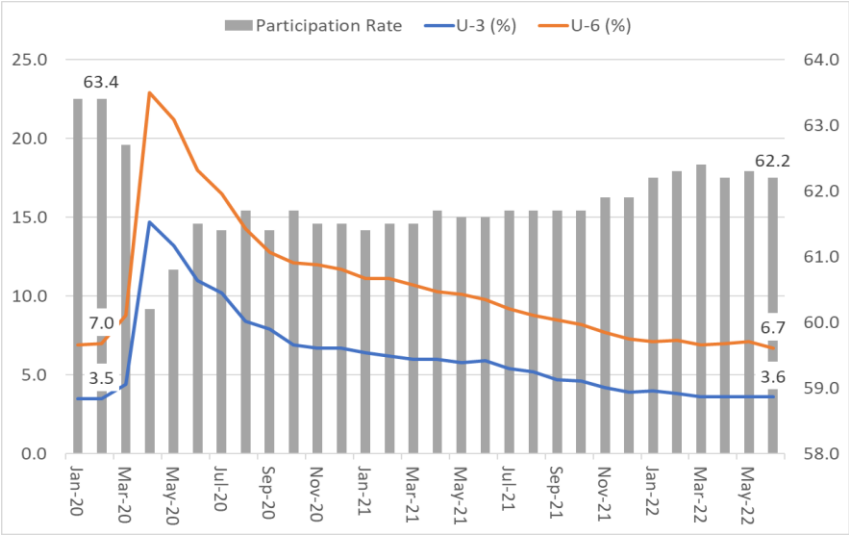
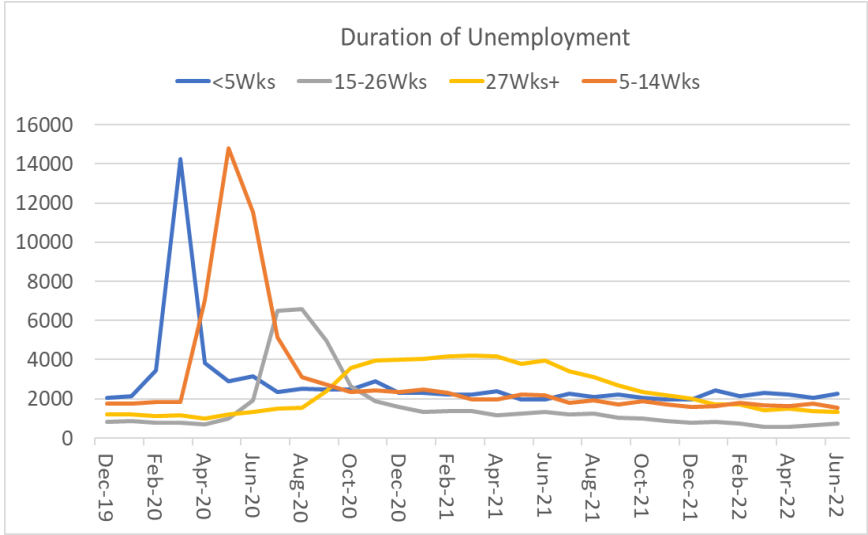
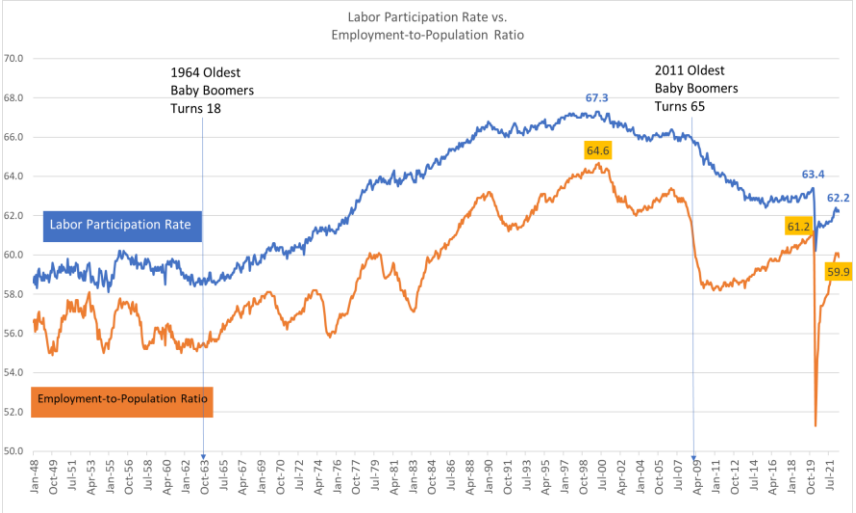
The Labor Economic, is still strong for now



https://www.bls.gov/webapps/legacy/cpsatab1.htm





On the headline basis (U3 @ 3.6% vs pre-Covid at 3.6%), unemployment has returned to and continued at pre-Covid levels, even though the labor participation rate @ 62.2% remains below pre-Covid level of @63.4%. Also, the Employment-to-Population ratio shows the prior Covid level @61.2% vs. the current rate of 59.9%. Duration of unemployment has also continued to improve, especially for the long-term unemployed (27-weeks or longer). The labor economy is still holding up nicely from a number of key measures even though the participation rate and employment-to-population ratio are shifting down. This is one reason the Fed is willing to be more aggressive with its monetary policies to combat inflation.

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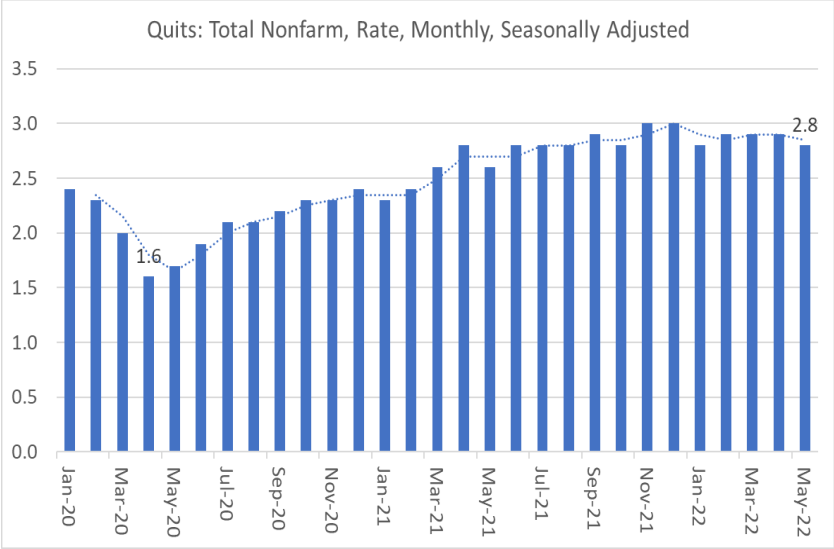
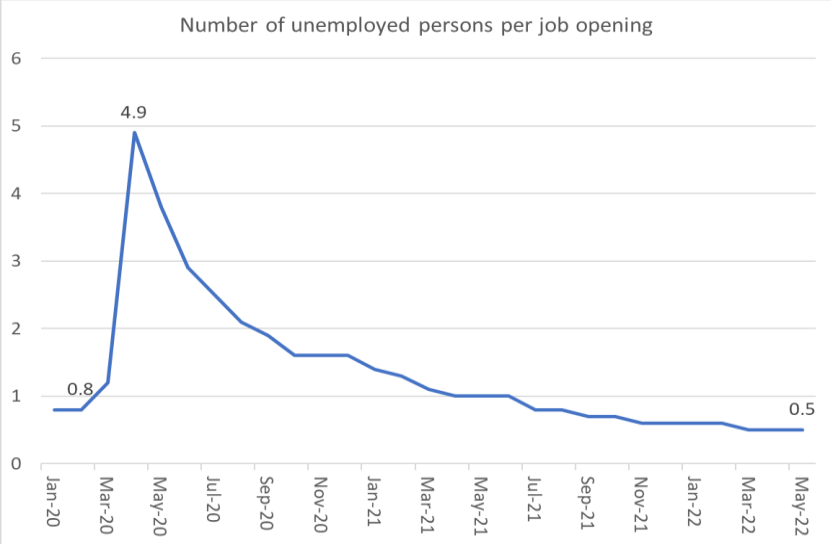
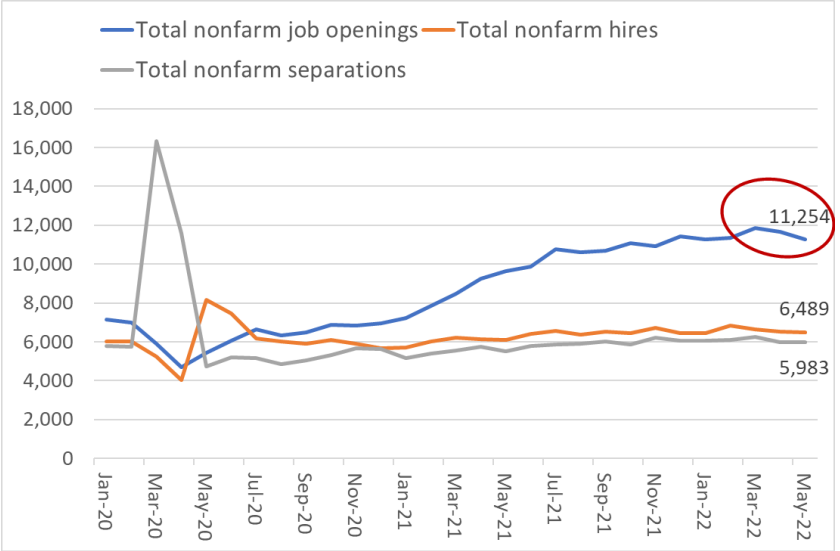
Quits, Hires and Openings







In May, hires and total separations were little changed at 6.5 million and 6.0 million, respectively. Within separations, quits (4.3 million) and layoffs and discharges (1.4 million) were little changed.

The number of job openings decreased to 11.3 million on the last business day of May. This is likely the first sign of companies becoming more cautious and freeze hiring. If this drop persists, it will bring down the quit rates, an indicator of worker confidence that a new or better job is available.

The ratio of # of unemployed and job opening remains at 0.5. This is an important data point to watch if the number of opening will continue to shrink while the number of job seeker may grow. This is what we expect as the economy slows.

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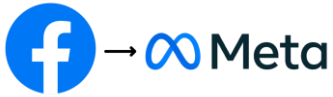
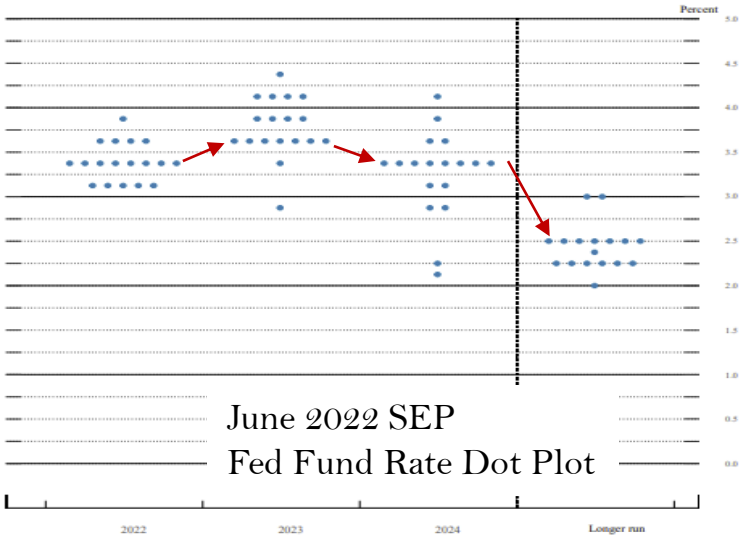
Employment Freeze and/or Cut

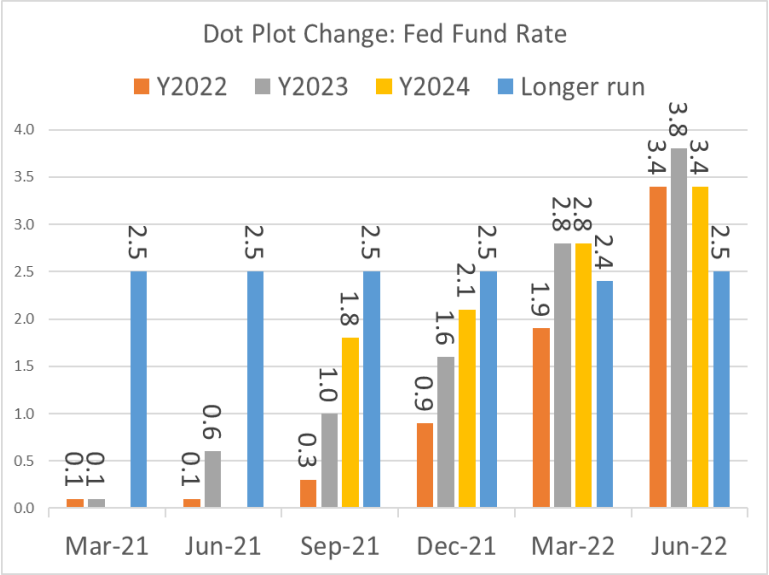



Although the announced employment freezes and cuts have thus far been limited to the high-tech companies, if the economy continues to slow, these phenomenon will bleed into the general economy. Since the Fed is determined to bring down inflation, the damage to this economy must go beyond technology companies. With major contributors to inflation coming from supply shocks and the recovery of the supply chain, the only way to contain demand is to increase unemployment and make financial conditions tighter to constrict demand.

Summary of Economic Projections – Fed Fund Rate



https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20220615.pdf



The FOMC members have been broadcasting an immediate and aggressive monetary policy action – both raising interest rates and quantitative tightening. After a 50bp increase in rates in May's meeting, the Fed had moved to a 75bp increase in its June meeting. Chair Powell is signaling that another 75bp increase is likely for the July FOMC meeting decision. This continues their "front loading" preference. The data on the economy and employment as well as financial/stress conditions remain positive and with strength. The Fed wants to take advantage of these favorable conditions to act as a sponge for meaningful tightening through rate hikes and QT (likely to be the last opportunity).

The dot plot in its June Summary of Economic Projections release clearly shows the disparity of opinion among members of where the neutral Fed Fund's rate (r*) should be for this year and the next two years, For 2022, the expectation now is a 3.1% – 3.6% bp rate by the end of this year. This is a jump from the range of 1.6% to 2.4% projections released during the March meeting. At the projected CPI by the FOMC at 2.6% by year end, it is reasonable to assume a 3.1% - 3.6% Fed Fund's rate. Historically, the r* should be approximately 100bp above the inflation rate. This means 3.6% rate over an inflation of 2.6%. We believe this is unlikely to be the case.

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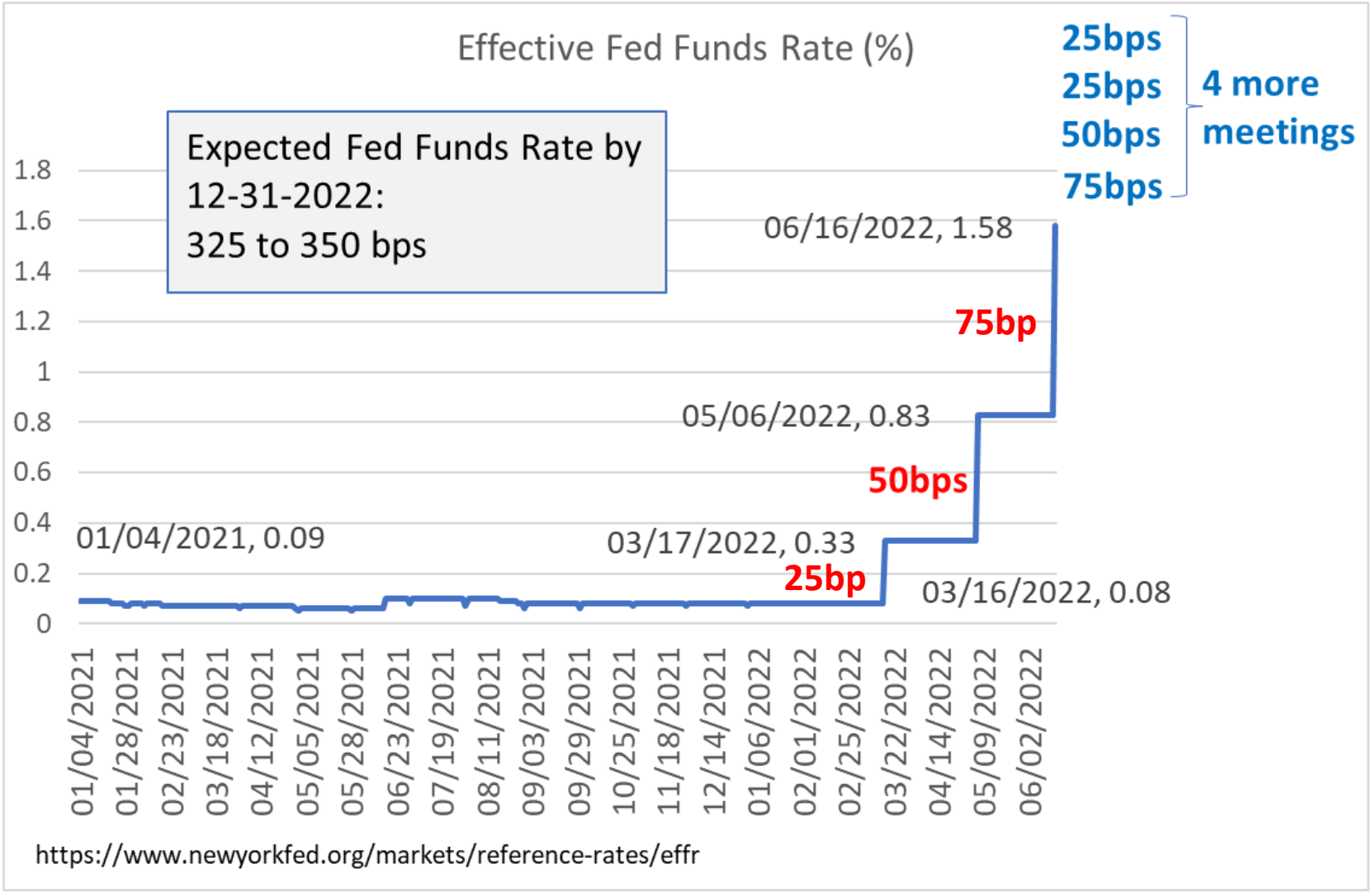

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Market Expectation of FOMC's Rate Hiking Cycle

January 26, 2022, CME Fed Watch Tool

MEETING PROBABILITIES											
MEETING DATE	25-50	50-75	75-100	100-125	125-150	150-175	175-200	200-225	225-250	250-275	275-300
3/16/2022	87.6%	12.4%	0.0%	0.0%	0.0%						
5/4/2022	31.4%	60.7%	7.9%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
6/15/2022	1.8%	33.0%	57.7%	7.5%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
7/27/2022	1.0%	18.9%	46.5%	30.2%	3.4%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
9/21/2022	0.4%	8.1%	29.9%	40.0%	19.5%	2.0%	0.0%	0.0%	0.0%	0.0%	0.0%
11/2/2022	0.3%	5.4%	22.3%	36.5%	26.7%	8.2%	0.7%	0.0%	0.0%	0.0%	0.0%
12/14/2022	0.1%	2.2%	11.8%	27.7%	32.8%	19.7%	5.3%	0.4%	0.0%	0.0%	0.0%
2/1/2023	0.1%	1.6%	9.1%	23.2%	31.3%	23.3%	9.4%	1.8%	0.1%	0.0%	0.0%
3/15/2023	0.0%	0.7%	4.5%	14.5%	26.3%	28.3%	18.0%	6.5%	1.2%	0.1%	0.0%
5/3/2023	0.0%	0.5%	3.5%	12.0%	23.4%	27.8%	20.5%	9.3%	2.5%	0.3%	0.0%
6/14/2023	0.0%	0.3%	2.2%	8.3%	18.4%	25.9%	23.7%	14.2%	5.5%	1.3%	0.2%
7/26/2023	0.0%	0.2%	1.8%	6.9%	16.2%	24.2%	24.2%	16.4%	7.4%	2.2%	0.4%

https://www.cmegroup.com/education/demos-and-tutorials/fed-funds-futures-probability-tree-calculator.html

April 8, 2022, CME Fed Watch Tool

MEETING PROBABILITIES															
MEETING DATE	50-75	75-100	100-125	125-150	150-175	175-200	200-225	225-250	250-275	275-300	300-325	325-350	350-375	375-400	400-425
5/4/2022	19.5%	80.5%	0.0%	0.0%	0.0%										
6/15/2022	0.0%	0.0%	12.6%	58.7%	28.7%	0.0%	0.0%	0.0%	0.0%	0.0%					
7/27/2022	0.0%	0.0%	0.0%	5.1%	31.1%	46.6%	17.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
9/21/2022	0.0%	0.0%	0.0%	0.0%	3.7%	24.3%	42.6%	24.8%	4.5%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
11/2/2022	0.0%	0.0%	0.0%	0.0%	0.0%	3.5%	23.2%	41.6%	25.8%	5.6%	0.2%	0.0%	0.0%	0.0%	0.0%
12/14/2022	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	3.4%	22.2%	40.7%	26.6%	6.6%	0.5%	0.0%	0.0%	0.0%
2/1/2023	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.9%	8.6%	27.4%	36.7%	21.0%	4.9%	0.4%	0.0%	0.0%
3/15/2023	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	2.2%	11.6%	28.9%	34.3%	18.4%	4.2%	0.3%	0.0%
5/3/2023	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	1.2%	7.0%	20.4%	31.6%	26.2%	11.2%	2.2%	0.2%
6/14/2023	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.3%	2.5%	10.1%	23.0%	30.4%	22.7%	9.1%	1.7%	0.1%
7/26/2023	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	1.0%	4.8%	14.0%	25.2%	28.0%	18.6%	6.9%	1.2%

July 1, 2022, CME Fed Watch Tool

MEETING PROBABILITIES										
MEETING DATE	200-225	225-250	250-275	275-300	300-325	325-350	350-375	375-400	400-425	425-450
7/27/2022	17.4%	82.6%	0.0%	0.0%						
9/21/2022	0.0%	0.0%	14.3%	70.8%	14.9%	0.0%	0.0%	0.0%	0.0%	
11/2/2022	0.0%	0.0%	0.0%	8.6%	48.4%	37.1%	5.9%	0.0%	0.0%	0.0%
12/14/2022	0.0%	0.0%	0.0%	2.0%	18.0%	45.7%	29.7%	4.5%	0.0%	0.0%
2/1/2023	0.0%	0.0%	0.0%	1.6%	14.7%	40.0%	33.0%	9.7%	0.9%	0.0%
3/15/2023	0.0%	0.0%	0.0%	1.4%	13.0%	36.6%	33.9%	12.8%	2.1%	0.1%
5/3/2023	0.0%	0.0%	0.8%	8.2%	26.9%	35.1%	21.5%	6.5%	0.9%	0.1%
6/14/2023	0.0%	0.4%	4.4%	17.2%	30.8%	28.5%	14.3%	3.8%	0.5%	0.0%
7/26/2023	0.2%	2.3%	10.4%	23.6%	29.7%	21.8%	9.4%	2.3%	0.3%	0.0%

January annualized CPI was 7.5%, and for May it was 8.6%.annualized. With Chair Powell's firm and aggressive rhetoric of fighting inflation and front loading the interest rate hikes, the market is revising its expectation of the Fed Fund's rate by year end. For example, on January 26th, the market expected the rate to be at 125bp – 150bp. By April 8th it was at 250bp – 275bp, doubling the January expectation. On July 1st, the market expects the Fed Fund's rate to be 325bp to 350bp by the end of the year. This projected rate range was not even in the projection expectation rang set back on January 26th. This also means that the market participants are expecting another 175bp increase from July through the end of the year with July's meeting increasing by another 75bp.

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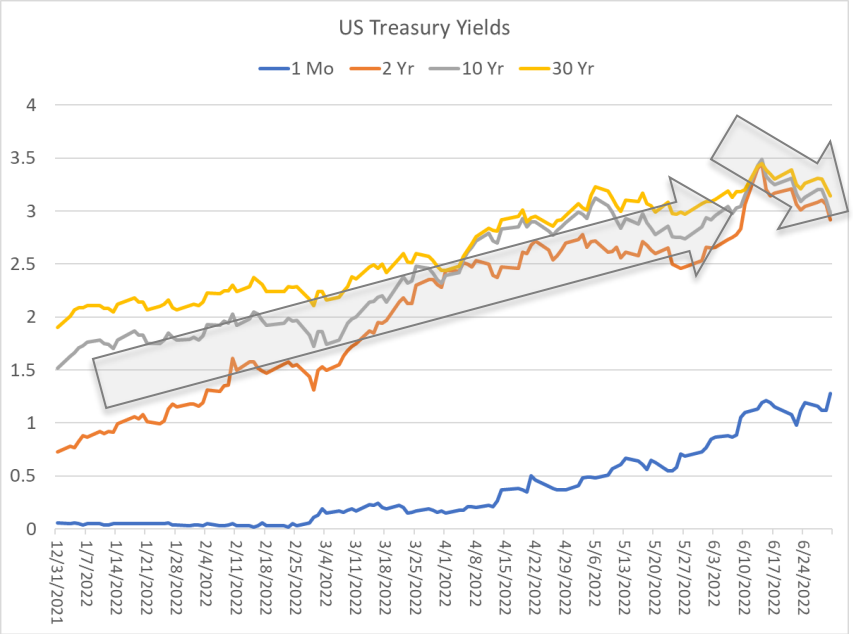
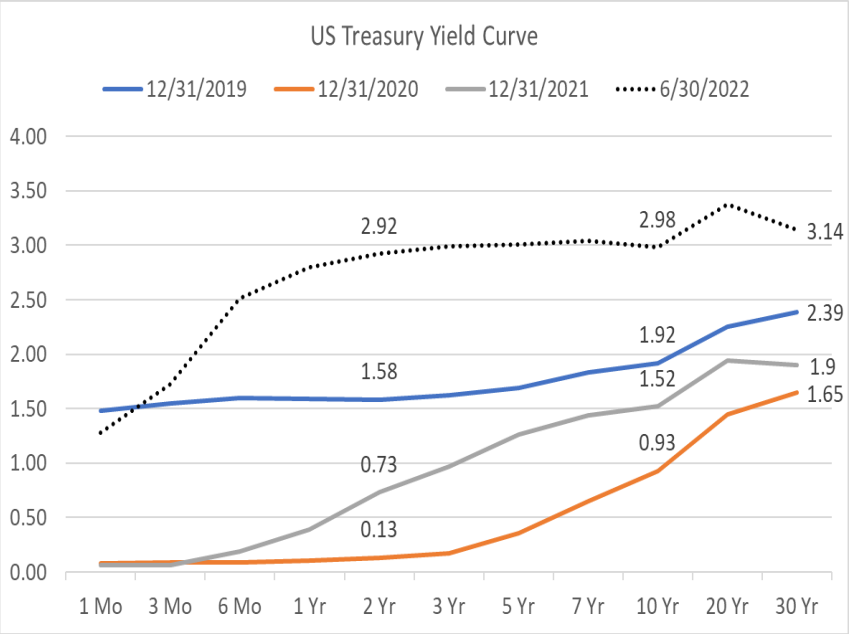
A Hawkish Fed – Good for savers, not for bonds or stocks





US Treasury yields have increased with the market anticipation of the interest rate hiking cycle and the follow through of an increasingly aggressive policy. As a result of the rate rises, bonds have had their worst performance in decades with the yield on the 10-year Treasury reaching 3% for the first time since late 2018. But lately, the long end of the yield curve has dipped. Professional bond investors have always looked at the long-end of the yield curve as an indicator for long-term inflation. This reversal of yield suggests that inflation will be brought into control.

The above graph shows the yield curve at the end of each of the last 3-years and as of the end of 2022Q2. It shows the extraordinary rise in yields for 2022. The 2-year treasury yield is an indicator of r*, the neutral rate. In this case, the market is suggesting 2.92%, which is much less than the 3.6% projection by the Fed. The market is most likely taking a wait-and-see approach towards rates as the U.S. economy begins to show signs of weakness and consumer sentiment also weakening. The market is thinking the Fed will not have the resolve to keep raising rates if the economy tanks.

https://home.treasury.gov/policy-issues/financing-the-government/interest-rate-statistics

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U.S. Factors & Sectors Quarterly Total Return

S&P 500 Investemnt Style Total Return	Q2 2022	Q1 2022	Q4 2021	Q3 2021	YTD 2022
Low Volatility Index	-6.58	-0.16	12.85	1.85	-7.14
Dividend Aristocrats	-9.06	-1.72	12.25	1.47	-10.28
Value	-10.60	-3.01	10.91	-0.21	-11.03
Momentum Index	-13.97	-5.27	8.68	-0.22	-18.21
Quality	-14.92	-5.88	6.89	-1.52	-19.81
Growth	-20.30	-8.59	6.03	-2.26	-27.02
S&P 500	-15.50	-4.60	9.77	0.05	-19.11

S&P 1500 Sector Total Return % Change	Q2 2022	Q1 2022	Q4 2021	Q3 2021	YTD 2022
Energy	-4.60	39.10	16.37	2.61	32.77
Financials	-4.90	4.45	16.35	1.54	-17.04
Industrials	-5.86	-0.89	14.56	1.28	-16.78
Materials	-6.40	-1.21	13.05	1.16	-16.72
Utilities	-14.78	-1.60	12.88	1.15	1.84
Communication Services	-15.85	-2.96	11.99	0.88	-29.56
Consumer Discretionary	-16.52	-3.24	10.38	-0.40	-31.24
Consumer Staples	-16.89	-5.46	9.05	-0.69	-4.39
Real Estate	-20.16	-8.37	7.00	-1.46	-18.94
Health Care	-20.66	-9.58	4.77	-3.90	-8.03
Information Technology	-25.38	-11.82	-0.06	-3.93	-26.70
S&P 1500 TR	-16.02	-4.64	10.71	0.35	-19.06

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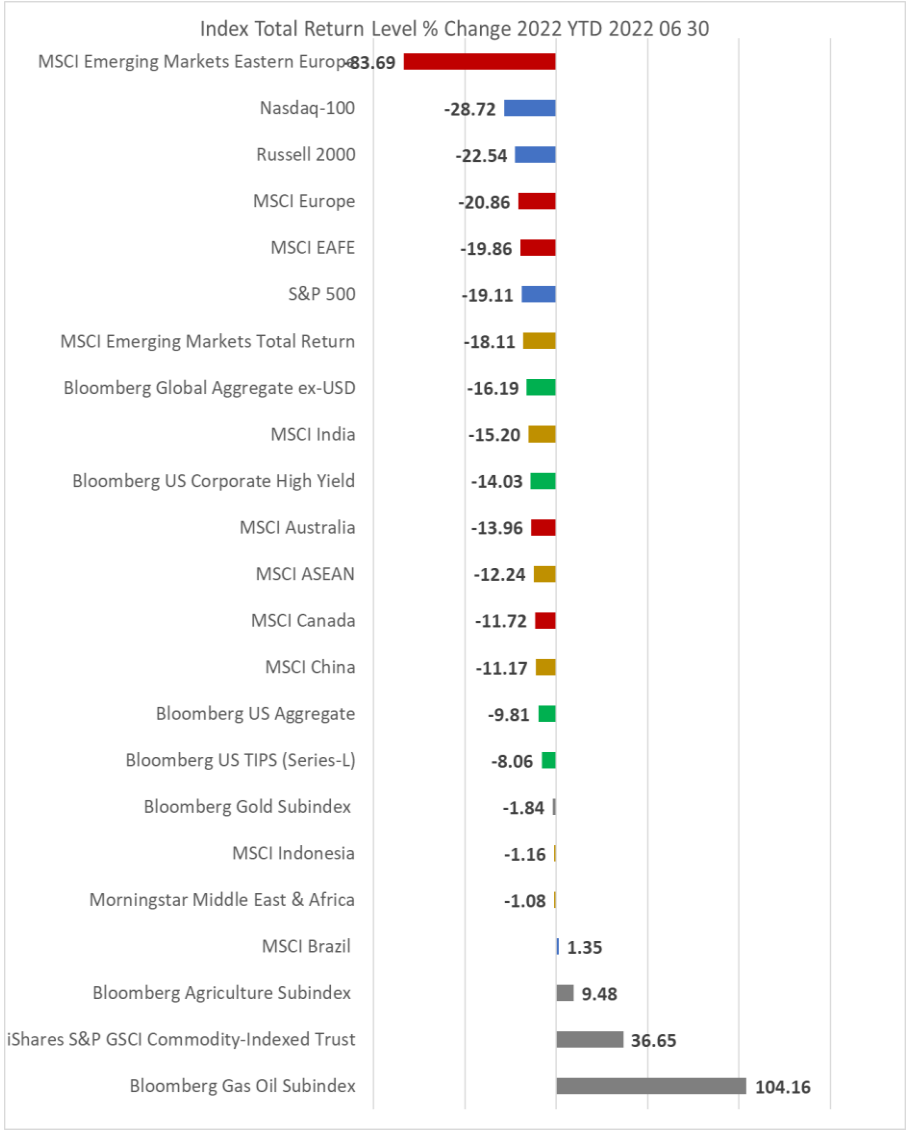
The tough 6-month market may have more downside to come.



The first month of the equity and fixed income market, locally and globally, responded to a tough and stubborn (non-temporary) inflation spike which required tough central bank monetary actions. In the case of the U.S., we witnessed a hike from 0.0% - 0.25% to 1.5% - 1.75%, a 75bp increase in June's FOMC meeting. Chair Powell has signaled in various speeches and testimonies that the FOMC will take necessary monetary tightening actions to meet its "price stability" mandate. All this means more aggressive rate hikes are expected with another 75bp hike possible in July meeting. With fast and furious hikes coupled with the beginning of Quantitative Tightening (QT), the market continues to adjust to the new reality without any certainty as to where the neutral rate (r*) is. With every economic data release (data dependency) and every FOMC meeting (action + forward guidance), the market reacts and anticipates. As such, expect more volatility as the market adjusts its own forward view of when and where the landing will be and will it be soft or hard. Signs of a slowing economy are already evident, and now the market is also responding to the possibility of a recession, which adds more market volatility.

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World Growth is Receding

OECD	Project 2022					Project 2023		
Report Date	Apr-21	Sep-21	Dec-21	Jun-22	Dec v.Jun	Dec-21	Jun-22	Dec v.Jun
U.S.	4.0%	3.9%	3.70%	2.50%	⇓	2.40%	1.20%	⇓
World	4.0%	4.5%	4.50%	3.00%	⇓	3.20%	2.80%	⇓
G-20	4.1%	4.8%	4.70%	2.90%	⇓	3.30%	2.80%	⇓
Euro Area	3.8%	4.6%	4.30%	2.60%	⇓	2.50%	1.60%	⇓
China	4.9%	5.8%	5.10%	4.40%	⇓	5.10%	4.90%	⇓

	Project 2022						Project 2023		
Report Date	Apr-21	Jul-21	Oct-21	Jan-22	Apr-22	Jan v. Apr	Jan-22	Apr-22	Jan v. Apr
U.S.	3.50%	4.90%	5.20%	4.00%	3.70%	⇓	2.60%	2.3	⇓
World	4.40%	4.90%	4.90%	4.40%	3.60%	⇓	3.80%	3.6	⇓
Euro Area	3.80%	4.30%	4.30%	3.90%	2.80%	⇓	2.50%	2.3	⇓
Advanced	3.60%	4.40%	4.50%	3.90%	3.30%	⇓	2.60%	2.4	⇓
China	5.60%	5.70%	5.60%	4.80%	4.40%	⇓	5.20%	5.1	⇓
Emerging	5.00%	5.20%	5.10%	4.80%	3.80%	⇓	4.70%	4.4	⇓

The Organization for Economic Co-operation and Development (**OECD**) and the International Monetary Fund (**IMF**), in their latest global growth projections, show continuation of a slowing growth trend. As Russia and Ukraine are large commodity exporters, the war has sent energy and food prices soaring. Elevated inflation across the globe is eroding households' real disposable incomes and living standards and, in turn, lowering consumption. Uncertainty is deterring business investment and threatening to curb supply for years to come. At the same time, China's zero-Covid policy continues to weigh on the global outlook, lowering domestic growth and disrupting global supply chains.

Final Words – A No-Win Situation

- Market participants tend to equate the Fed's monetary policies in shaping the intended outcome of the U.S. economy as a pilot navigating a plane to land. For a pilot, there are weather, traffic, and mechanical elements, among other variables, over which they often do not have control, and which require careful and skillful balancing and rebalancing to reach a destination. The landing can be a soft and smooth one or a hard landing that could range from very uncomfortable to a crash. In the case of this Fed, the mission is to bring inflation down to a 2% anchored level as quickly as possible. The challenge is to do so without a hard landing or ending up in a recession. The odds are not on the Fed's side as aggressive monetary policies are needed to bring demand down and contain inflation due to :(1) the starting interest rate was near zero, and it takes quite a few interest rate increases for consumers and companies to feel the effect; (2) the current economy is still strong, and unemployment is near pre-Covid lows with good and strong corporate balance sheets and revenue expectations; and (3) although the post-COVID resurgence of demand for services while there is a labor shortage contributes to wage increases and a demand driven price increase, the larger factors remain on the supply side. From the slow process of healing the supply chain to the Russian invasion of Ukraine, many factors have placed strains on finished products and energy and agricultural commodities. Hiking rates will have little impact on supply-push inflation unless consumer demand is so restricted that it impacts supply pricing. This means higher unemployment which will likely end in a recession. Moreover, to feel the impact of a rate hike, it has historically taken 6 to 12 months. If this remains true, the Fed will likely raise rates past the level needed to bring down inflation to 2%. Recession is no longer a possibility but a probability.
- Stagflation is a present condition already, and if the economy does not end in a recession and inflation is not brought down to 2% or thereabout, we would likely be in a longer-term state of stagflation. This means higher inflation and lower growth - the worst of all worlds where the Fed has little influence unless it uses more hawkish policy to bring the economy into a recession. This is likely the scenario if the Fed "blinks" and stops short of controlling or bringing inflation back to 2% in an effort to not push the current economy into a recession and significantly higher unemployment.
- Many observers predict a shallow and short recession (less than the average recession of 15 months) for the U.S. This self-imposed slowdown is happening during a good economy with low unemployment, strong corporate and personal balance sheet, and a sound banking system. As such, the damage and financial transmission mechanism should be limited. But this base case may give way to a rapidly deteriorating U.S. economy, and it takes time for unemployment to rise, which ultimately leads to recession. The probability of a recession has increased and is this Firm's base case for the U.S. if the Fed is true to its word of bring inflation down to or around 2%.
- The U.S. should fare the best among the developed economies in the economic downturn. Europe is hit by inflation, spiking energy cost, rising rates, and slowing growth. Japan is struggling with high inflation and the inability or unwillingness to move rates higher. Much of the emerging markets (who are mostly export driven) do not have the fiscal room after Covid to support their economies and citizens in a global slowdown, especially when the dollar continues to strengthen.

Investment Implications

- Our base case is a shallow and below average length recession in the U.S. Technically, we could be in a recession now as we expect the second quarter to be weak as well. This will lead to an increase in unemployment and lowering corporate earnings and investments.
- The market is already pricing in a slowdown, and as such, the long end of the yield curve has moved lower and is ultimately showing a sustained inversion (i.e., front-end rates are higher than the back-end rates).
- Based on this scenario of high inflation coming down and giving way to an economic slowdown akin to a recession:
  - the supply-push inflation is temporary due to a confluence of factors (supply chain healing and Russian Ukraine conflicts) even though, due to the lack of a clear path to an energy transition, the energy sector prices are likely to remain elevated going forward;
  - the demand-pull inflation will likely be contained by central bank actions;
  - we remain bearish on equities (U.S. and global) due to the inflation, Fed policy uncertainty and economic slowdown impacting earnings and demand;
  - with global growth slowing and some countries likely falling into recession (Europe and the U.S.), demand will naturally wane with most commodity prices receding from their peaks; and
  - the bond market is beginning to price in a recession, which means the rates on the longer end of the yield curve may have peaked and we favor core bonds (i.e., longer duration investment grade bonds) and are not as comfortable with credits yet.

Disclosures and Limitations

- Experiential Wealth is a Securities & Exchange Commission registered investment advisory firm.
- This quarterly review is prepared for educational and informational purposes only and should not be deemed as this Firm or any member of this Firm offering investment advice to the public.
- Information provided or discussed regarding any one specific issue or trend are insufficient or incomplete for investors to rely upon in making any financial decisions.
- This document is not an offer to buy or sell any investment products and investors should consult with their independent fiduciary investment advisor before taking any related action.
- This Firm has no obligation to update this quarterly commentary going forward.

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