

Economic & Financial Outlook

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July 6, 2022

	<u>S&P 500</u>	<u>10-year rate</u>	<u>Oil</u>	<u>Gold</u>	<u>Bitcoin</u>	<u>ETH</u>
Fundamental value:	3100	5.5	\$72	\$1,150	NA	NA
Actual price:	3831	2.8	\$101	\$1,770	\$20,200	\$1,100

Recent Supreme Court decisions have clarified the rule of law by placing series restraints on government power. Since the rule of law is paramount as a policy prescription for prosperity, these rulings are good news.

The most important of the rulings places limits on the Environmental Protection Agency (EPA). The Agency's rulings had involved restrictions on critical parts of the economy, such as the mandates which closed coal plants. The Court ruled such requirements must be explicitly authorized by Congress, instead of from unelected bureaucrats. The damage done by EPA rulings which shut down coal plants has been significant. Unless Congress decides otherwise, clean-burning coal plants will be able to contribute to US energy production and aid an ailing national power grid.

Placing authority directly with the people's representatives was the original intent of the Constitution. The Court's ruling can help reduce the extensive regulations and mandates that have recently slowed the nation's productivity and weakened the economy.

Other rulings placed more responsibility in the hands of state legislatures and clarified the power of executive orders. Strengthening the rule of law can have a positive impact on the economy in the years ahead.

As for the economy, the most anticipated recession in history has begun. So far, the recession has been so mild, few would know it's here were it not for the decline in stock prices.

As yet, there is no indication of any restraint from the Fed in terms of the amount of money entering the economy. However, the Fed's determination to shock the economy into a downturn appears to be working. Sharp increases in short-term interest rates, along with promises of additional hikes, have caught the attention of businesses.

The latest business surveys show the economy was flat to down in June. New orders also are declining. With federal regulations bringing productivity to a halt, the economy has entered a period of no growth at best and a steep downturn at worst.

Businesses have responded to promises of monetary restraint by laying off workers and cutting new orders. As the economy suffers, the initial reaction in the fixed-income market has been a decline in inflationary expectations and lower longer-term interest rates.

If the Fed is able to restrain spending with tough talk about higher interest rates and restraint, the end result will take pressure off inflation. In response to the developing weakness in the economy, our forecast has slowed the pace of future spending.

If the Fed follows through on its efforts to restrain spending, without overdoing restraint, there is a chance of avoiding a severe downturn. However, without significant relief from government spending and regulations, it will be difficult to improve productivity and reignite the economy.

Monetary Indicators

Having completely missed the magnitude of the current surge in inflation, the Fed is insisting it will now do whatever is necessary to contain it.

The Fed's first move was to raise the fed funds rate to 0.33% in April, then to 0.83% in May. They added $\frac{3}{4}\%$ at its mid-June meeting and indicated adding another $\frac{3}{4}\%$ at its meeting in late July.

Most commentators associate higher interest rates with monetary restraint. However, monetary restraint usually happens when the Fed sells securities. Selling securities not only reduces the money supply, it also lowers security prices, which raises interest rates naturally.

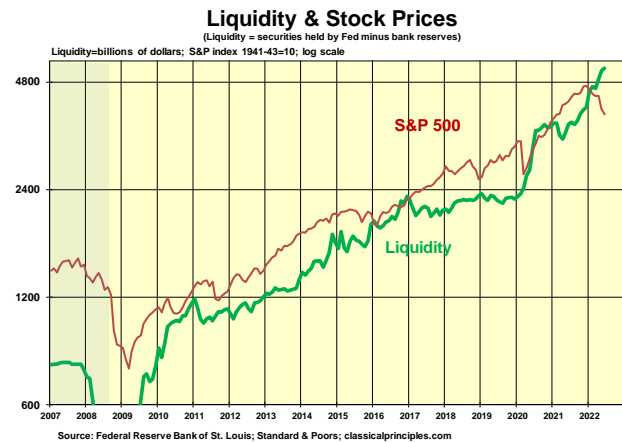
Traditionally, shifting from an expansive to a restrictive policy was fairly simple. The Fed would sell securities and drain money from the economy while the higher interest rates would help restrain spending.

Current Fed policy is different. The Fed sets targets for interest rate and purchases or sales of securities independently. Since the two targets are not directly related, the net effect on monetary policy is confusion.



In June, the Fed increased interest rates by $\frac{3}{4}$ of a percentage point and there was an increase in money. The increase occurred

because banks shifted \$93 billion from their deposits at the Fed into the economy.



Can higher interest rates restrain spending even if money continues to flow into the economy? Since the Fed's monetary experiments are unprecedented, we can't be certain.

The best we can do is track the shape of the yield curve (See charts on the following page) and various monetary aggregates to see if a clear pattern develops.

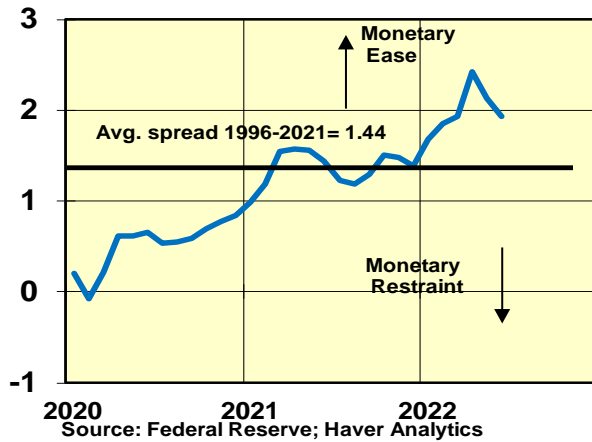
The yield curves on the following page point to a highly expansive policy over the next two years and a slightly less expansive policy over the next ten years.

Traditionally, the raw ingredients of money should dominate. However, if the Fed follows through on its intent to drive interest rates artificially high enough to slow the economy, they will eventually succeed.

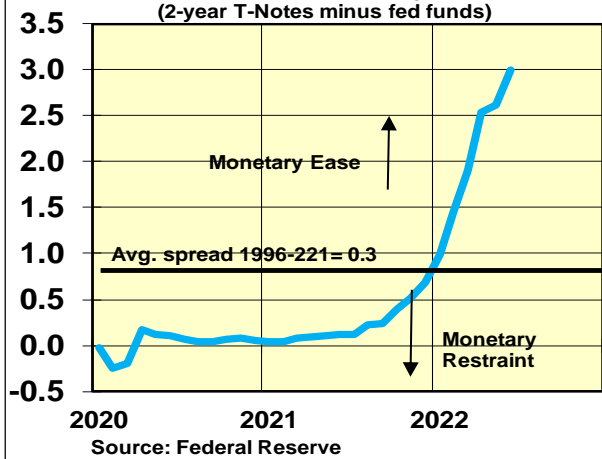
For now, the forecast assumes businesses will adjust their plans by limiting new orders and new hiring. The result is assumed to be a slowdown in the pace of spending from the double-digit rates of 2021.

MONETARY INDICATORS

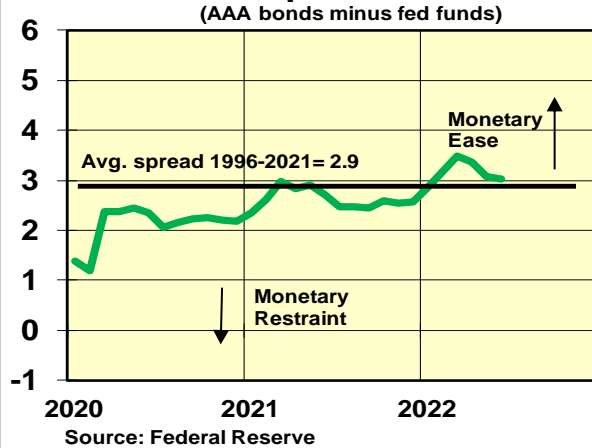
Yield Spread: 10-yr-FF



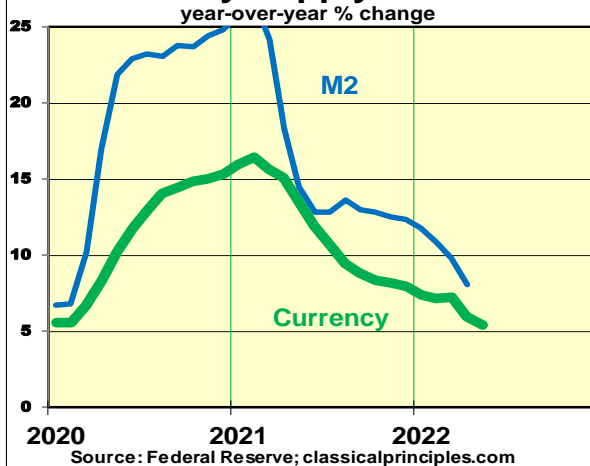
Yield Spread: 2yr-FF



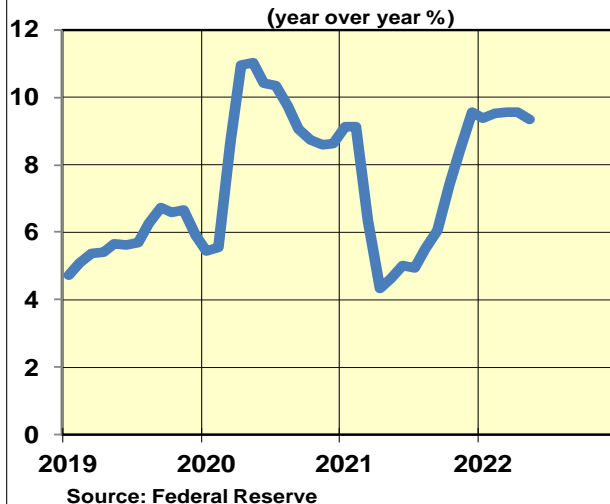
Yield Spread: AAA-FF



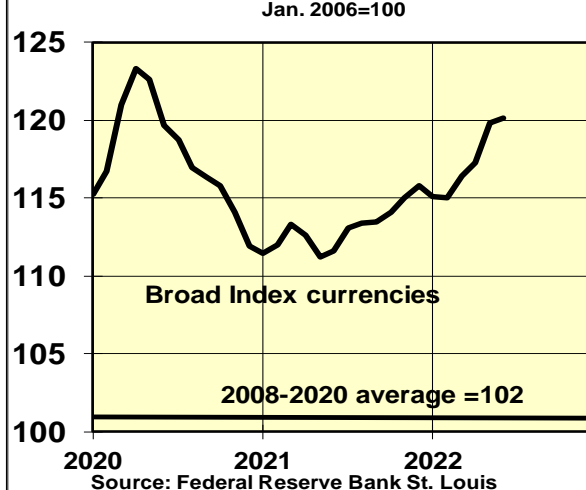
Money Supply Measures



Bank Loans & Investments



U.S. Dollar Index



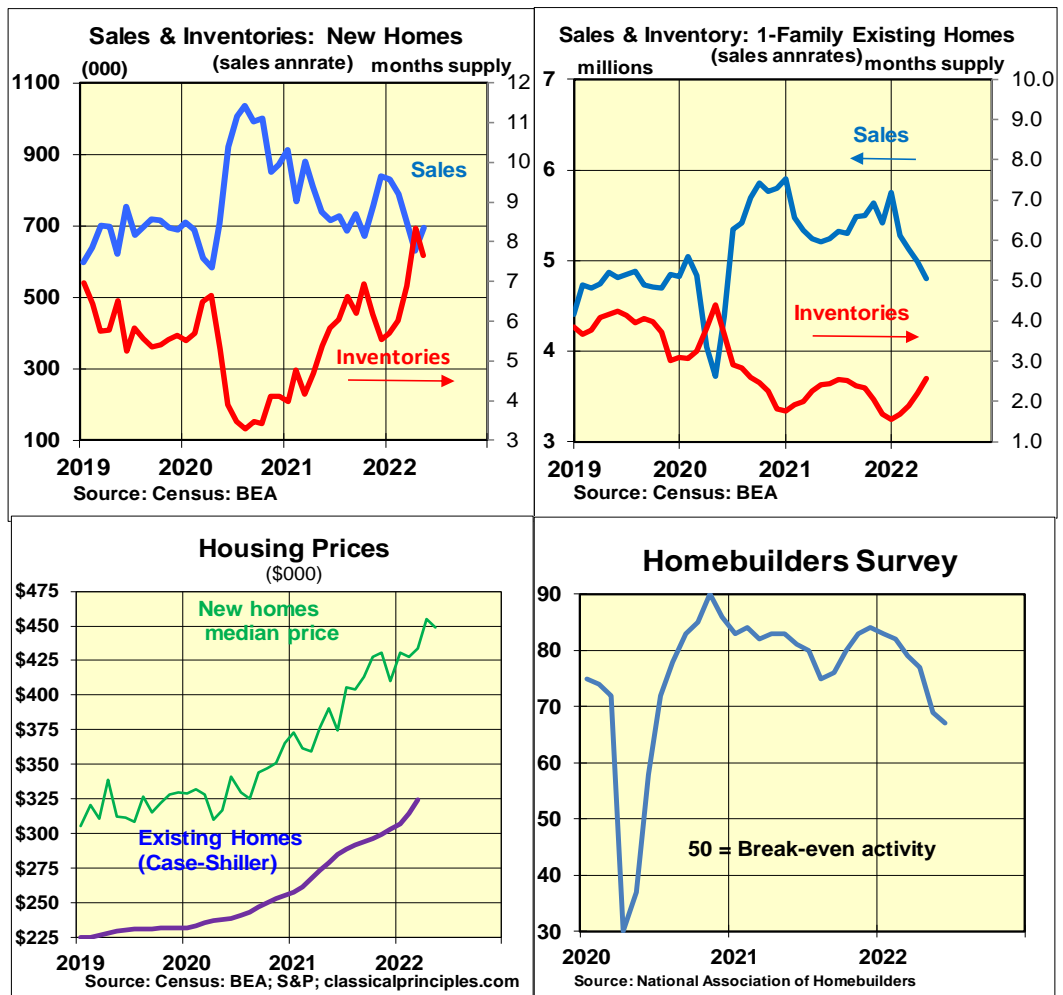
Sensitive Indicators

Sensitive short-term indicators have turned negative. Two of the most reliable—stocks and housing—already have pointed to a downturn. In June, a decline in commodity prices, a negative reading for manufacturing new orders and a persistent increase in initial unemployment claims all point to an emerging downturn.

Higher mortgage rates and soaring home prices led to a sharp decline in existing home sales

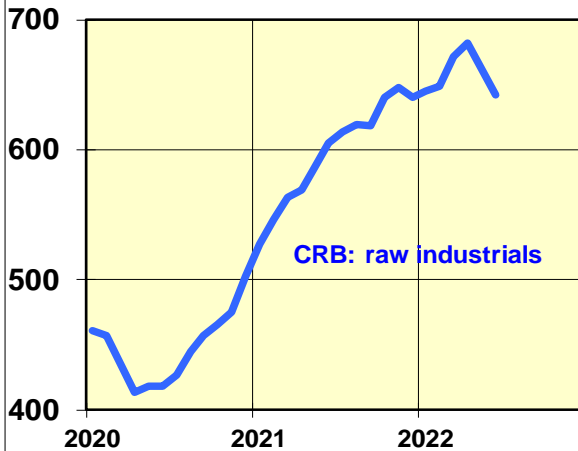
through May. Although new home sales rebounded in May, a sharp increase in inventories of new homes suggests the downward trend in sales will continue.

Coincident indicators are leveling off. Job growth is the only coincident indicator with an upward trend through May. High inflation rates have reduced real growth with little, if any, increase in June.



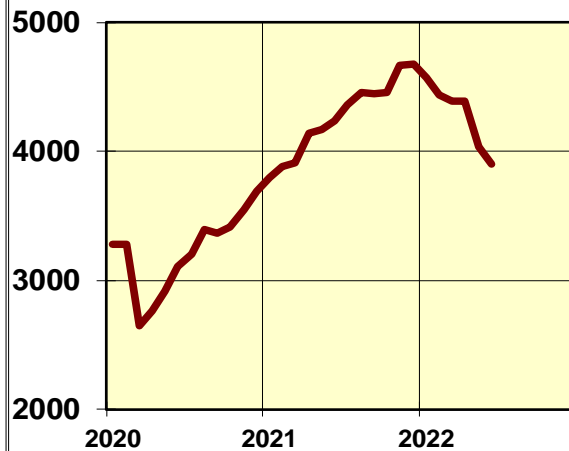
SENSITIVE INDICATORS

Commodity Prices



Source: Haver Analytics

S&P500



Source: S&P-Dow-Jones

Housing Starts

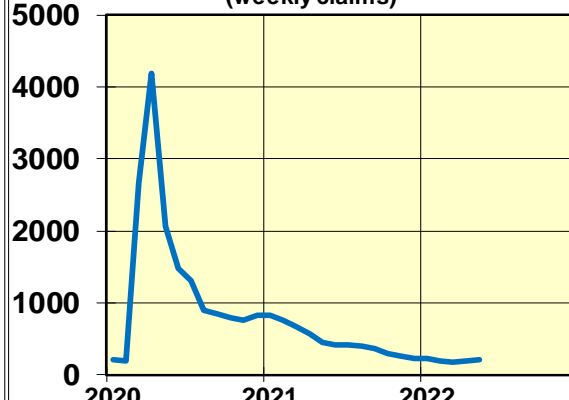
(millions per year)



Source: Census: BEA

Unemployment Claims

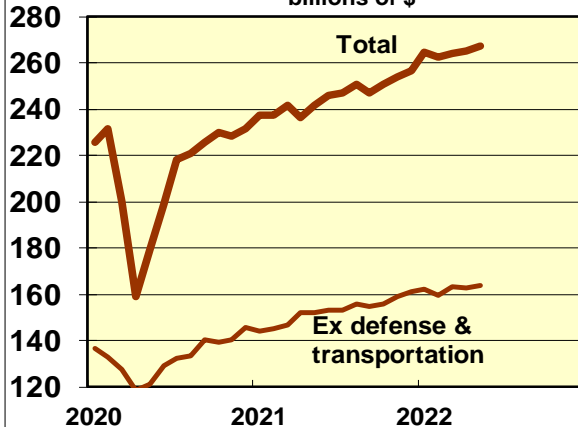
(weekly claims)



Source: BLS

New Orders Durable Goods

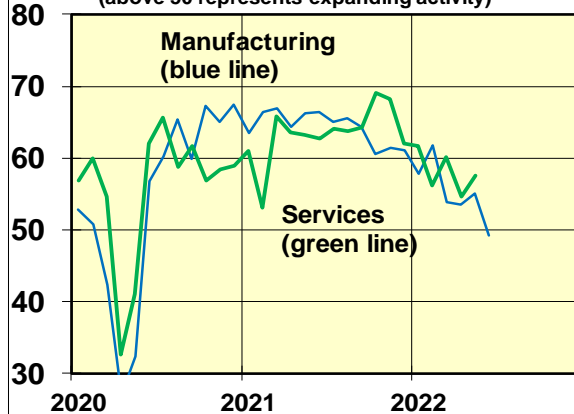
billions of \$



Source: Census: BEA

ISM: New Orders

(above 50 represents expanding activity)

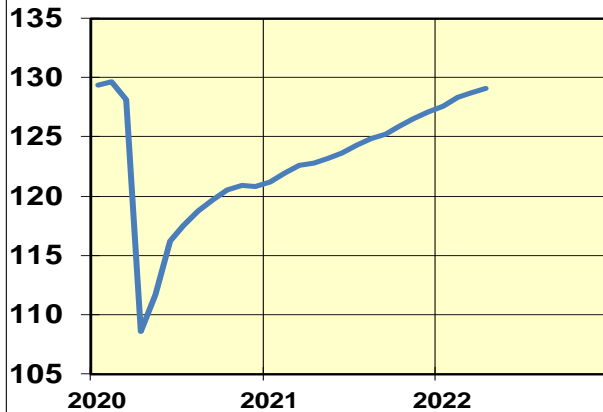


Source: Institute Supply Mgmt.

ECONOMIC INDICATORS

Jobs: Private Payrolls

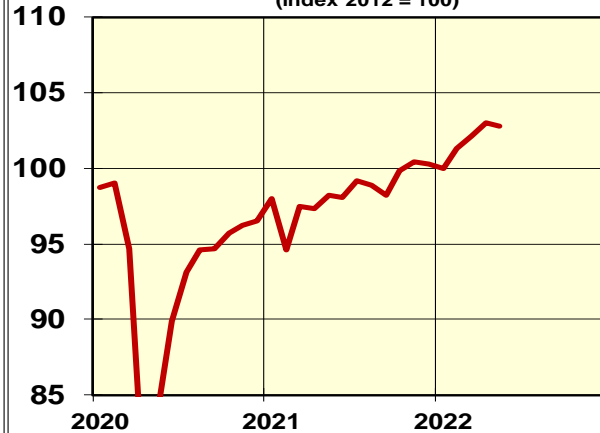
(000 of workers)



Source: Bureau of Labor Statistics

Manufacturing Production

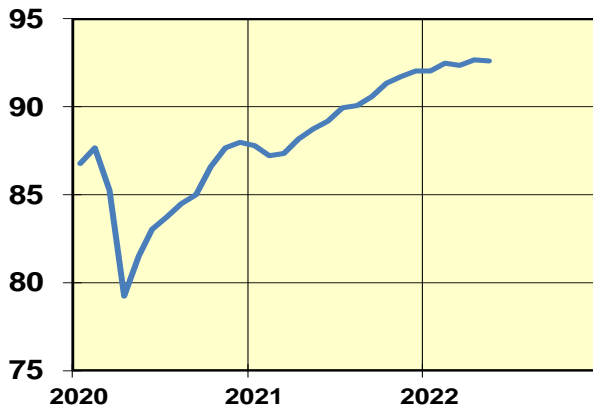
(index 2012 = 100)



Source: Bureau of Labor Statistics

Real Wages & Salaries

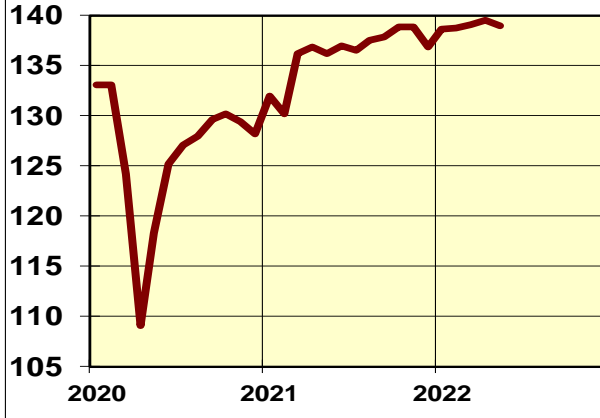
(billions of 2012 dollars)



Source: Census, BEA

Real Consumer Spending

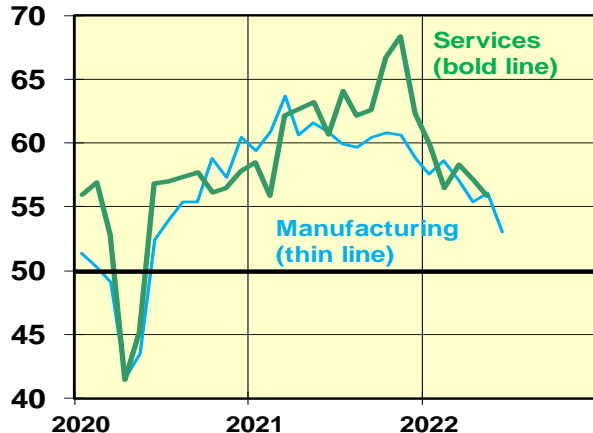
(billions of 2012 dollars)



Source: Census, BEA

ISM: Composite

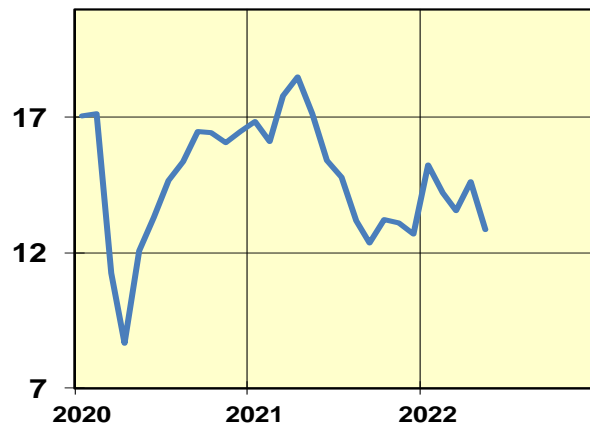
(over 50 represents expanding activity)



Source: ISM

Vehicle Sales

(cars and light trucks, millions, saar)



Source: Haver Analytics

Inflation Indicators

Inflationary pressures show signs of easing as demand in the economy slows. Most sensitive commodity prices declined recently.

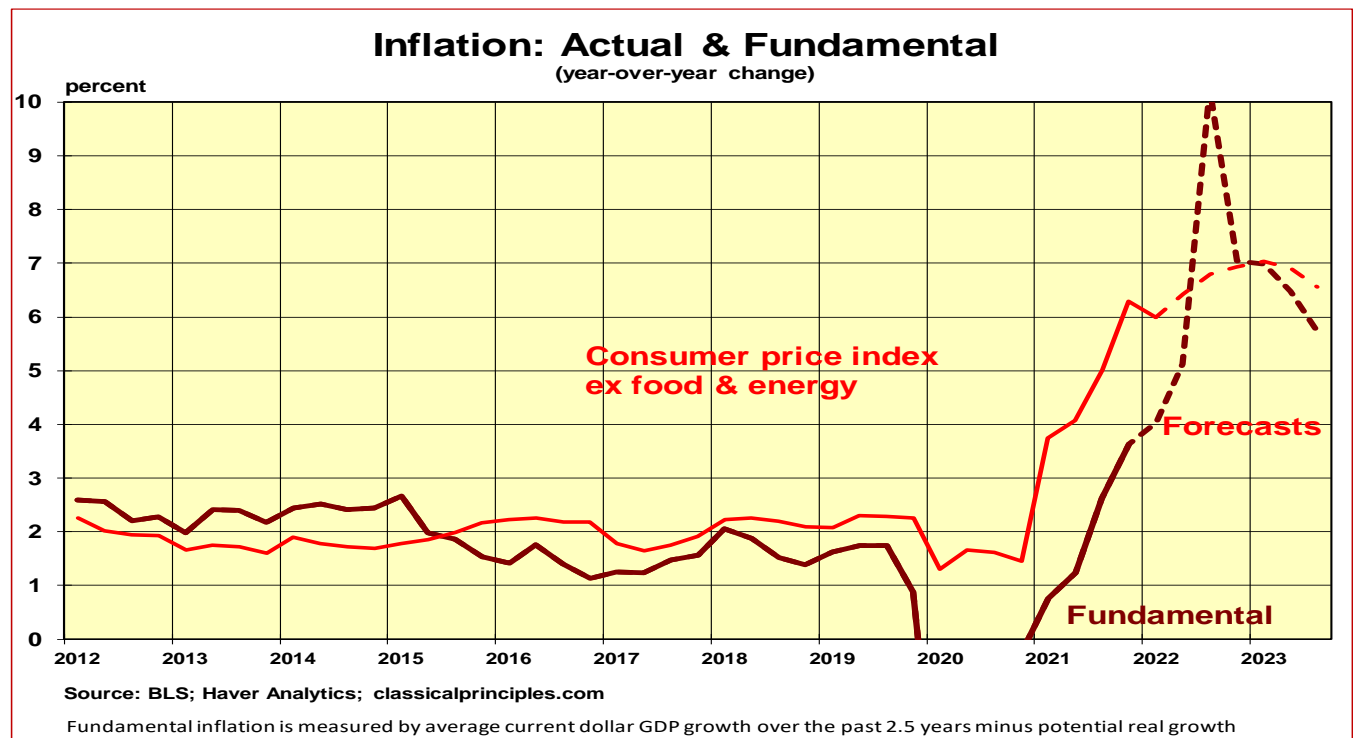
Although business surveys show some moderation in price pressures, prices are a continuing problem with overall readings showing rapid prices increases.

The signs of some easing in inflation are due to a moderation in demand. Current dollar spending (GDP) was up at a 6.6% rate in the first quarter. Personal spending and incomes in

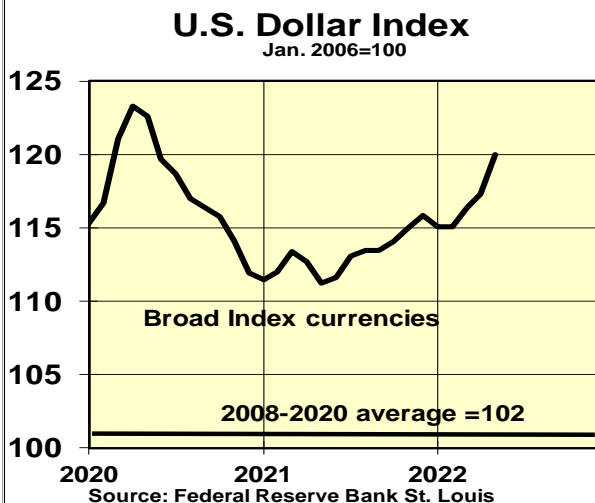
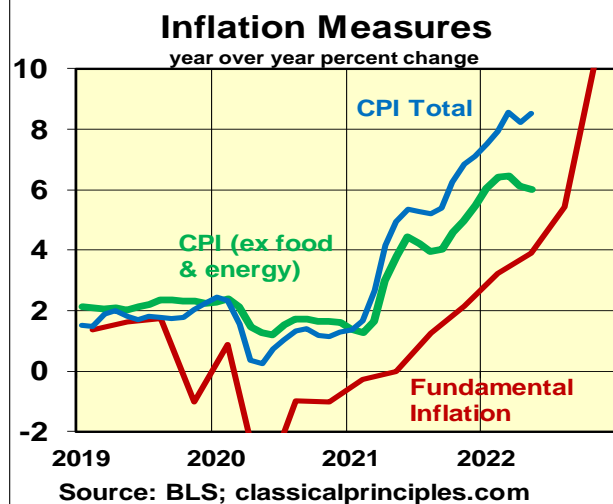
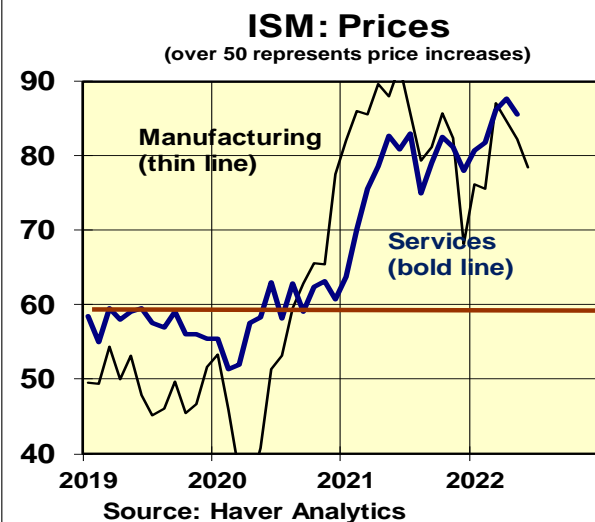
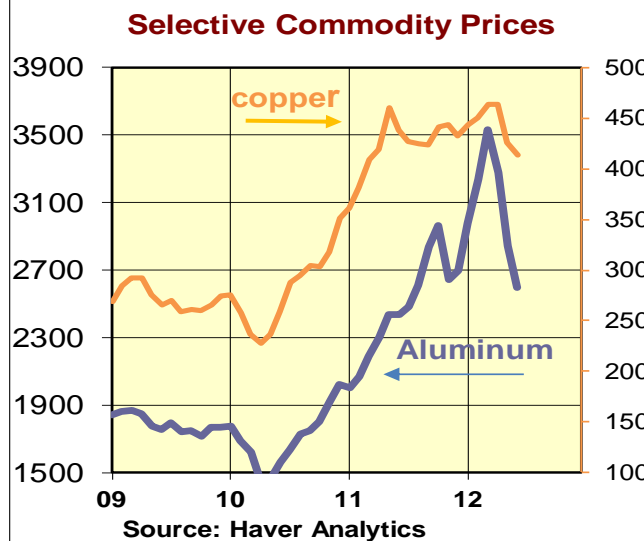
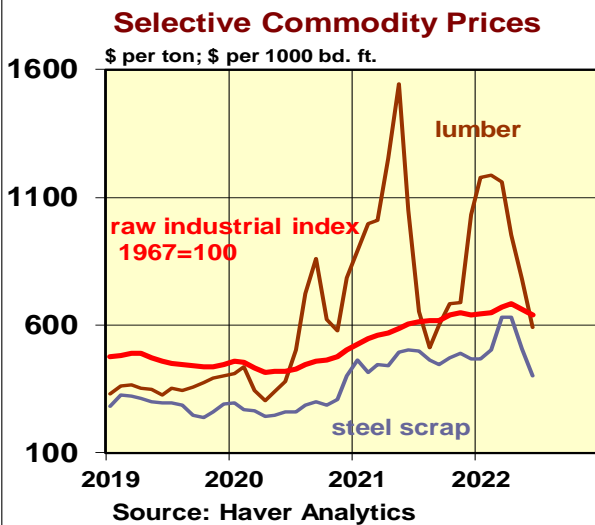
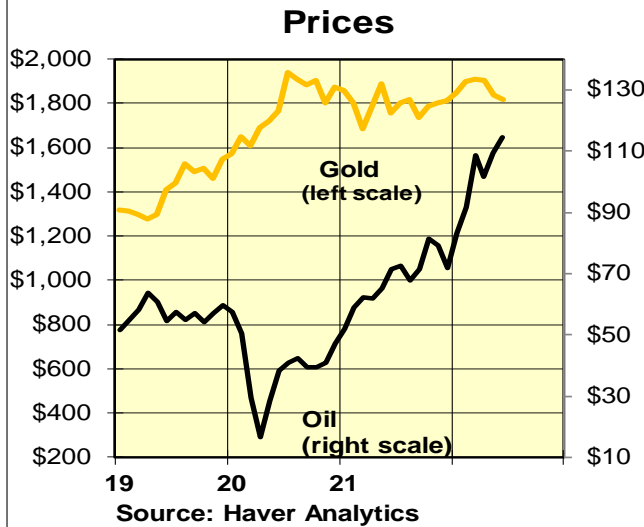
May rose at 7% rates from the first quarter. Hence, demand is clearly slowing from the 10% rates of 2021

Our analysis of money shows rapid increases in interest rates, such as the Fed is currently using, can reduce the rate of spending and demand in the economy. This appears to be happening.

The more aggressive the Fed is in raising interest rates, the sooner demand will ease and the sooner inflationary pressures can abate.



INFLATION INDICATORS



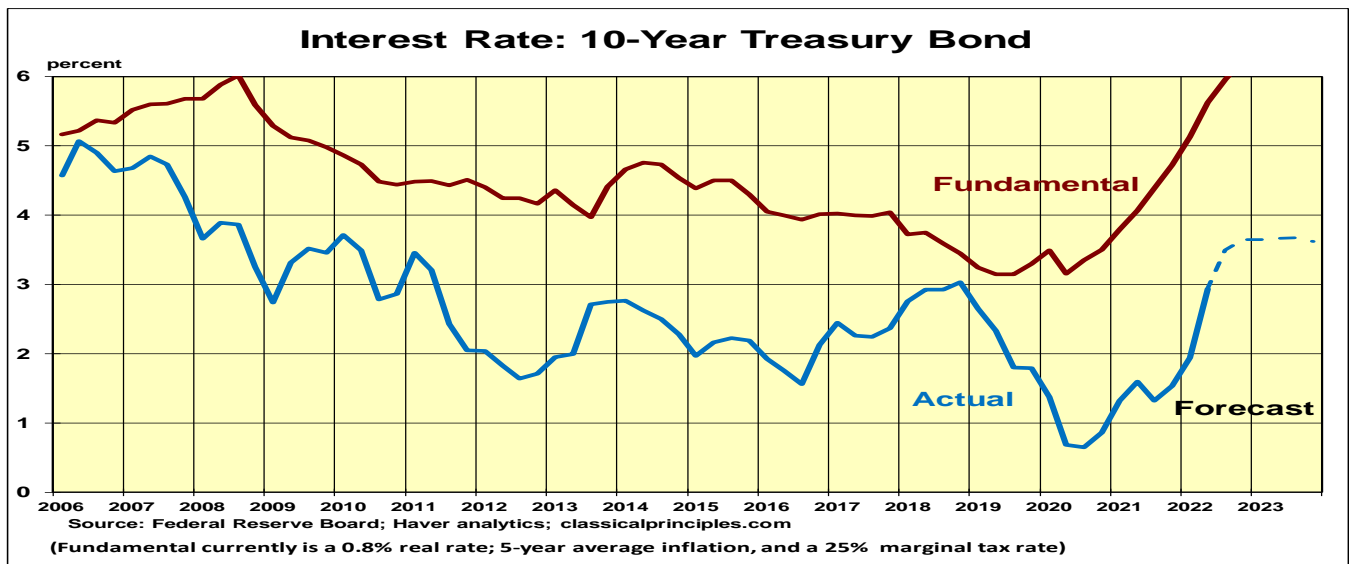
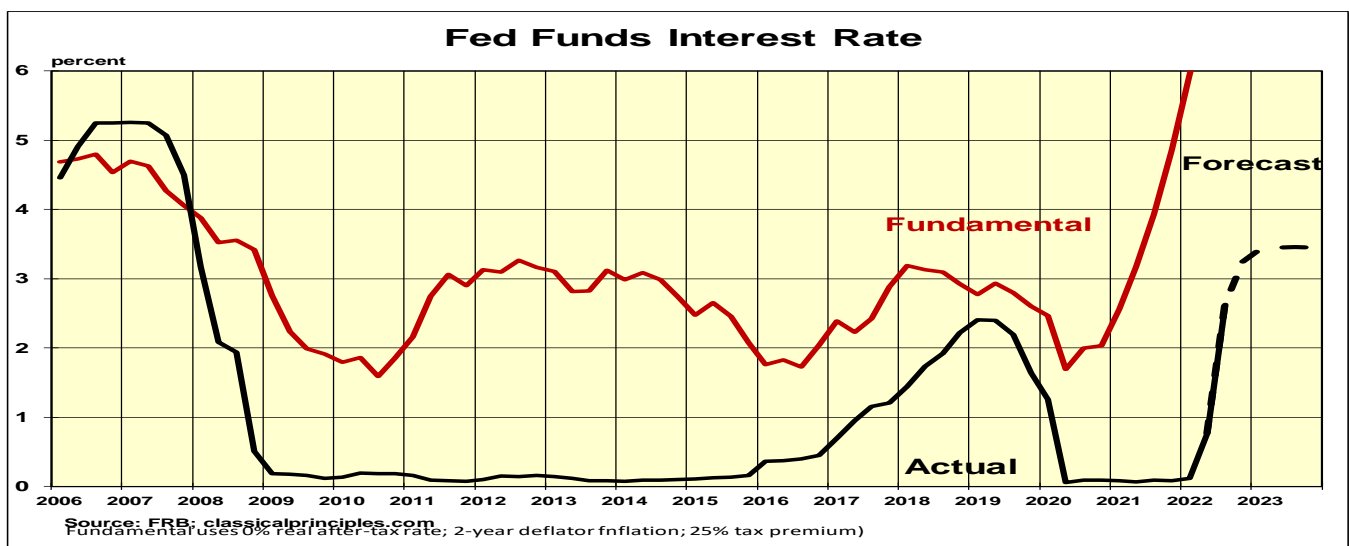
INTEREST RATES

With the Fed's late July meeting expect to see another increase in the fed funds target to $2\frac{1}{4}\%$ - $2\frac{1}{2}\%$. While still a very low rate, the speed of moving from 0.08% in March to as much as $2\frac{1}{2}\%$ in July is a shock to financial markets. Financial markets are beginning to believe the Fed is serious about containing inflation.

The Fed's main concern is inflationary expectations. The difference between the yield on 10-year T-Notes and inflation-adjusted Notes shows longer-term inflationary

expectations peaked at 2.9% in April and currently are 2.2%.

This decline in inflationary expectations indicates financial markets assume the Fed will contain inflationary pressures. If the Fed follows through with actions, the most likely outcome is a downturn in the economy in the second half of this year. While the magnitude and length of the downturn remain speculative, the Fed is on track in acting decisively to contain inflation.



STOCK PRICES

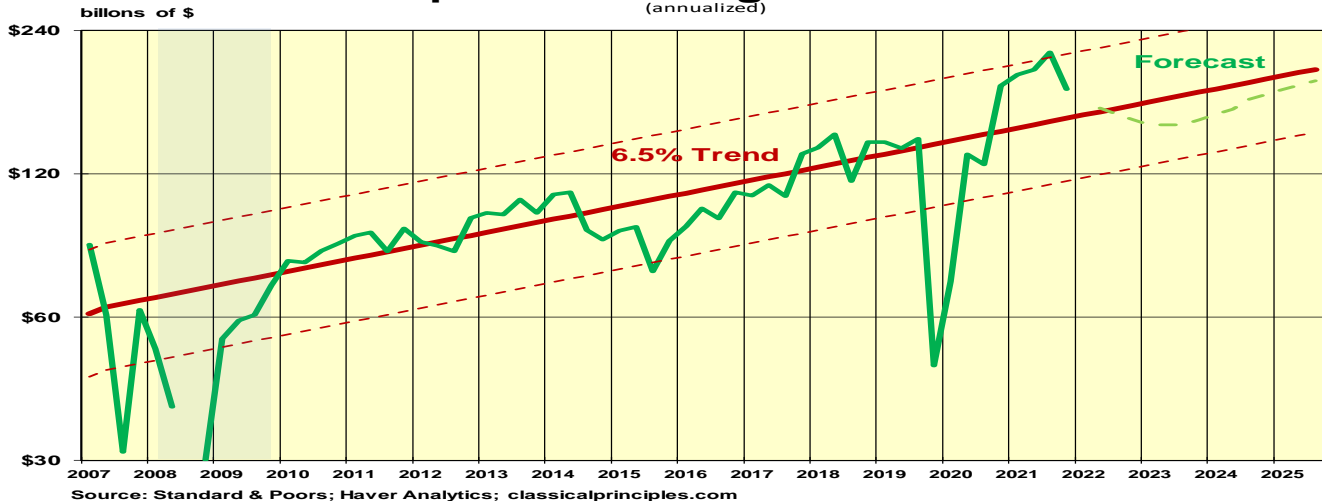
First quarter S&P500 companies' reported earnings were down 16% from the fourth quarter of 2021. Even so, first quarter earnings were still almost 20% above their longer-term trend. Given the pressures from increased costs and higher interest rates, earnings are likely to continue to decline in the period immediately ahead.

Historically, earnings tend to return to their longer-term trend. Given the weakness in productivity, cost pressures from higher energy and the turmoil in Ukraine, the odds are that likely earnings will decline to below their longer-term trend.

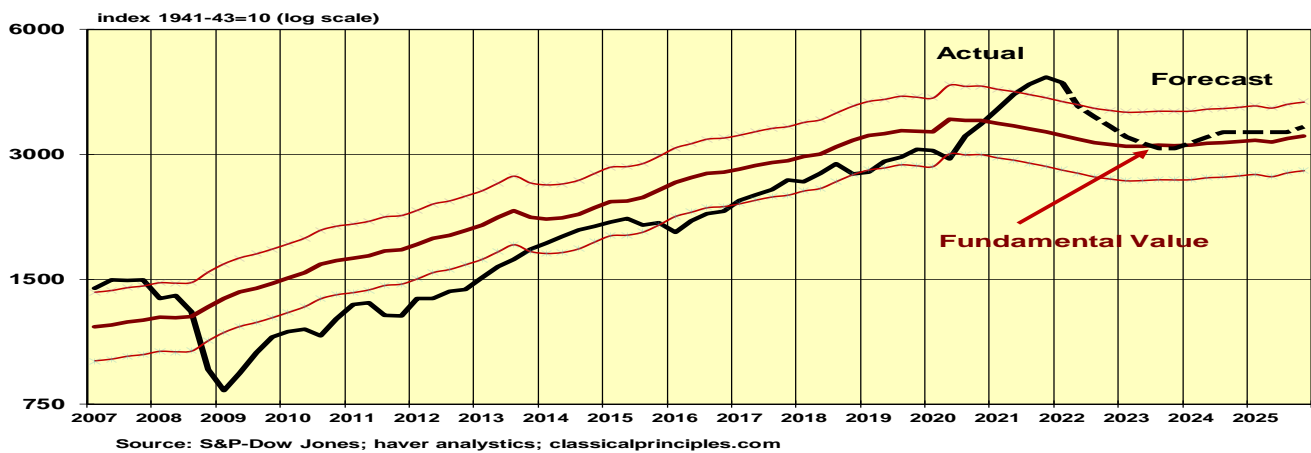
Our estimate of the fundamental value S&P500 is currently near 3100. Despite of a 20% decline, the S&P500 still remains close to 20% overvalued.

While all projections of the stock market are highly speculative, our projected scenario points to further weakness in stocks. With the mistakes the Fed has made so far in underestimating inflation, the potential for future policy errors remains high. Investors should remain cautious in facing what is likely to continue to be a difficult financial environment.

S&P Reported Earnings: Actual and Trend



S&P 500 Index: Actual & Fundamental



Fundamental value of stocks is based on a regression with the S&P's long-term earnings trend and an estimate of the fundamental AAA corporate bond rate as explanatory variables; boundary lines plus & minus 1 standard deviation

7/5/2022	<u>Actual</u>			<u>Forecast</u>				<u>YEARS</u>			
	<u>2021</u>	<u>2022</u>	<u>2022</u>	<u>2022</u>	<u>2022</u>	<u>2023</u>	<u>2023</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>
	IV	I	II	III	IV	I	II				
GROSS DOMESTIC PRODUCT	24003	24387	24832	25196	25566	25879	26259	20894	22996	24995	26455
%ch	14.5	6.6	7.5	6.0	6.0	5.0	6.0	-2.2	10.1	8.7	5.8
REAL GDP	19806	19728	19728	19678	19629	19580	19580	18385	19427	19691	19616
%ch	6.9	-1.6	0.0	-1.0	-1.0	-1.0	0.0	-3.4	5.7	1.4	-0.4
CHAIN PRICE INDEX	1.213	1.237	1.259	1.280	1.302	1.322	1.341	1.137	1.185	1.270	1.349
%ch	7.1	8.2	7.0	7.1	7.1	6.1	6.0	1.3	4.2	7.2	6.2
CPI- ALL URBAN%ch	7.9	9.2	10.0	7.1	7.1	6.1	6.0	1.2	4.7	8.3	6.4
FUND. INFLATION%ch	2.6	3.6	4.0	5.1	10.3	7.0	7.0	-1.3	2.8	2.9	3.2
PRETAX PROFITS	2902	2838	2565	2515	2465	2365	2329	2184	2820	2596	2364
%ch	2.9	-8.5	-33.2	-7.6	-7.7	-15.3	-6.1	-3.1	29.1	-7.9	-8.9
PRETAX PROFITS ADJ (1)	2937	2600	2600	2550	2500	2400	2363	2243.8	2805.8	2630.7	2398.6
%ch	2.8	-32.9	-32.9	-7.5	-7.6	-15.1	-6.0	-5.2	25.0	-6.2	-8.8
AFTER-TAX PROFITS	2520	2175	2175	2133	2090	2005	1974	1908	2455	2202	2004
%ch	2.9	-33.3	-33.3	-7.6	-7.7	-15.3	-6.1	-2.3	28.6	-10.3	-9.0
AFTER-TAX PROFITS ADJ(1)	2555	2210	2210	2168	2125	2040	2009	1968	2441	2236	2039
%ch	2.8	-32.9	-32.9	-7.5	-7.6	-15.1	-6.0	-4.7	24.0	-8.4	-8.8
PERSONAL INCOME	21010	21604	21604	21921	22243	22516	22846	19628	21093	21756	23016
%ch	3.6	6.7	6.7	6.0	6.0	5.0	6.0	6.5	7.5	3.1	5.8
REAL DISPOSABLE INCOME	15462	15145	15145	15104	15064	15024	15024	15677	16032	15116	15053
%ch	-4.5	-0.2	-0.2	-1.1	-1.1	-1.1	0.0	6.2	2.3	-5.7	-0.4
PRODUCTIVITY	1.132	1.110	1.110	1.137	1.140	1.143	1.146	1.102	1.122	1.124	1.147
%ch	6.3	-7.3	-0.1	1.0	1.0	1.0	1.0	2.5	1.9	0.2	2.0
CIVILIAN EMPLOYMENT	155.2	157.8	158.4	158.9	159.3	159.7	160.2	147.8	152.6	158.6	160.4
%ch	5.2	6.9	1.1	1.1	1.1	1.1	1.1	-6.2	3.2	3.9	1.1
UNEMPLOYMENT RATE	4.0	4.0	3.6	3.7	3.9	4.0	4.3	8.1	5.3	3.8	4.4
INDUSTRIAL PRODUCTION: mftng	100.2	101.1	103.0	103.0	102.7	102.2	102.2	93.1	98.4	102.5	102.7
%ch	5.8	3.9	7.6	0.0	-1.0	-2.0	0.0	-6.3	5.7	4.2	0.2
LIGHT VEHICLE SALES (2)	13.0	14.3	13.5	14.5	15.0	15.4	14.8	14.6	15.1	14.3	15.1
Cars	2.7	3.0	3.0	3.5	3.5	3.7	3.5	3.5	3.4	3.2	3.6
Light Trucks	10.3	11.4	10.5	11.0	11.5	11.7	11.3	11.1	11.7	11.1	11.5

%changes are at annual rates
(1) Profits adjusted for capital consumption and inventory adjustment. Second quarter 2022 profits are estimates.
(2) Millions at seasonally adjusted annual rates.

	<u>2021</u>	<u>2022</u>	<u>2022</u>	<u>2022</u>	<u>2022</u>	<u>2023</u>	<u>2023</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>
	IV	I	II	III	IV	I	II				
Monetary Aggregates quarterly:											
M2 %ch at annual rates	10.0	8.0	0.3	6.0	6.0	6.0	6.0	26.0	12.6	5.1	6.0
Securities less excess reserves (bil\$)	4004	4566	5101								
year over year % change	11.7	29.0	46.6								
Interest Rates:											
Moody's BAA corp bonds 15+years	3.31	3.95	5.02	5.80	6.00	6.09	6.11	3.6	0.9	5.2	6.1
Moody's AAA corp bonds 15+years	2.65	3.29	3.93	5.05	5.20	5.19	5.21	2.4	1.6	4.7	5.2
Mortgage rates 30-year fixed	3.08	3.79	5.24	5.80	6.00	6.09	6.11	3.1	3.0	5.2	
10-YR GOVT SECURITIES	1.54	1.94	2.93	3.50	3.65	3.64	3.66	0.9	1.3	3.0	3.6
5-YR GOVT SECURITIES	1.37	2.03	3.17	2.87	3.35	4.52	3.85	0.5	0.8	2.9	4.0
2-YR GOVT SECURITIES	0.53	1.44	2.72	1.84	3.05	5.40	4.05	0.4	0.2	2.3	4.4
3-MONTH T-BILL	0.05	0.31	1.09	1.74	3.05	3.70	4.00	0.4	0.1	1.5	3.9
FEDERAL FUNDS RATE	0.08	0.12	0.77	3.24	3.80	4.00	4.00	0.4	0.1	2.0	4.0
STOCKS:											
S&P 500	4601	4467	4110	3700	3500	3300	3200	3219	4267	3770	3175
S&P 500 fundamental value	3399	3326	3224	3176	3151	3145	3140	3385	3485	3219	3139
S&P 500 reported earnings annualized	215.8	183.8	172.0	165.0	160.0	156.0	152.0	94.1	197.9	170.2	153.0
S&P 500 p/e on reported earnings	21.3	24.3	23.9	22.4	21.9	21.2	21.1	34.2	21.6	22.2	20.8
S&P 500 operating earnings annualized	226.9	197.4	184.8	180.6	168.0	163.8	159.6	127.4	180.9	198.7	166.4
S&P 500 p/e on operating earnings	20.3	22.6	22.2	20.5	20.8	20.1	20.1	25.3	23.6	19.0	19.1
S&P 500 reported trend earnings*	154.5	157.0	159.5	162.0	164.6	167.2	169.8	142	151	161	171
S&P 500 p/e on trend earnings****	29.8	28.5	25.8	22.8	21.3	19.7	18.8	22.7	28.3	23.5	18.5

*reported earnings based on a 6.5% long-term growth rate; second quarter earnings are estimates.

*price earnings based on reported earnings trend.