SlateStone WEALTH

Balancing Your Life Goals with Financial Results

Investment Review & Outlook

April 2022

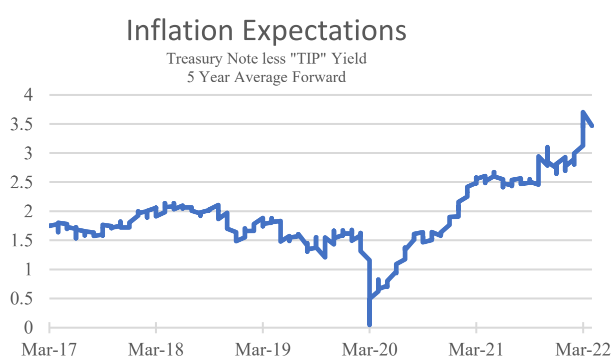
Review

Following a solid rebound in economic growth in the second half of 2021, the US and the global economy are expected to be materially weaker in the first quarter.

Real GDP						
	FY 2022	FY 2023	1Q:22	2Q:22	3Q:22	4Q:22
United States	3.3	2.3	0.5	3.3	3.5	2.5
Canada	3.8	2.8	3.5	3.5	3.5	3.0
Japan	1.7	1.8	-1.8	5.0	3.5	2.5
China	4.9	5.4	4.9	5.7	6.6	5.5
Euro Area	2.8	2.8	-0.3	2.3	3.0	2.8
United Kingdom	4.1	1.1	4.1	1.0	0.6	0.3

Source: JP Morgan, Global Data Watch, April 1, 2022

The two major domestic constraints on growth this year are inflation and waning fiscal stimulus. To some extent, historically high post-pandemic saving rates coupled with a robust labor market should help cushion the blow from higher prices at the grocery store and the gas pump. The end of outsized pandemic-related transfer payments in the form of stimulus checks, augmented unemployment benefits, forgivable loans to small businesses, and an expanded child tax credit will impede growth this year.



Source: Bloomberg, April 1, 2022

There are about 11 million job openings (1.8 jobs for every unemployed person) implying the labor market has more room to run. The increase in job growth means nominal labor income is expanding in excess of 10% per year. While average wage growth is below the rate of inflation, wages in lower-income industries are growing at a faster pace.

Global Markets

The Energy sector took the leading role in terms of price performance in the first quarter by a wide margin. The only other sector with positive numbers in the first quarter was the Utilities sector. Communication Services generated the weakest results, with Consumer Discretionary slightly less awful.

The Russian invasion of Ukraine has profound implications for global markets, only some of which can be ascertained at this point.

The US Dollar was strong against a basket of 10 major currencies during the first quarter 2022.

Equity Market Performance To 31-March-2022, in US Dollars

	1st Quarter 2022	12 Months 3/31/2022
MSCI World Index	-5.2%	10.1%
EMU	-11.1%	-3.6%
France	-8.7%	4.5%
Germany	-12.9%	-12.0%
Switzerland	-6.4%	13.9%
United Kingdom	1.8%	13.6%
Japan	-6.6%	-6.5%
Pacific, ex Japan	3.8%	3.8%
EAFE	-5.9%	1.2%
USA	-5.3	13.6%
Emerging Markets	-7.0%	-11.4%

Source: Morgan Stanley Capital International,
Total return, dividends less withholding tax reinvested

 Continued on page 2

Continued from page 1

Outlook

The biggest risks for the US economy come from abroad. Russia's war on Ukraine certainly undermines any confidence in the outlook for financial markets. If the war escalates it could lead to meaningfully higher interest rates, and sharp appreciation in the US Dollar. The main channel by which the war in Ukraine affects the US economy is through inflation and the Fed's response to it. In this adverse scenario, Consumer Price Inflation could reach 8.3% this year. Having signaled a more aggressive stance against inflation, the Fed would probably raise interest rates more quickly. We would expect the Fed to hike interest rates at every meeting for the rest of the year, with at least two bumps of 50 basis points.

Conversely, in the optimistic and perhaps unrealistic scenario where the war in Ukraine de-escalates and oil prices return to $80/barrel, we would look for the US economy to grow 3% in real terms with inflation at 5.5% for the year. In this scenario, the Fed would hike interest rates 25 Basis Points in each of the remaining 2022 meetings.

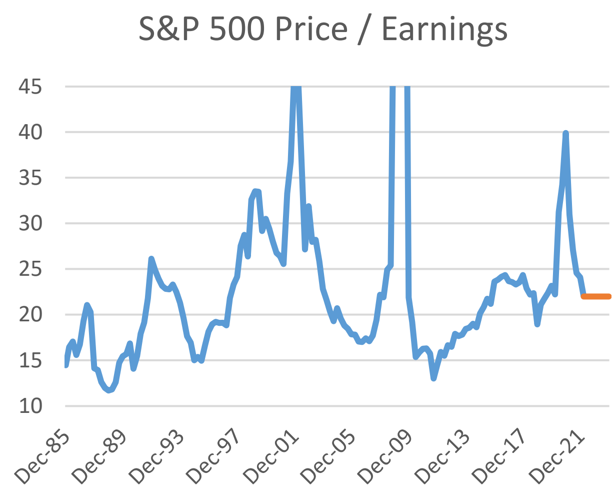
At the end of 2021 the nominal GDP growth rate stood at 10.6% more than 10% above the 0.08% Fed Funds rate. We expect the year-over-year nominal GDP run rate to be between 7% and 8% by the end of this year and decrease further to between 4% and 5% by late 2023.

The Federal Reserve hiked the funds rate by 25 basis points at its March meeting. The market is now pricing in a pair of 50 basis point hikes in April and June, followed by four quarter-point increases this year and another four in 2023. That would put the funds rate at 2.25% by the end of 2022, and 3.25% at the end of 2023. That is close to the current level of 5-year average inflation expectations at year-end 2023.

Standard & Poor's 500				
	Annual Earnings	%Change Y-o-Y	Price/ Earnings	Year-end Price
Dec-13	100.20	15.8%	18.5	1848.36
Dec-14	102.31	2.1%	20.1	2058.90
Dec-15	86.53	-15.4%	23.6	2043.94
Dec-16	94.55	9.3%	23.7	2238.83
Dec-17	109.88	16.2%	24.3	2673.61
Dec-18	132.39	20.5%	18.9	2506.85
Dec-19	139.47	5.3%	23.2	3230.78
Dec-20	94.13	-32.5%	39.9	3756.07
Dec-21	197.87	110.2%	24.1	4766.18
Dec-22e	207.77	6.0%	22.0	4616
Dec-23e	230.90	10.0%	22.0	5080

Source: Standardandpoors.com Mar 31,2022, Slatestone Wealth

Earnings growth was stellar last year, but it is not sustainable. As we work our way through the first quarter earnings reporting season, we would expect to see much more modest gains. S&P 500 consensus earnings growth is currently estimated at 6% for 2022 and 10% next year. But we cannot say we have a lot of confidence in those guesses given profit margin pressure related to wages, supply chain issues and energy prices.



Source: Standardandpoors.com Mar 31, 2022, Slatestone Wealth

Interest rates have moved up substantially in recent weeks. There is a rising threat of recession, albeit in the somewhat distant future. The immediate impact of rising interest rates can be seen in the falling Price / Earnings ratio for the S&P 500. Since both interest rates and the market P/E are mechanisms that discount future cash flows they are loosely correlated. Our best guess is that a market P/E of 22X earnings can be sustained over the visible horizon.

What if the rise in inflation persists beyond the next few quarters, leading to the dreaded "wage price spiral"? This is not our current thinking, but of course it could happen. It would not be attractive, but the Fed knows how to tame an inflationary spiral. They would drive interest rates higher sufficiently to cause a recession. Recent movement in the yield curve does not suggest that this is a meaningful risk. While shorter maturity yields have increased reflecting the end of "quantitative easing" long dated interest rates have been more restrained. This suggests that a "wage price spiral" is a diminishing risk, rather than an increasing one.

On the fixed-income side, our conservative approach to bond investments in the context of credit quality remains in place. The short end of the yield curve has moved up over the course of recent weeks. As Treasury Notes move up toward 3.0%, we will begin to extend our average maturity by reducing our exposure to cash equivalents. That assumes the 5-year average inflation rate tops out near the current estimate of 3.5%

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