



BANK OF MILLBROOK TRUST AND INVESTMENT SERVICES

REVIEW AND OUTLOOK

PUBLICATION 57

JULY 2022

I like the dreams of the future better than the history of the past.

-Thomas Jefferson

The first half of 2022 has been a mix of wild swings in all financial markets. In January, we were considering the year would bring challenges to the economy, as inflation was already rising. Two years into the COVID pandemic, the economy has still been digesting the large amounts of monetary stimulus injected to keep households and businesses afloat during shut-downs. Much has changed since January. In the past 28 months we have experienced a vast amount of significant economic, political, and global events.

The war in Europe has rattled an already fragile recovery. The markets, from all sides, have been uncertain in their response. Portfolios are structured to have diversity so that when some holdings go down, others will hold steady to protect the portfolio from downside risk. So far this year we have seen negative returns across the board.

Ray Dalio, the founder of Bridgewater Associates, points out “there are two main drivers of asset class returns – inflation and growth”. We have seen steady growth over the past 13 years. Now we are navigating inflation, which is at a four-decade high. The damage to households’ wallets and our portfolios is being felt acutely. It is important to remember that the economy is a series of cycles. Our portfolios enjoyed the growth cycle, and we are now dealing with the inflation cycle, which is a byproduct of an overheating economy. The growth will return, we just will have to be patient. *(continued)*

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So where do we go from here? While the June inflation (CPI) came in at 9.1% we are also seeing some key signs that inflation may have peaked. Oil prices seem to have peaked, and natural gas, metals and lumber have all seen declines.

Currently there is much concern about the possibility of a recession. Since 1945, there have been nine instances of inflation spiking above 5%. Every single one of those spikes were followed by a recession. It makes sense that the economy will dip into a recessionary period to stop the spiking of prices. A recession will slow the economy down and cool inflation.

We have heard the expected recession to be “mild, but messy”. 2022 has given us plenty of messy, so we hope a mild recession is the result. The job market is tight, still with a large demand for labor. Corporate earnings for the 2nd quarter have been coming in at expectations. Savings rates for individuals and corporate balance sheets started the year in a strong position, which is good news. If or when we go into a recession, it would be with a relatively healthy economy.

We hope that the summer months have been good to you.

With best wishes,

Meredith

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ECONOMIC OUTLOOK

Summary

So far, the labor market has remained steady in the face of the most aggressive Fed-tightening cycle in decades. However, we are beginning to see cracks in other areas of the economy. For example, the final revision to first-quarter GDP included a drop in consumer consumption from 3.1% to 1.8%. Additionally, April consumer spending was recently revised lower by 0.3% and May had estimates of 0.4% spending growth, while the actual number came in at half as much.

The reduction in spending aligns with the trend in the University of Michigan index of consumer sentiment, which has been dropping rapidly and is currently at an all-time low. This indicates that the consumer is no longer as “strong” as they recently seemed. The savings rate has dropped precipitously throughout the year, but the most recent data showed the first increase, although small, in about seven months. This might be evidence that the consumer is no longer willing to dip into savings to keep up with inflation and the demand destruction desired by the Fed might be starting.

However, on the business side of the economy, investment continues. Capital goods orders and shipments both exceeded expectations, the latter of which is more notable. Shipments increased by 0.8% month-over-month, and since items are often paid for once shipped, this data point often works its way into the GDP calculation. With a negative GDP print already in the books for the first quarter, this gives hope that business investment could provide enough second-quarter growth to prevent a “technical” recession. Additionally, the gap between orders and shipments seems to be narrowing, indicating that supply chain issues may finally be improving.

The Fed’s members are committed to taming inflation. They fully understand that their actions could cause a recession, but they also understand the hardships for most caused by the current level of inflation in the economy. While there are indications that we may soon see improvement, such as earnings calls from retailers during the quarter mentioning excess inventories (Target Corporation, Walmart, Inc., etc.), at this point, we have yet to see a meaningful decline in inflation.

Positives

ISM manufacturing and services remain in expansionary territory

PCE inflation (while still high) was below expectations for the first time in eight months

Fewer people are receiving unemployment benefits than in the years prior to the pandemic

Negatives

First-quarter GDP was revised lower for a second time (-1.6%)

Retail sales missed expectations (-0.3% vs 0.1% est.)

University of Michigan consumer confidence hit an all-time low (50.0)



EQUITY OUTLOOK

Summary

Stock market woes continued in June with the S&P 500 finishing down 8.3% for the month. That capped off a second-consecutive quarter in the red and the worst opening half of a year since 1970. Domestic equity returns were relatively comparable by style and size. The Russell 1000 Growth and Russell 1000 Value Indexes declined 7.9% and 8.7% respectively. The Russell mid-cap index fell 10.0% while the small-cap Russell 2000 index lost 8.2%.

While there have been many factors that have contributed to the stock market's poor performance to begin the year, perhaps none have been more meaningful than the fear of elevated inflation and all of the complications associated with inflation. In recent weeks, those fears seem to have refocused on slowing economic growth, which is the exact expected outcome from the Federal Reserve's hawkish policy to combat inflation.

Generally speaking, earnings drive the market. The decline in stocks, to date, has primarily resulted in a contraction of valuation or the multiple, relative to earnings, that investors are willing to pay for stocks. Corporate earnings and expectations for earnings moving forward have generally remained steadfast. With economic growth now in question, the focus will likely be on the resilience and outlook for future earnings in a slower growth environment.

Earnings reporting season for the second-quarter kicks into high gear in mid-July and much attention should, be paid to those reports. Expect market volatility to continue as investors sift through the results. Investors will be looking for signals of easing supply chains, cost and wage pressures. If management can deliver with little demand destruction and solid earning guidance, stocks may be poised to rally. Anything less and we could be set for a long, uncomfortable summer.

Positives

Peak inflation/supply chains

Equity valuations historically cheap

Negatives

Consumer sentiment

Slowing economic growth

Unknowns

Fed potential to overtighten



FIXED INCOME OUTLOOK

Summary

Following May's modest decline in yields, and positive return for bond investors, yields resumed their upward trend in June reaching new multi-year highs. Yields pressed higher early in the month but then surged after the release of the latest Consumer Price Index (CPI) data on June 10. The higher than expected inflation report led investors and strategists to forecast even more aggressive Fed action. Even though Fed Chairman Powell had previously dismissed the idea of a 75 basis point (bp) rate hike, the Federal Reserve's Open Market Committee (FOMC) was forced to show they are serious about fighting inflation and did make the bold step of increasing the overnight rate by 75 bps at their June 15 meeting. This was the first rate increase of that amount in nearly 28 years. During the subsequent press conference, Chairman Powell indicated that additional increases can be expected until there is clear evidence that inflation is abating.

We have long believed that yields out of the curve should represent the future path of the overnight rate set by the Fed. This logic stands true, but with inflation continuing to surprise, even the Fed is having trouble figuring out the path of their next move. The futures market for the Fed funds rate had implied that there would be another 75 bp hike in July, followed by a 50 bp hike in September and then 25 bps at the remaining meetings this year. Though more recently, recession fears have gained the market's attention, casting inflation to the side as the primary driver for the path of the overnight rate. Even still, for the month, yields moved up across the curve with the 2-year Treasury note ending June 40 bps higher at 2.96% and the 10-year note 17 bps higher at 3.02%. After the reprieve from negative returns in May, like every other month this year, June returns were negative for bond investors with the Bloomberg Intermediate Index returning -1.11%. At this point, the fear of a Fed induced recession is the only thing capping the outlook for Fed rate increases and higher yields across the curve.

Bonds have certainly become more attractive for both income and diversification as their ability to offset equity volatility has

improved. However, as the Fed keeps aggressively raising rates, there are increasing odds that they will fail to engineer a "soft landing" and that a recession will ensue. A recession will ease inflation, lower the outlook for the overnight rate and longer maturity yields will slide lower. Credit spreads have increased and corporate bonds have performed poorly in advance of this happening. Historically, longer-term yields tended to peak sometime before the third rate hike as the market prices in increases in the overnight rate, some of which never occur. If that stands true in this instance, we may have seen the peak at 3.48% on the 10-year Treasury note.

Positives

Long-run inflation expectations have actually declined

Demand for safety investments should increase as global economic uncertainties rise

Bonds now offer an attractive yield component and increasing diversification benefits

Negatives

The Fed will be reducing their balance sheet run-off in a few months

Yields sliced through technical support levels

Inflationary pressures will persist due to Russia's invasion of Ukraine

Unknowns

Russia/Ukraine war