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QUARTERLY REVIEW & OUTLOOK **Q2-2022**

"Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man."

— Ronald Reagan

1980 saw the "Miracle on Ice", the beginning of CNN, the introduction of Post-It notes, and the death of John Lennon. Did we mention 14.6% inflation? Yes, we have to go back 40 years to see high inflation numbers, and it took former Federal Reserve Chair, Paul Volker, who raised interest rates significantly, to snuff it out. Back then, the markets took rates even higher than the Fed, as the Prime Rate, the rate banks charge their best customers, rose to a stunning 21.5%. Inflation has been tame ever since, until now.

Why did inflation escape from the bottle it's been in for 4 decades? Since the housing crisis of 2008, the Federal Reserve has fostered an easy money environment of extremely low interest rates. Covid came along and governments flooded the system with stimulative cash. As people were stuck at home, they bought 5 years' worth of goods such as televisions, Peloton Bikes, washing machines and even speculative stocks, all in a short period of time. Covid caused worldwide supply chains to break down driving up prices for everything from shipping to automobiles. Then the War in Ukraine occurred pushing food and energy prices significantly higher.

What outcome can we expect from here? Let's start by what could continue to go wrong. The Federal Reserve is raising interest rates to tamp down on inflation. However, much of the inflation caused by the Ukraine War is out of their control such as energy and food costs. Inflation could stay stubbornly high or get worse if the energy supply to Europe was cutoff or food supplies were constrained further. The U.S economy is slowing and additional interest rate hikes risk sending our economy into recession, if we're not there already. A significant reduction in 2023 earnings might cause the markets to reflect a lower valuation then seen currently.

What can go right? The markets have already corrected with the S&P 500 off nearly 25% from peak to trough and the Dow Jones nearly 20%. Interest rates have moved up significantly as the 10-year Treasury has risen from roughly .50% to nearly 3.5% since August of 2020. In other words, at least some of these worries have already been discounted in the markets. Over the last several weeks, inflationary pressures have started to ease as oil, copper, lumber, retail sales, interest rates and other commodities have fallen rather significantly. The 2-year Treasury can give us a hint at what the market believes is the ending rate for the Fed's tightening cycle. The 2-year Treasury is currently above 3.0%. A significant interest rate hike in July by the Federal Reserve will get them close to this 2-year Treasury rate. If investors believe we

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are close to peak inflation and that the Fed is close to completing the lion share of rate hikes, the markets may find great relief and act significantly better.

Many are nervous that we are witnessing a 2008 type of bear market where the S&P 500 and Dow Jones Averages declined roughly 50% from their highs. However, today's economy is far different as unemployment is low and jobs are plentiful. Corporate and consumer balance sheets are strong. Domestic manufacturing operating capacity is full. Most importantly, the banking system is more regulated and better capitalized.

A summer rally could be building if these inflationary inputs continue to lessen. We may not be completely out of the woods, but an upward move would not surprise us going into the fall. Though the overall environment has been challenging, there have been sectors and individual securities that have and will continue to be places of opportunity going forward.

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