Investment Commentary

HANOVER
ADVISORS

June 2022

Surging Inflation Awakens a Bear

The U.S. economy and stock market have both struggled in the first half of 2022. The highest inflation in more than four decades, aggressive tightening of monetary policy by the Federal Reserve, and the ongoing war in Ukraine have weighed heavily on the markets, with the S&P 500 falling into a bear market, meaning a drop of 20% or more, in recent weeks. The bond market has also seen historic losses. The Bloomberg Barclay's US Aggregate Bond Index has seen its biggest decline in more than 40 years. Prices for the highest quality corporate bonds are down 14.73%, while long-term Treasury prices have fallen by a staggering 23.6%.

As steep as the losses have been in the stock market at the index level, they have been even more severe for most of the underlying individual stocks. The S&P 500 is down about 22% from its 52-week high, but the average stock listed on the index has seen a drawdown of 30%. The losses beneath the surface are even more drastic for the Nasdaq 100. The index is down 33% from its 52-week high, but the average member has seen losses of 51%.

The primary drivers of this downturn have been persistently high inflation and the Fed's efforts to combat it. Hopes that we would see inflation peak in the spring were dashed by May's consumer price index reading, which showed an acceleration of price increases, driven by surging energy costs. May's year-over-year consumer price index (CPI) reading of 8.6% was the highest since 1981. Because of the complex way that CPI calculates housing costs, current readings do not yet reflect the record-breaking home price growth seen across the country. Furthermore, the producer price index, which tracks the prices that businesses and manufacturers pay, was even higher, climbing 10.8% year-over-year, and these businesses are likely to pass their higher costs onto consumers down the line. All of this suggests that inflation will likely remain elevated in the coming months.

Rapidly climbing prices are beginning to weigh on consumers. Consumer sentiment, as tracked by the University of Michigan's consumer sentiment index, fell in June to the lowest level ever recorded on data that goes back to 1952. The portion of the index that tracks consumers' assessment of buying conditions for big ticket items like appliances and vehicles has cratered. Retail sales unexpectedly declined in May, and the use of revolving consumer credit, which is largely credit cards, has increased. This suggests that consumers are being stretched by higher prices and are relying on debt to maintain

their level of consumption. Consumer spending accounts for roughly 70% of the nation's total economic output, so a slowdown there would be a major drag on the economy.

Some economists are optimistic that the massive amount of savings that consumers amassed during the pandemic will allow them to weather a protracted period of higher prices. During the pandemic, American consumers, stuck at home with little to spend money on and awash in stimulus money, were saving a great deal. The savings rate peaked in April 2020 at an all-time high of 33.8%, but since then it has fallen precipitously to just 4.4%, well below the historical average of 8.97%. While the savings rate has fallen, Americans still have about $2 trillion in excess savings. The problem with this is that it is largely concentrated at the higher end of the income spectrum. Low-income households, which are the ones most likely to be stretched by higher prices for essentials like food and fuel, have a much smaller amount of savings, and high-income households have seen their net worth pummeled by losses in the stock and bond market, so may not be willing to deploy their excess savings.

It is not just consumers that are feeling the pinch of higher prices. Tighter financial conditions, surging mortgage rates and ongoing supply chain problems have started to cool the red-hot housing market. Price growth has remained robust, but sales activity has been slowing for several consecutive months. Mortgage demand has fallen to the lowest point since 2018. Homebuilder sentiment is at the lowest point since the early days of the pandemic, and the number of building permits and home starts have fallen faster than expected in recent months.

More broadly, CEO confidence declined sharply in the second quarter. A survey of sentiment from The Conference Board, a business research organization, found that sentiment among chief executives plummeted in the second quarter, falling from 57 in the first quarter to 42, its lowest level since the start of the pandemic. Historically, a reading of that level has coincided with profits recessions or negative year-over-year changes in earnings. This also suggests that CEOs will reduce capital investments, adding an additional drag on the economy.

With inflation weighing so heavily on the economy, the Federal Reserve has declared that it will tighten policy "expeditiously" until inflation comes down. The central bank has followed through on this promise by raising interest rates by 0.75 percent earlier this month, the largest increase since 1994. Though by waiting so long to take action on inflation, the Fed now finds itself in the difficult position of tightening conditions when the economy is already slowing. The big uncertainty now facing investors is whether the Fed can tamp down inflation without tipping the economy into a recession.

If history is any guide, the chances that the Fed will be able to engineer a "soft landing" are not great. In recent history, there have been just two tightening cycles where the Fed has avoided a decline

into a recession, and there has never been a soft landing when inflation has been above 4.5%. Still, signals from the markets suggest that traders are optimistic that the Fed's current trajectory is working. The Bloomberg U.S. Financial Conditions Index is now the tightest since 2018, aside from a brief pandemic-induced plunge in March 2020. In the wake of this tightening, credit spreads (meaning the difference between yields on Treasuries and corporate bonds) have widened, real interest rates have moved into positive territory, the dollar has strengthened, and most importantly, inflation expectations have softened.

One proxy for inflation expectations is the breakeven on 10-year TIPS, meaning the difference between the yield on nominal and inflation-protected Treasuries. At 2.6%, the breakeven is high, but not much higher than the Fed's 2% target. Another important proxy is the difference between 5- and 10 -year Treasury yields. The current spread suggests that the market expects inflation to average about 3.2% over the next five years. Considering that the current rate of inflation is more than 8%, that is a promising sign that investors expect inflation to cool off.

Another promising sign for the Fed is that the growth of the M2 money supply has slowed drastically. The M2 money supply, which tracks cash, checking deposits and easily convertible cash equivalents, exploded amid the frenzied federal stimulus spending in the wake of the pandemic and has been one of the primary drivers of the inflation we are now seeing. The M2 growth rate reached an all-time year-over-year high of 26.9% last February. It has slowed significantly since then, falling to an annualized rate over the last three months of just 1.3%, and in April it actually declined from its March level. This makes the Fed's task much easier, as it effectively removes a major source of potential inflation from the equation.

The recent downturn in the stock market may have also made the Fed's job easier. The fall in stock prices may push executives to reduce spending and hiring, which would slow the economy, lessening the need for the Fed to raise rates so aggressively. Economists at the Leuthold Group have found that over the last 55 years, major drops in the S&P 500 (about 19% based on their data) have "usually unleashed a powerful disinflationary impulse." There have also been steep declines in key commodity prices recently, which may slow the pace of inflation. Some economists are now forecasting that the Fed may be easing monetary policy by the end of next year.

Ultimately, however, there is only so much the Fed can control. Ongoing supply-chain disruptions and the war in Ukraine will continue to drive inflationary pressure, regardless of what the Fed does. Uncertainty remains high and there is an elevated probability that we will see a recession in the next 12 months. It will likely be a shallow recession, but with so many unknowns, it remains possible

that we will see a protracted period of high inflation and slow growth similar to the stagflation seen in the 1970s.

It remains to be seen how much further the bear market will sink before it reaches its bottom, but current valuations are already becoming attractive. As stated, the losses at the index level hide much deeper losses beneath the surface as some stocks are down 30% or more. This represents a very attractive buying opportunity. As always, we recommend investors take a 3-5 year time frame, and from this perspective, we are optimistic about the market's prospects. Corporate earnings have likely peaked, but are expected to remain robust, even as economic growth moderates. Volatility is likely to remain high and bear markets typically see sharp, short rallies despite the overall downward trend. Identifying the bottom is largely a guessing game, but investors who are willing to deploy cash at current valuations are likely to see higher returns 12-18 months down the line.

Now that interest rates have reset at a higher level, the steep losses seen in the bond market are unlikely to continue in the second half of the year, though volatility is likely to remain high as central banks continue to tighten. The current higher yields make the bond market more attractive. With a possible economic downturn on the horizon, bonds with a long duration are likely to generate higher returns, especially if interest rates come back down. Credit rating is also paramount. If we do see a drastic slowdown in the economy, it could spark a wave of defaults and downgrades that could roil the market. In this environment, we prefer high quality corporate bonds. The recent surge in Treasury yields makes them more attractive, and though yields are not stellar when inflation is factored in, the security that Treasuries offer makes them more attractive during this period of increased uncertainty.

Hanover Advisor Bulletins
Special Reminders to all Hanover Clients

- Hanover's annual ADV form has been filed with the SEC. This important disclosure document allows clients to learn more about Hanover's investment practices and compensation model. The form can be accessed at hanoveradvisorsinc.com.
- We invite all clients to schedule an online portfolio review. Because we respect your time, we offer three different meeting formats that vary in length and level of specificity. For more information or to schedule a meeting, please contact us.
- The Hanover Advisors website can be accessed at hanoveradvisorsinc.com. There you will find our latest newsletter and investment commentary, articles, our blog, and videos. You can also learn more about our services, access both the Black Diamond performance reporting system and your Pershing brokerage account(s).
- All Hanover clients have free access to our internet-based reporting system known as Black Diamond. This robust system provides comprehensive performance reporting, asset allocation and risk assessment on clients' portfolios. Our office is available to assist in accessing and utilizing the Black Diamond system.

The content of this newsletter is based on information from sources believed to be reliable. However, accuracy and completeness can not be guaranteed. We recommend clients consult their legal or tax advisor before making any investment. Nothing herein should be construed as an offer, or the solicitation of an offer, to buy or sell any security. The publisher and its associates, directors or employees may have positions in and may from time to time make purchases or sales of securities mentioned herein. We cannot guarantee, and you should not assume, that future recommendations will equal the performance of past recommendations or be profitable.