ECONOMIC OUTLOOK & INVESTMENT PERSPECTIVE

SECOND QUARTER, 2022

THE ECONOMY: FEDERAL RESERVE PROGRAM TO TAME INFLATION EXACERBATED BY RUSSIAN - UKRAINE WAR

The Federal Reserve, in their program to control inflation, started with a 25 basis point increase in the Federal Funds rate in March from a rate of 0 to .25%. However, inflation is currently running at approximately 8.5% in March over March of last year, far in excess of their desired 2% rate. This higher than desired inflation is compounded by the supply chain interruptions from the pandemic and war in Ukraine. To combat inflation, the Federal Reserve is most likely to be more aggressive with several 50 basis point increases. Short-term interest rates should move up from 25 basis points to 2% by the end of 2022 with another 1% - 1.5% increase in the first half of 2023. The likely target for the Federal Funds rate is between 3 – 3.5%. The Federal Reserve will continue to shrink the Treasury Bonds and mortgage-backed securities they own, which will have a contractionary effect on economic growth. As we know from history, this is an important effort because economies with low inflation tend to have stable growth. But high inflation economies tend to be very cyclical.

The economic medicine of low interest rates lasted too long and was too much. The concern now is that raising interest rates too much and too quickly could precipitate a potential recession. HDA is of the opinion that while growth in GDP was 5.7% for 2021, it will slow to 2% for 2022, and avoid a recession. The main drivers for weaker growth this year are continued supply chain disruptions, exacerbated by the Russia-Ukraine conflict, higher prices, particularly for food and energy, and a much more aggressive Fed policy to fight these high prices.

Oil prices have, in our opinion, peaked at $100 a barrel for West Texas Crude. The war in Ukraine has also increased food and industrial metal prices and will further snarl the global supply chain at a time when global shipping costs had been rising because of China’s Omicron-related lockdowns of major economic hubs.

America’s labor market soared back in March adding another 431,000 jobs and bringing the unemployment rate to 3.6%, a new pandemic-era low. The economy is now just 1.6 million jobs or 1% short of where it was in February 2020, before the pandemic. Leisure and hospitality led the gains followed by professional and business services and retail trade. The strong labor market has given policy makers confidence that they can slow the economy somewhat without causing a recession.

The Institute of Supply Management (ISM) index of national factory activity fell slightly to 57.1 in March from 58.6 in February. A grading above 50 indicates expansion in manufacturing, which accounts for 11.9% of the U.S. economy. The slowdown in manufacturing reflects a shift in spending back to services and a significant decline in Covid-19 infections, which has resulted in the rolling back of restrictions in the United States.

Consumer confidence was up slightly in March after declines in January and February. However, expectations weakened further with consumers citing rising prices, especially at the gas pump, and the war in Ukraine as factors. Meanwhile, purchasing intentions for the big-ticket items like automobiles have softened somewhat over the past few months as expectations for interest rates have risen. The seasonally adjusted rate for 2022 total new vehicle sales is expected to be 12.7 million units down 5.1 million units from 2021.

Existing home sales in 2021 were the best in 15 years, reaching 6.12 million homes. Prices followed suit rising 19.8%. Record low mortgage rates and households flush with cash from savings and federal stimulus payments drew new buyers into the market while willing sellers found willing buyers. Labor and materials shortages held back new construction while tight inventories of existing homes for sale drove prices higher. However, for this year a combination of rising mortgage rates and a decline in affordability should slow the market down – still healthy but more like pre-pandemic levels.

The United States can curtail importing Russian oil supplies (8% of U.S. oil consumption) because of the Russian invasion of the Ukraine. European leaders are under pressure to end the European Union’s decade long dependence on the country’s oil and gas from Russia as well. However, the European Union imports about 30% of its oil and 40% of its gas from Russia. It would be difficult to remove Russian gas from the European energy mix without imposing stringent curbs on individual consumption that could curb economic growth. Weaning Europe of Russian oil would be challenging. Getting rid of Russian gas would be harder.

In Europe, for the 19 countries that use the euro, soaring energy and food prices driven by the Russian-Ukraine conflict pushed inflation upward by 7.5% year over year in March. Adding to the economic strain on Europe are surging costs, as supplies of wheat, corn and barley remain trapped in Russia and Ukraine, which produce a major portion of these crops for world consumption. Consumer prices increased year over year in Germany 7.6%, Spain 9.8%, and the Netherlands 11.9%.

THE STOCK MARKET: MARKET TAKES A BREATHER AFTER REACHING NEW ALL-TIME HIGHS IN 2021

The S&P 500 Index posted its worst quarter in two years. The S&P 500 Index declined 4.95% and the NASDAQ declined 9.1% during the first quarter. The market absorbed multiple blows during the first quarter: inflation at its highest level in four decades, the war in Ukraine further crippling already tight supply chains and the Federal Reserve increasing interest rates.

Consensus earnings estimates for the S&P 500 Index are now approximately $231 per share for 2022. Using a 20x P/E multiple on the consensus S&P earnings estimate for 2022 of $231 equates to a year-end value of 4620, or 2% upside from current levels.

During the quarter ending March 31, 2022, Harold Davidson & Associates decreased equity exposure. We added to our value strategy mutual fund positions. We sold shares in a semiconductor company, a digital payments company, an enterprise software company and reduced exposure to the health care sector.

The composition of the assets currently managed by Harold Davidson & Associates is as follows: Cash and cash equivalents – 4%; municipal bonds – 3%; corporate bonds – 3%; bond mutual funds – 10%; equity mutual funds – 14%; common stocks – 54%; and real estate equities – 12%.

THE BOND MARKET: FOMC BEGINS RAISING RATES

The Federal Reserve’s Federal Open Market Committee (FOMC) increased the Federal Funds rate by 25 basis points during the first quarter to a new target rate range of 0.25-0.50%. Over the next three years, the FOMC is unwinding its bond buying stimulus program which began in March 2020, by reducing the balance sheet of $4.6 trillion in Treasuries and mortgage-backed securities in an effort to tighten credit markets and lower inflation.

Typically, the stock and bond market move in opposite directions; however, the bond market also declined during the quarter in anticipation of higher rates. The Federal Reserve raised rates during the first quarter for the first time since 2018, sending the ten-year U.S. Treasury to 2.32% from 1.52% at the end of 2021. In addition, rates on some shorter-term Treasuries rose above longer-term bonds, creating a flat or inverted yield curve during the quarter.

Our bond purchases are concentrated on quality issuers and low duration. Inventories for both high quality corporate and municipal fixed income securities remain tight, and we selectively substitute purchases of individual bonds with institutional-quality bond mutual funds offering favorable maturity and yield, particularly inflation protected bond funds.

REAL ESTATE: DUE TO RISING INTEREST RATES BOTH COMMERCIAL AND RESIDENTIAL PROPERTY VALUES HAVE SLOWED THEIR RAPID INCREASES

During the past quarter commercial real estate prices hit all-time highs and it is widely anticipated that due to raising interest rates, values may have reached a plateau. Higher borrowing costs for real estate investors usually translates into lower prices. However, with a significant shortage of quality real estate available for sale, demand is outpacing supply, and prices have remained relatively stable. Industrial real estate and apartments continue to be the most sought-after asset classes followed by retail and hospitality. Office continues to be the least desirable asset class.

Residential real estate home sales have slowed due to rising mortgage interest rates and a shortage of homes available for sale. Nationally, buyers are finding the highest interest rates since 2019 which is limiting their affordability for new homes. The rate of increase of residential values has slowed significantly but demand has continued to propel the residential real estate market.

We are of the opinion that in the short-term real estate values will remain relatively unchanged. As interest rates continue to increase, there will be downward pressure on values. However, continued increased demand shall overcome the downward pressure and we anticipate real estate values ending the year similar to their current levels.

SUMMARY AND CONCLUSION:

Aggressive moves to increase the Federal Funds rate by the Federal Reserve to tame inflation are in progress. Continued supply chain disruptions and higher interest rates will contribute to slowing economic growth but avoid a U.S. recession. The stock market will have modest growth this year at best. Shorter maturities are optimum for bond purchases in a rising interest rate market. Real estate values will be challenged by higher interest rates, but limited available product should help maintain pricing.

CLIENT REFERRALS

We greatly appreciate the referrals of new business that we continue to receive from our clients. If you have acquaintances, who, in your opinion, can benefit from receiving this investment newsletter, please contact Doreen in our office at (310) 553-5551 or email dferritto@hdainvest.com.