Schroeder | Capital Management, LLC

Global Investment

Investment Review and Outlook – Summer 2022

The U.S. Economy – Very Mixed Signals:

Recent economic reports are quite mixed. While there are pockets of strength, it is also increasingly apparent that the more-restrictive Federal Reserve monetary policies during early 2022 are taking a toll on some sectors within the overall economy, especially on the consumer.

On the positive side, healthy increases in job creation continue. The U.S created 372,000 jobs in June, surpassing the consensus expectation and nearly in line with the solid May total of 384,000. For the first six months of 2022, nonfarm payrolls grew by 2.74 million positions, signaling a healthy labor market that is unlikely to occur during an economic recession.

The interest rate sensitive housing market, however, has softened considerably this year with sales of newly built single-family homes declining by 8.1% in June from the year earlier, as reported by the Commerce Board. Also, by mid-July, the average 30-year fixed-rate mortgage rate rose to 5.5% from 2.8% over the past twelve months.

In addition, a recent report from the National Association of Home Builders (NAHB) Index of homebuilder sentiment, registered the largest single-month drop in the survey's 37-year history and lowest non-pandemic reading since 2015. Homebuilder sentiment had been at an all-time high coming out of the pandemic with historically low mortgage rates and a shift in demand toward single-family housing, especially favoring suburban areas.

Consumer behavior is also showing stress resulting in a moderation of overall spending. While more consumer spending has shifted toward travel, entertainment and leisure pursuits, a slowdown has been seen for discretionary items such as autos, appliances, home furnishings and apparel. Some of this has to do with ongoing global supply-chain disruption stemming from the war in Ukraine and COVID-19 lockdowns in China. Meanwhile, significant price increases for food and energy commodities are causing many consumers to draw down savings and make greater use of credit card debt.

This week the Bureau of Economic Analysis reported gross domestic product for the second quarter of 2022 declined at an annual rate of 0.9 %, according to the advance estimate. A second estimate for this period will be released on August 25th that is based on more complete data. In the first quarter, GDP decreased by 1.6%. While two consecutive quarters of declining GDP is often used to signal a recession, the recent report still shows areas of growth. Most prominent was the recent growth in the labor market, as mentioned above. Also, expansion was noted in exports, food services, healthcare and recreation. We will know more in August when more details are released regarding the recent GDP report.

Earnings Season – Also Very Mixed:

Results so far can be best characterized as "not as bad as expected," considering the geopolitical turmoil, elevated inflation, and increasing worries about the current economic slowdown. In general, reported earnings have been mixed with many companies missing their previous guidance forecasts.

The decline in corporate profit momentum is being highly scrutinized by Wall Street to see what impact the stubbornly high level of inflation is having on Corporate America. There is a sharp focus on analyzing forward-looking views of companies and how they expect to face current challenges. The current consensus earnings growth forecast for all S&P 500 companies for the recent quarter has fallen below 5.0%. If this slowing growth expectation finally materializes, this would be the lowest rate of profit expansion since the fourth quarter of 2020.

Inflation – A 40-year High:

As the second half of 2022 began, one of the biggest questions was whether some signs of easing inflation will start to show after the disappointing June report for both consumer and producer prices. Widespread increases in what American consumers are paying for goods and services drove annual inflation to a new 40-year peak. The Consumer Price Index (CPI) rose by an annual rate of 9.1%, excluding the volatile food and energy component. Also, the Producer Price Index (PPI) jumped by 11.3% during June to the largest increase since the record 11.6% advance set in March of this year.

A silver lining to the inflation reports was a smaller-than-expected increase in the core PPI. That figure, which also excludes the food and energy components, showed a moderate month-to-month rise of 0.4%. Hopefully, this may be a sign that the Federal Reserve's attempt to slow demand is starting to influence wholesale prices that may eventually trickle down to the consumer sector and lead to moderation in overall inflation. In addition, the core CPI also ticked down a bit in June to 5.9% from 6.0% in May.

Federal Reserve – More Interest Rate Hikes to Come:

The high June readings of both consumer and producer price indices were two data points that were large factors in the Federal Reserve's decision to increase the Fed Funds rate by another 0.75 % this week, the second such move in the past two months.

Chairman Jerome Powell said the Federal Reserve Open Market Committee (FOMC) goal is to achieve maximum employment and reduce inflation to 2% over the longer run. Consistent with those objectives, the Fed anticipates a series of ongoing rate increases. Over the next several months, a target range for the Fed Funds was stated to be approximately 3.50%, up from its current range of 2.25-2.50%. This would imply perhaps three more increases in the months to come, perhaps 0.50% at the next meeting in September and then possibly two additional increases of 0.25% in the months ahead. While recent indicators of spending and production have softened, the Fed appears willing to accept further reductions in economic growth to achieve price stability and avoid current inflation becoming entrenched. However, this approach also risks driving the economy into a prolonged slowdown.

To that end, Chairman Powell made the following statement:

"In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments." July 27, 2022

Investment Strategy – Remaining Cautious:

The current business climate has been impacted by considerable global economic challenges, as previously discussed, along with increased geopolitical tension. The ongoing war in Ukraine has resulted in food security concerns, as the country is a major exporter of wheat, and a reshaping of global energy supply flows.

The hot-button topic for Wall Street will continue to be broad-based inflation in the U.S. economy and the role the Federal Reserve will play to achieve its goal of stabilizing inflation at an approximate 2% annual rate. Efforts to tame currently elevated inflation will drive interest rates higher and that will impact the overall economy. The full effect of this policy will gradually unfold in the coming months as the Fed's restrictive monetary actions impact the economy. One thing we do know is that current inflationary pressures and higher interest rates, that we have not seen in sometime, will likely persist for a while.

The recent swings in the stock market, specifically in the high growth sectors, have resulted from the aforementioned conditions and concerns. In the coming months, we expect a continuation of market volatility as Wall Street evaluates the impact of the Fed's more restrictive monetary actions, the health of corporate America in dealing with inflationary pressures, profitability and the ability to fund future growth in a rising interest rate environment. In addition, consumer spending, approximately 70% of overall economic activity, will be closely scrutinized.

Under these circumstances, we believe it is especially prudent to remain most cautious with our security selection choices as we manage investment portfolios. Historically, financial markets do not like uncertainty and there is an abundance of that right now.

We continue to emphasize high-quality companies with attractive long-term prospects that produce steady earnings growth, generate ample cash flow, maintain strong balance sheets and importantly, have pricing power for their products and services.

Investment portfolios that have a combination of very high-quality companies with strong balance sheets along with a higher than usual level of cash have proven to minimize potential downside market risk during a slowing economy. While the U.S. stock market has firmed up in July, it should be noted that advances during bear markets are not likely to lead to sustained rallies until there is less uncertainty in the marketplace.

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