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Q2 2022 Outlook

April 1st, 2022

Economy: Expect to see decelerating GDP growth for the rest of 2022 with inflation peaking in the first half of the year but persisting above average for the forecastable future.

- Our outlook calls for US GDP growth in a range of 3.5%-4% with inflation likely still running slightly ahead of that pace by the end of the year.

- Recession risk is increasing as policy decisions tighten financial conditions, inhibiting growth on the demand side. At the same time, policymakers lack the ability to address supply-side headwinds that are fanning the flames of inflation and restricting growth.

- Credit conditions exiting the first quarter of 2022 are still very favorable, with credit spreads low and both consumer and corporate balance sheets in great shape. We do not yet see signs of a credit crunch that could trigger an impactful recession, with defaults and bankruptcies leading to job loss and an overall downshift in economic activity. However, Fed communication has become increasingly hawkish as inflation borders on running out of control. Certain rates, such as that of the 30-year mortgage, have already increased materially to the point where demand side activity is being impacted. As the Fed Funds target rate increases, borrowing costs in other areas will increase in an impactful way as well, and as liquidity is withdrawn from the system through the Fed's balance sheet runoff, borrowers may find it increasingly difficult to finance growth or refinance existing debt.

- The recent partial inversion of the yield curve is yet another red flag we are monitoring. Inversions do not cause recessions; however, every recession in modern economic history has been foreshadowed by such a shift in the yield curve. We have recently seen 3, 5 and 7-year treasuries trade at yields slightly higher than the 10-year, with the 2-year also trading higher briefly. History shows that inversions can precede recessions by many quarters if a recession follows at all. Inversions are troubling because they show the market is demanding a higher rate of annualized return for a short-term investment than a long-term investment. This environment disincentivizes long-term investment as saving through short-term cash equivalents becomes more appealing.

- Globalization, one of the most powerful forces fighting inflation in recent decades, has been under attack the past few years. The trend has recently accelerated, with geopolitical events joining with a continuing effort to bring supply chains and production back within the borders of the United States. While there are logical arguments for doing so, it often involves the rejection of the lowest cost provider and is inherently inflationary. We watch this as something that could go two ways, continuing to push costs higher, or possibly returning as a force that will fight inflation if a return to globalization occurs

- Despite cautions given above, there is still a great chance the supply-side of the economy could mend itself, with some signs of supply chain and logistic logjams dissipating already showing. With inflation moderating, interest rate policy could be adjusted accordingly, paving the way for the secular expansion to continue undeterred.

Stocks: The S&P closed out the first quarter at 4,530 and we expect it to remain rangebound between 4,000 and 4,800 for the remainder of the year, with risks to breaking through the lower end of that range if a recession unfolds quicker than expected.

- Valuations improved during the first quarter as prices fell while forward earnings expectations continued their ascent. With risk free rates moving higher, the "there is no alternative" ("TINA") trade boosting demand for stocks lost favor as earnings yields had to improve to stay ahead of bond yields. If earnings expectations continue to rise, a return to all time highs by year end is very achievable.

- The inflation and bond yield story will likely determine the winning and losing sectors for the remainder of the year, with potential for significantly differing performance among those winners and losers.

- Profit margins will be one of the most important metrics to monitor in coming quarters. Any deterioration in profit margins that begins to uncover itself in the April-May reporting season could be a harbinger of declining forward earnings, a further pullback in stocks and a corresponding drop in economic growth. Stocks and sectors that demonstrate an ability to pass on cost pressures and maintain profit margins will be the best performers and provide a great inflation hedge.

Bonds and Rates: Longer-term rates should grind higher in 2022, with the Fed rapidly raising the front of the curve to rein in inflation through demand restriction.

- Fed liquidity injections are over (finally). Without their purchases holding rates down, and with inflation accelerating, long-end rates and mortgage yields have surged higher.

- The 10-year Treasury bumped up against 2.5% at the end of the first quarter, blowing through many economists' expectations for where this yield might end the year. We now expect a consolidation and continued move higher in long-term yields, likely moving toward 3% and hitting a technical challenge in breaking through that level, although it will likely end up moving well above that level by the end of the year if inflation does not abate.

- As expected, the focus of both economists and the markets is trained on Jerome Powell and his voting Fed members. With their voices heard more often and more clearly than ever, the market is pricing in a pace of rate hikes not imagined as the year began. As we look out at their most hawkish peak Fed Funds forecasts, we question if the 2023 economy will be able to handle Fed Funds at 3%+. While we don't expect that they are attempting to blatantly mislead the markets with their projections, it is quite possible they are erring on the side of sounding more aggressively hawkish to influence sentiment and talk risk markets down.

- Credit spreads are getting our special attention as a meaningful increase would fuel any existing concerns. We expect spreads on floating rate instruments to drop as Fed Funds rises with investor demand for those kinds of products increasing.