MARKET COMMENTARY

Goldilocks and the Two Bearish Scenarios

May, 2022

- Equity markets remained volatile in May as a late-month rally erased losses, pushing most indexes to slight gains for the month.
- Energy prices continued to increase as supply constraints sent gasoline prices to new highs for the year.
- The path for markets and the broader economy will largely depend on the Fed's success in using tightened monetary policy to slow inflation.
- The three most likely economic scenarios for the coming year can be summarized as (1) a soft landing (Goldilocks), (2) a recession brought on by policy tightening, or (3) stagflation.

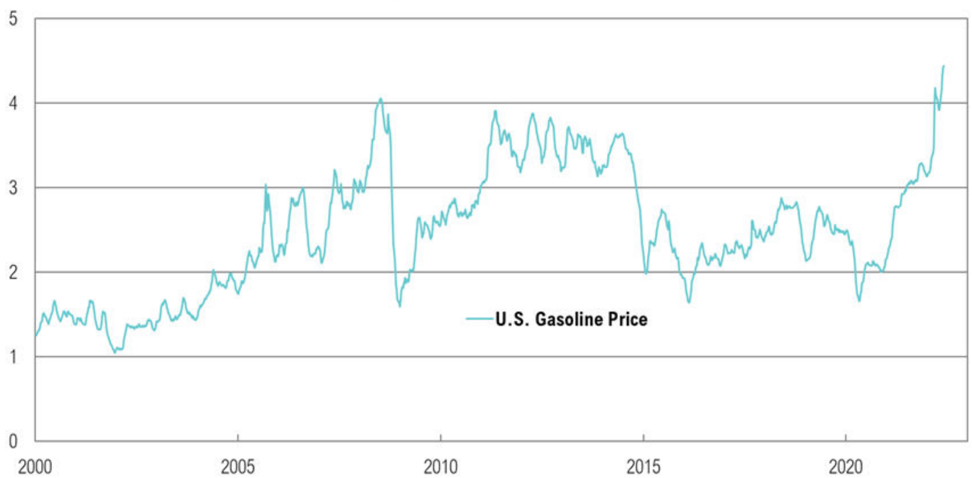
Markets

May might seem like a reprieve from 2022's notorious volatility; however, intra-month returns tell a more sensational story.

On the surface, May might seem like a reprieve from 2022's notorious volatility as the S&P 500 index slightly increased by 0.2%. However, intra-month returns tell a more sensational story. On May 20, the index was down over 5% for the month to date before rallying over the last week-and-a-half to recover its losses. From a style perspective, value stocks (+1.9%), as measured by the Russell 1000 Value Index, outperformed growth stocks (-1.9%), as measured by the Russell 1000 Growth Index. Energy stocks, which represent 8.4% of the value index compared to just 0.6% in the growth index,[1,2] were a major contributor to value's relative performance, finishing the month as the top-performing sector, up 16%.

Gas Prices Continue to Climb

U.S. Regular Conventional Gasoline Price ($), *As of 5/30/2022*



Source: U.S. Energy Information Administration

The price of WTI Crude oil is now $115 per barrel, its highest level since March.

The price of West Texas Intermediate (WTI) crude oil is now $115 per barrel, its highest level since March. Despite higher prices, oil producers remain hesitant to ramp up supply. Rig counts are still 16% lower than in February 2020 when crude was trading around $60 per barrel.[3]

Year-to-date, the average U.S. regular conventional gas price is up 41% and currently sits at $4.40 a gallon, surpassing the previous high set back in July 2008 at $4.05 a gallon.

U.S. crude oil inventories excluding the U.S. Special Petroleum Reserve are at just 414 million barrels per week, down from 480 million a year ago.[4] With the U.S. banning imports of Russian oil and natural gas back in March[5] and OPEC unwilling to meaningfully increase production this year so far,[6] U.S. producers will likely need to significantly ramp up production to curb further price increases. Year-to-date, the average U.S. regular conventional gas price is up 41% and currently sits at $4.40 a gallon, surpassing the previous high set back in July 2008 at $4.05 a gallon.[7]

In May, stocks outside of the U.S. outperformed their U.S. counterparts. Foreign developed and emerging market equity returns, as measured by the MSCI EAFE and Emerging Market Indexes, rose 0.9% and 0.5% in U.S. dollar terms. A contributing factor was the weakening of the U.S. dollar over the month as the U.S. Dollar Index fell 1.2%. U.S. REITs were the worst-performing asset class in May, falling 6.2%, as 30-year fixed mortgage rates remained above 5%. Rising interest rates can serve to cool real estate markets since they reduce mortgage affordability and—eventually—property values.

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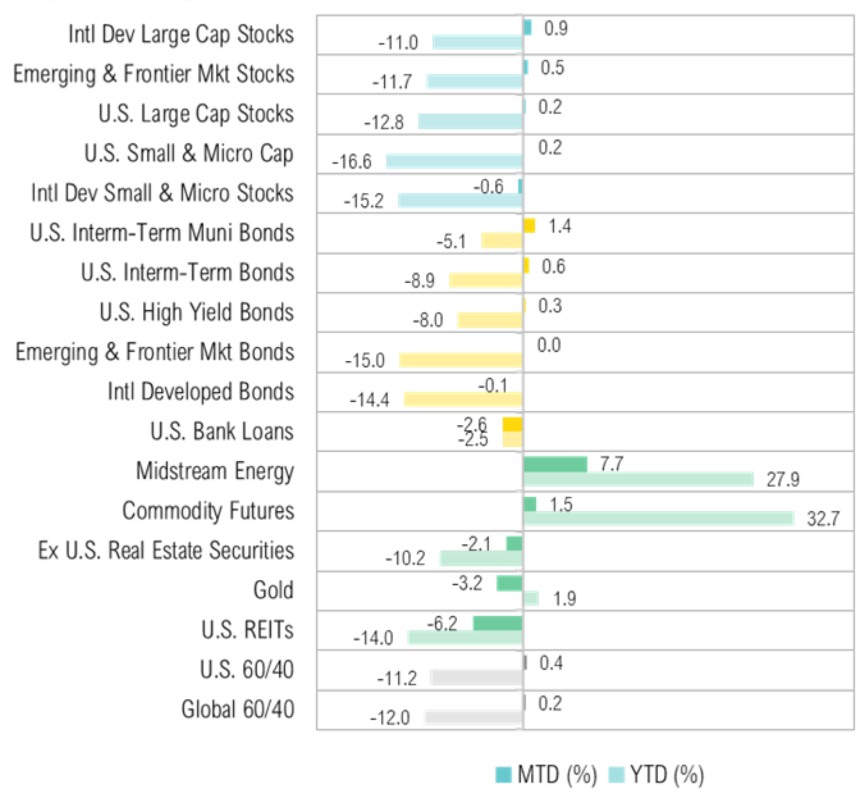
Within fixed income, the Bloomberg U.S. Aggregate Bond Index rose 0.6%, ending its streak of five straight months of negative returns. The 10-year Treasury yield hit 3% in May for the first time since December 2018, which coincidentally was the end of the last Federal Reserve hiking cycle. High-yield bonds slightly lagged behind higher quality bonds, rising just 0.3%. Finally, bank loans were the worst performing fixed income asset class, returning -2.6%. U.S. loan funds posted their largest weekly outflow since the onset of the pandemic, losing $1.56 billion for the week ended May 18, as investors started to worry about deteriorating loan fundamentals.[8]

May 2022 Key Market Total Returns



Source: Bloomberg

In stark contrast to its accommodative policy stance for most of the past fourteen years, the Fed wants to slow demand to cool off inflation and is willing to sacrifice today's low unemployment rate to do it.

Economic Scenarios

The Federal Reserve is charged with an excruciatingly difficult task – slow down the economy to cool inflation. Federal Reserve Chairman Jerome Powell hinted at this fragile dynamic in a recent interview in May with the *Wall Street Journal*:

> *"It's challenging because unemployment is very low already and because inflation is very high. But I will just say there are pathways for us to be able to moderate demand, get demand and supply back in alignment, and get inflation back down while also having a strong labor market. Doesn't mean that the unemployment rate needs to remain 3.6%, which is a very, very low rate…You'd still have quite a strong labor market if unemployment were to move up a few ticks."*[9]

In stark contrast to its accommodative policy stance for most of the past fourteen years, the Fed wants to slow demand to cool off inflation and is willing to sacrifice today's low unemployment rate to do it. Based on what the Fed does and how the economy responds, three scenarios seem possible – (1) a soft landing (Goldilocks), (2) a recession brought on by policy tightening, or (3) stagflation. The first scenario would be more constructive (bullish) for risky assets, whereas the last two scenarios would be more challenging—or bearish—at least in the short term.

Red Hot Labor Market
Total Non-Farm Job Openings, *As of 4/30/2022*

Source: U.S. Bureau of Labor Statistics

Goldilocks

The ideal outcome for markets is a soft landing or what we call the "Goldilocks" outcome. In this scenario, the Federal Reserve's monetary tightening slows the economy just enough to cool inflation, but it avoids a recession, ultimately prolonging the current economic recovery. This scenario would be generally good for asset prices and probably resume stocks' bull market trajectory.

In the "Goldilocks" scenario, the Federal Reserve's monetary tightening slows the economy just enough to cool inflation, but it avoids a recession.

Despite a steady stream of negative headlines, this possibility should not be dismissed. Many of the factors contributing to the Fed's inflation headache – supply chain disruptions, China's zero-COVID policy and resulting lockdowns, and the Russian/Ukraine conflict – could provide significant pain relief if they shift. Of course, these events are out of the Fed's control, but if any are resolved, it would ease inflation and reduce the amount of policy tightening needed. With such a strong labor market, the Fed may have some cover to reduce demand without tipping the economy into recession. The unemployment rate sits at 3.6%, which other than pre-pandemic, was last experienced during the 1970s.[10] Further, there are 11.4 million job openings.[11]

Recession

In this scenario, aggressive tightening by the Fed could push the economy into recession sooner than expected, and the resulting decline in demand could change the broader economic outlook. While painful in the short term, the recession could set the stage for a more healthy and sustainable recovery than the stimulus-driven bounce experienced after the pandemic.

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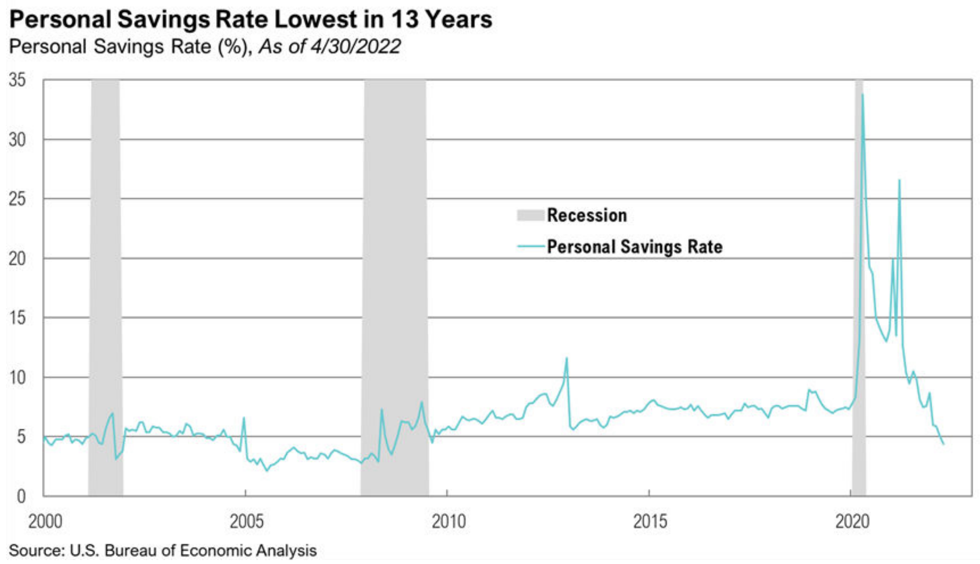
Working against the Fed is the need to unwind the unprecedented monetary stimulus provided over the past fourteen years, including holding interest rates at 0% for many years and amassing a balance sheet that once held nearly $9 trillion worth of bonds.[12] This level of stimulus served as enormous tailwinds for asset prices, and reversing these policies will have the opposite effect. So far, the Fed has only hiked interest rates by 75 basis points and is expected to hike another 50 basis points in each of the next two FOMC meetings in June and July. In addition, the Fed intends to decrease its balance sheet holdings by $47.5 billion per month starting in June, eventually increasing the amount to $95 billion per month in September.[13]

Although the National Bureau of Economic Research (NBER) officially decides when a recession has begun, informally, a recession is characterized by two consecutive quarters of negative real GDP growth.[14] In the first quarter, the U.S. economy produced annualized GDP growth of -1.5%, meaning that if the second quarter is also negative, it could imply a recession – the second in just over two years. Regardless of labels, the U.S. economy is clearly slowing. In the current economic recovery starting in July 2020, real GDP growth has averaged an annualized 9.3%, including a robust 5.5% in 2021.15 GDP is made up of four components—consumption, investment, government spending, and net trade—of which consumption carries the most weight.[15] In the U.S. Bureau of Economic Analysis' first quarter 2021 report, consumption grew at an impressive 3.1%, investment was essentially flat at 0.5%, government spending fell 2.7%, and net trade was -23.7%. The -23.7% net trade contraction contributed -3.23% to the headline real GDP number, dragging down respectable consumption growth. Some economists believe the extreme net trade number is a false signal for things to come. According to Ian Shepherdson, Chief Economist at Pantheon Macroeconomics:

> "This is noise, not signal. The economy is not falling into recession. Net trade has been hammered by a surge in imports, especially of consumer goods, as wholesalers and retailers have sought to rebuild inventory. This cannot persist much longer, and imports in due course will drop outright, and net trade will boost GDP growth in Q2 and/or Q3."[16]

Given consumption makes up roughly two-thirds of GDP and is seemingly its strongest component, it also poses the biggest risk to economic strength.

The Atlanta Fed's GDPNow, which provides a forecast of the official GDP estimate before its release, currently projects second-quarter real GDP growth at an annualized 0.9%, fueled by strong consumption growth of 2.5%.[17] Given consumption makes up roughly two-thirds of GDP and is seemingly its strongest component, it also poses the biggest risk to economic strength.



Stagflation

While the U.S. consumer should not be underestimated, if inflation continues at its current blistering pace, consumers will not be able to sustain enough spending to drive any meaningful economic growth.

Inflation has outpaced wage growth for over a year now, and the most recent U.S. real wage growth rate, released at the end of April, was -3.7% on a year-over-year basis.[18] This is no doubt causing some stress to once-strong consumer balance sheets, and cracks are starting to show. Revolving consumer credit is back up near all-time highs again after collapsing 12% in February 2020 due to pandemic stimulus.[19] At the end of April, the personal savings rate fell to 4.4%, its lowest level since August 2008, a period when the economy was in a recession.[20] While the U.S. consumer should not be underestimated, if inflation continues at its current blistering pace, consumers will not be able to sustain enough spending to drive any meaningful economic growth.

If stagflation is more specifically defined as periods with inflation above 5%, real GDP growth less than 2% per year, and unemployment above 6%, there have been 41 months (less than 5% of the time) since 1947 that have fit these criteria.

Stagflation is defined by slow economic growth and relatively high unemployment—or economic stagnation—and accompanied by rising prices (i.e., inflation).[21] An important component of stagflation is the unemployment rate. Typically, the unemployment rate is inversely related to inflation. When the economy is expanding rapidly, prices rise, and the unemployment rate falls. In a stagflation regime, the opposite happens, usually when the money supply is expanding while supply is being constrained by some exogenous shock. The 1970s and early 1980s are textbook examples of this phenomenon. During these two decades, inflation averaged 6.3%, real Gross Domestic Product ("GDP") growth averaged 3.2% per year, and the unemployment rate averaged 6.7%. In this case, the exogenous shock was the 1973 Organization of the Petroleum Exporting Countries (OPEC) oil embargo against western nations during the Arab-Israeli war. OPEC restricted supply in retaliation for the U.S. decision to re-supply the Israeli military and to gain leverage in post-war peace negotiations.[22] This caused upward pressure on oil prices, and oil rose from $25/barrel in 1972 to a peak of $140/barrel in 1980.[23] Today has some striking parallels. Oil futures traded in negative territory in April 2020 as a result of COVID -19 lockdowns. Over the next two years, the price of a barrel of WTI crude oil rose to over $115 per barrel, exacerbated by a new wartime embargo, this time imposed by Western nations to restrict the demand for Russian oil in retaliation for the Russian invasion of Ukraine.[24]

If stagflation is more specifically defined as periods with inflation above 5%, real GDP growth less than 2% per year, and unemployment above 6%, there have been 41 months (less than 5% of the time) since 1947 that have fit these criteria. Most of these months (85%) happened from 1973 to 1982, and 68% occurred when the economy was in recession. Today, inflation is at 8.2%, and first-quarter 2022 real GDP growth was -1.5% (annualized), both well within the defined boundaries of stagflation. While the May unemployment rate was still low at 3.6%, this measure usually lags behind current economic conditions. An earnings slowdown could result in hiring freezes and layoffs and subsequently slow down a currently red-hot U.S. labor market relatively quickly.

Looking Forward

The future is uncertain, and the three scenarios presented may not be mutually exclusive. Regardless of the unknowns, we do believe that incoming inflation data and the Fed's response over the next few months remain crucial to determining where the economy—and markets—are headed.

Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

Citations

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DEFINITIONS

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Intermediate-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Intermediate-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

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