Summary

Economic data for the week included both producer and consumer inflation coming in higher than expectations, and continuing the string of multi-decade highs, which have weighed on business and consumer sentiment. Jobless claims also ticked up again, off of cyclical lows. Retail sales also came in stronger than expected, as did consumer sentiment (with lower long-term inflation expectations).

Global equity markets were down on net for the week, with mixed reactions to economic and inflation data. U.S. bonds gained ground as yields fell back and the treasury curve inverted; foreign bonds were held back by a strong U.S. dollar. Commodities fell back due to continued recession concerns.

Economic Notes

(+) The advance **retail sales** report for June came in at a 1.0% gain, beating expectations by a tenth, and far better than the prior month's negative reading, post-revision. This was led by gas station sales, up 4% along with higher gasoline prices, while non-store/online sales grew by 2%; however, department stores and building materials lost ground. Removing the more volatile segments of autos, gasoline, and building materials, core/control sales still gained 0.8%. A factor not discussed much until recently—inflation has played a rising role in sales data, as higher prices drift into nominal results. While the 'real' retail sales figure still is likely positive by a few tenths of a percent, inflation has been detracting from headline numbers over the last 3-6 months.

(-) **Industrial production** in June fell back by -0.2%, relative to an expected increase of 0.1%, and breaking a five-month winning streak. Manufacturing production fell a deeper -0.5%, led by a downturn in auto production (to a 10.3 mil. annualized rate, well below the pre-pandemic average), although non-auto fell back as well, with goods buying tapering off. Weather-related utilities production also fell over -1% while mining production rose nearly 2%, with oil extraction activities ramping up. **Capacity utilization** for the month fell by -0.3% to 80.0%.

(+) The New York Fed's **Empire State Manufacturing Survey** for June rose by 12.3 points back to an expansionary reading of 11.1, beating expectations calling for -2.0. This was led by stronger new orders, but more sharply by a 25-point gain in the shipments category. Employment growth also remained strong. Delivery times also fell back, but remained positive, which implied an improvement in recent logjams. Prices paid and received also moved significantly lower, which was positive from an inflation cost input perspective. However, expected business conditions six months out turned negative (falling -20 points to a 20-year low), noted as a 'rare' event in the survey report, but in keeping with other pessimistic opinions from small businesses out there.

(-) The final demand **producer price index** for June rose by 1.1% for the month, rising at an accelerating pace from the prior two months, and higher than the 0.8% expected. Core PPI rose a bit less, at 0.4%. A 10% rise in energy prices was the primary catalyst for the headline move, with half of the increase attributed to the 19% rise in gasoline, with the prices of other crude materials outside of food and energy declining by -2%. In positive breakfast news, egg prices dropped -30%, demonstrating the volatile nature of various components. Year-over-year, PPI is up 11.3%, although it remains below the 11.6% mark from March, while core PPI came in at 8.2%. The older 'finished goods' PPI metric, which contains a higher weight to energy, rose an incredible 18.6% year-over-year (a pace last seen in around 1974). While it doesn't look like it, there does appear to be some signs of 'peaking' in production costs.

(-) The **consumer price index** for June re-accelerated higher by 1.3% on a headline level, and 0.7% core, after removing food and energy prices. These were higher than expectations by a few tenths of a percent. While price gains were described as being broad-based, highlights included a 10% one-month rise in energy commodities (particularly gasoline), as well as 8% for residential natural gas service. Food prices gained another 1%, with other areas such as transportation also being affected indirectly by fuel. Used car prices also rose nearly 2% for the second month in a row.

For the trailing 12 months, headline CPI rose by a headline 9.1% (highest in 41 years) and core 5.9%, with the latter showing continued deceleration. Energy prices up 60% represent the most obvious catalyst, although car prices were up approximately 10% (between new and used), and shelter up 6%, also contributed at a higher-than-average rate. Rising shelter costs, as a large component of CPI, are obviously of the rising concern to economists due to their 'stickiness'. All-in-all, the growing divergence and slowing of core inflation (at least a bit) is the positive takeaway from the report. Additionally, gasoline prices have come down since June, which also is a positive trend.

Comments from President Biden prior to the release of CPI appeared to be prepping the country for the high reading, which fueled more negativity in financial markets. Inflation and upcoming inflation expectations remain one of the most closely-watched data points of 2022. The primary question is: When is the peak? We've asked this so often, no doubt it's become old. Estimates have continued to evolve, and be pushed out further into the future, but there does remain a consensus that inflation will peak in the coming months and begin to normalize by later this year and into 2023. The two assumed sources of inflation—fiscal stimulus injections driving demand and continued supply backlogs—remain the culprits. The supply element, formerly known as 'transitory' inflation, is still expected to improve as global manufacturing gets back on track, but is still very dependent on sensitivities in China to Covid outbreaks. For good or bad, a slowing economy otherwise produces 'demand destruction' that helps the supply/demand balance naturally, although that type of solution is not the one usually preferred, as it can be a rockier ride.

(+) On the positive cost side, **import prices** rose only 0.2% in June, well below the 0.7% increase expected, and a deceleration from the prior month. Removing the effect of higher petroleum prices, prices fell -0.4%, with declines in food and consumer goods offset by higher prices for industrial supplies and capital goods. Overall import prices remain 11% higher on a year-over-year basis, in keeping with broader inflation levels. Import prices typically represent the 'bad' inflation, although it could be argued that no inflation today is 'good' inflation—that is, the small amount (2% target) that is solely the product of stronger domestic economic growth.

(+/0) The preliminary **Univ. of Michigan index of consumer sentiment** for July showed a 1.1 point increase to 51.1, beating expectations calling for no change. Assessments of current conditions rose by over 3 points, while expectations for the future fell a bit. High inflation was indicated by half of respondents as being the primary source of angst, resulting in an overall sentiment index number running about the lowest it's been since the early 1950s. Speaking of which, inflation expectations for the coming year declined by -0.1% to 5.2%, while those for the next 5-10 years fell by -0.3% to 2.8%. The latter number has been closely watched by the Fed, and may actually help steer the probability of a hike back toward 0.75% as opposed to the 1.00% some have assumed could happen in late July. In another 'bad news is good news' takeaway, history has shown that extremely poor sentiment has tended to overreach, resulting in better-than-average financial market outcomes a year later and beyond, as we've mentioned before, although (due to the fog of poor sentiment) it can be difficult for many investors to see through to the other side.

(-/0) **Initial jobless claims** for the Jul. 9 ending week rose by 9k to 244k, above the 235k median forecast. **Continuing claims** for the Jul. 2 week, on the other hand, fell by -41k to 1.331 mil., below the 1.380 mil. consensus forecast. Initial claims rose in KY, MA, and CT, while they fell in MI, GA, and NJ. Claims have continued to stealthily move higher, in fact up over 45% from lows in March, despite remaining 'low' in absolute terms. This has pointed to some questions over whether the job market is starting to peak and turn over. Continuing claims are still running at low levels, in a still-declining trend.

Question of the Week

What do potential forward-looking scenarios look like in fixed income?

Bonds were pummeled in the first half of 2022, to say the least. No doubt, these are trying times for bond owners and conservative investors generally, since fixed income hasn't typically experienced that type of price movement in many years. In fact, was one of the most volatile 6-month periods since the inception of the Bloomberg U.S. Aggregate Bond Index in 1976, back when it was known as the Lehman Agg.

Interest rates are unpredictable on an outright basis, not to mention navigating divergences between short-term and long-term rates. Recently, yields have stabilized, which may have potentially stopped the damage in the current cycle, but it might be useful to review future fixed income prospects through a few different scenarios.

'Bear case' (continued inflation, higher yields, lower prices). This assumes the Fed continues to battle inflationary forces from fiscal stimulus and pandemic supply disruptions that are perpetually weighing on the economy. Particularly, likely includes the Fed taking on an even more hawkish policy than already assumed (to 3.5% fed funds rate by Dec., for example). Due to the variety of influences, there is only so much monetary policy can do to battle inflation, with recent academic work at the San Francisco Fed reiterating that the current inflationary episode has been caused by roughly equal effects from each source. This was already assumed to some extent, but this provided more robustness to the analysis (and likely spurred by the Fed's claim that it can't solve all inflation problems through its tools solely). Nevertheless, high inflation could force continued rate hikes, rewarding cash and short-term bonds as opposed to long-term bonds. Even here, though, there's a limit to this, as Volcker found in 1980-81—you can't hike indefinitely without creating a recession. There is rising market uncertainty about the recession vs. 'soft landing' prospect right now.

'Base case' (more normalcy, stable yields, stable prices). A return to more typical conditions could mean a few additional months of higher inflation, but a peak and gradual calming over the next year. This is the path the Fed and many mainstream economists continue to see as the highest probability. It could also continue to coincide with some market volatility as investors speculate on the 'when' along with 'how much'. The scenario is hinged upon a combination of inflation from fiscal stimulus spending continuing to decelerate (looking at data like M2 balances, etc.) and the improvement in supply/logistics conditions globally, both in China and potentially any improvement or workarounds for Ukraine/Russia output. More clarity on the geopolitics could provide better stability in rates across the curve.

'Bull case' (recession/deflation, lower yields, higher prices). If the Fed hikes too much and too fast, it could push the economy into recession. Or, a recession could be in the cards regardless, due to slowing economic activity and the natural end of the quick post-Covid cycle. The rising probability of recession is what financial markets seem to be pricing in most recently, as such a scenario has happened many times before. Most directly, this can be seen in the treasury yield curve's steep positive slope from 3m to 2y, but flat to slight inversion from 2y to 30y. This implies the Fed raises rates to a certain point, but then stops somewhere around 3-4%, give or take—with long-term conditions and limited Fed balance sheet reductions putting a cap on further upward movement. Long-term bond yields are based on long-term conditions, such as expected inflation and secular GDP growth years from now. If recession becomes a base case, and inflation begins peaking, long-term bonds could actually fare well, in expectations for a reversal in Fed policy. (We've seen some limited examples of this in recent weeks.) A true recession and/or deflation could actually favor long-term bonds since rates could fall back, especially if Fed easing implied (even if hard to imagine now). Defaults would also be higher, so such a situation could reward higher-quality bonds less likely to have problems.

Long-term, rate levels will depend on the balance reached between long-term secular growth drivers, which continue to be held back by weak demographics (an aging population and far lower immigration, which decrease the size of the work force) and productivity trends that dampen inflation, including technology. From a national debt perspective, higher and rising interest rates create compounding challenges in servicing the already-large mountain of treasury debt. One might look at contained interest rates as being critical to the economy's fundamental condition, but also national security (these things are discussed in military circles). This is not only an issue in the U.S., but globally—with emerging markets, ironically, in the best shape fundamentally in terms of debt loads.

Back to today, the good thing about bonds (especially investment-grade bonds where default risk is minimal, so defaults will be disregarded for now), is that the $100 par price is the ultimate end point upon a bond's maturity. This is true regardless of price volatility based on changing yields that occurs over a bond's life. Transactions before maturity, of course, can end up being based on current market price, which can change the gain/loss math on both individual bonds and funds/ETFs. While simplistic, holding a bond long enough will return an investor's principal back. The eventual $100 par target of course limits upside, but also limits downside. This is in contrast to stocks where fundamental values are hinged to earnings, with unlimited upside but a downside of as low as zero, since they fall lower in the capital structure and feature less recourse and ability for asset recovery. This attribute is actually critical to the appeal of bonds as an investment and their place in a broader portfolio, but is easy to forget during times of poor short-term returns.

In short, holding to maturity can cancel out the 'noise' of price volatility. For a single bond, this is easy to view, but for a bond fund/ETF that holds a portfolio of bonds, this can be best thought of as tied to the portfolio's duration. For this reason, duration has been a good proxy for an investor's assumed holding period. The Bloomberg U.S. Aggregate currently has a duration of about 6.5 years, which implies an investor with that timeline or longer should be more insulated against near-term price volatility. Shorter-duration bond funds, such as the common 2-4 year area, have an even shorter period for price recovery, as do even shorter ultrashort funds and money market funds, etc.

The best predictor of future bond returns is the current yield, linked to the duration of the particular bond or fund. Now, short-term bonds offer yields just as high as those of long-term bonds, which is a positive attribute in a rising rate environment, but such situations don't continue forever. Short-term bonds 'reset' faster, which can be a plus or a minus. The trade-off (2022 aside) is that long bonds have often been better diversifiers from equity market drawdowns, so abandoning them entirely can backfire if conditions reverse quickly. Markets are constantly looking months or quarters in advance, so bond (and stock) markets will have reacted long before actual economic change occurs, so recent past performance is not a great gauge for future prospects.

Market Notes

Period ending 7/15/2022	1 Week (%)	YTD (%)
DJIA	-0.16	-12.97
S&P 500	-0.91	-18.27
NASDAQ	-1.57	-26.50
Russell 2000	-1.40	-21.76
MSCI-EAFE	-1.75	-20.81
MSCI-EM	-3.69	-20.54
Bloomberg U.S. Aggregate	0.89	-9.80

U.S. Treasury Yields	3 Mo.	2 Yr.	5 Yr.	10 Yr.	30 Yr.
12/31/2021	0.06	0.73	1.26	1.52	1.90
7/8/2022	1.98	3.12	3.13	3.09	3.27
7/15/2022	2.37	3.13	3.05	2.93	3.10

U.S. stocks fell back again last week, with a high inflation print and continued negative comments from corporate executives concerning the expected economic environment. Later in the week, stocks attempted a rally with stronger retail sales data as well as consumer inflation expectations that fell back from recent highs. By sector, declines in energy and communications of over -2% led the index downward, while defensive consumer staples, healthcare, and utilities were little changed on the positive side. Real estate fell back by roughly a half-percent.

Earnings season has begun for equities, with only a handful of companies having reported so far. But, it may become a two-pronged story based on which companies have or don't have pricing power (and able to pass inflation through to consumers). It started off disappointing for several banks, due to lower investment banking fees and an increase in loan loss reserves, taken in anticipation of slowing economic growth and higher defaults. Net profit margins have also fallen back year-over-year, with rising input cost pressures (unsurprisingly, 'inflation' was mentioned by over 80% of S&P 500 companies on recent earnings calls). Per FactSet, from a sector standpoint, earnings growth of over 250% is expected in the energy sector (although that sector represents only 3% of the index). Then, removing financials, which are affected by releases of reserves last year, the rest of the index is expected to see mixed earnings growth results.

We now appear to be in the second phase of bear market concerns. Phase one included the impact of rising rates on economic growth, which has traditionally been a headwind on risk assets generally. Much of this appears to have been priced in by now, based on historical tendencies, and is generally seen as an earnings multiple drawdown. Phase two is the prospect of an 'earnings recession', which includes a decline in company earnings that can accompany or precede a recession. There hasn't been much indication of the phase two part yet, but a drop in market expectations for earnings could be a sign. So far, earnings growth for Q2 and full year 2022 remains positive, at roughly 4% and 10%, respectively (per FactSet data). Growth estimates for full year 2022 and 2023 remain around 9-10% each. Of course, these are subject to potential change quickly. In a typical earnings recession, S&P earnings could decline by up -10% to -15%, so the current stats are much more optimistic, pointing to the 'earnings multiple' variety of slowdown, which has tended to be shallower and faster to recover, compared to the 'earnings recession' slowdown, which can be deeper and more drawn out. The forward 12-mo. P/E ratio has fallen to 15.8, which is right around the multi-decade historical average, but below the 10-year average of 17.0.

Foreign stocks underperformed domestic by a bit last week, held back by a stronger U.S. dollar. Developed markets fared better than emerging, which were pulled down by an -8% in China, tied to rising Covid cases and back-and-forth rhetoric with the U.S. In China, GDP grew by a meager 0.4% in Q2, well below expectations and the prior quarter. In addition to the extensive lockdowns this year, continued trouble in the real estate sector has dampened sentiment. On the positive side, the government has been quick to deploy stimulus to keep the machine in a positive direction, while careful to ensure funds aren't targeted to problematic and speculation-prone sectors, like real estate. Another worthwhile reminder is that equity markets and economic growth results operate on different timetables (equity troughs have tended to lead GDP growth troughs by 6-12 months historically, with equities rebounding as economic growth is still finding a bottom).

There has been talk this last week about the euro achieving 1:1 'parity' with the U.S. dollar, for the first time, since its creation in 2002. The weakness in the euro (-12% year-to-date) has been brought on by the obvious economic struggles on the continent and low relative interest rates compared to the U.S.—with a much more hawkish Federal Reserve. The same forces have been holding back the Japanese yen (down -17% ytd). Generally, when looked at in relative terms, a stronger economy and higher interest rates have tended to be bullish forces for a country's currency, and vice versa. Continued calls for an eventual dollar coming back to earth have yet to materialize.

U.S. bonds fared positively last week, as yields fell back significantly (by 0.10-0.20%). Treasuries and investment-grade corporates fared similarly, along with positive results from high yield and bank loans as well. The treasury yield curve, at least as measured by the 10y-2y, has again inverted—to its widest level in 20 years (by 0.20%). In fact, the 2-year to 30-year area of the curve has been remarkably flat overall for weeks as the inflation vs. recession battle rages. Foreign bonds were again hampered by a rising dollar, with returns in developed markets tempered, and emerging market bonds falling back.

Commodities saw declines in all sectors last week. The price of crude oil fell by -7% to just under $98/barrel, which offset a strong rise in natural gas prices. Diplomatic meetings between President Biden and Saudi Arabia are intended to ease tensions between the two nations and open the oil faucet. The oil market has become complicated in recent months, with sanctions on Russian oil now causing those barrels to trade at a substantial discount to the broader world price. Supply has been snapped up by China and India at these cheap prices, as well as Saudi Arabia, which is using this oil for internal consumption, while exporting its own internal production. This is another example of sanctions having unintended consequences, while 'price gouging' is the political story in the U.S. for higher energy prices.

Have a good week.

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Sources: FocusPoint Solutions, American Association for Individual Investors (AAII), Associated Press, Barclays Capital, Bloomberg, Citigroup, Deutsche Bank, FactSet, Financial Times, First Trust, Goldman Sachs, Invesco, JPMorgan Asset Management, Marketfield Asset Management, Morgan Stanley, MSCI, Morningstar, Northern Trust, PIMCO, Standard & Poor's, StockCharts.com, The Conference Board, Thomson Reuters, T. Rowe Price, U.S. Bureau of Economic Analysis, U.S. Federal Reserve, Wall Street Journal, The Washington Post. Index performance is shown as total return, which includes dividends. Performance for the MSCI-EAFE and MSCI-EM indexes is quoted in U.S. Dollar investor terms.

Notes key: (+) positive/encouraging development, (0) neutral/inconclusive/no net effect, (-) negative/discouraging development.