

# Where We Are, What We Think and Where We're Going

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## The Current Economic Picture

- **Inflation** surprised to the upside – at 9.1%, the June Consumer Price Index (CPI) was the highest in 40 years.
- **The Federal Reserve** raised short term rates faster than previously expected and commits to fighting inflation as their top priority.
- **2-Year Treasury rates** climbed from 2.29% to 2.93% from the beginning to the end of the quarter and stands at 2.98% today. The yield on 2-year Treasury notes rose above the 10-year Treasury yield – often a negative sign for the economy. However, most economists say the yield on the 3-month Treasury bill needs to be higher than 10-year treasury yield for several months to truly make a recession call. Stay posted.
- **The stock market** experienced significant multiple compression from over 20 price-to-earnings ratio (P/E) to less than 16 P/E, driving prices lower. Much of this move can be attributed to the strong relationship between higher interest rates and lower P/E multiples. Concerns about the Fed creating a recession also weighed on stocks.
- **Commodity prices fell** as people worried about lower materials and energy demand in a softer economy.

## How Our Canvas Looks

Pundits have switched from saying inflation is transitory to saying inflation has peaked. They aren't addressing the bigger issue – our current inflation is sticky. Here are the reasons why...

- **Deglobalization** – Congress is currently considering a bill to bring some semiconductor manufacturing back to the U.S. We wouldn't be surprised to see some drug manufacturing come back to the U.S. as well as other items that companies think are critical to their businesses. The U.S. is a relatively expensive place to manufacture goods, so these actions are inflationary.
- **Lack of Supply** – Energy and commodity prices have come down for now, but structural supply issues support longer term rising prices in oil, copper, and other commodities.
- **Labor shortages** – We aren't replacing ourselves. Help wanted signs aren't going away and companies are having to pay more for workers. This problem exists throughout the developed world.
- **Supply Chain issues** - While some supply chain issues have improved, additional problems with Covid in China could continue to threaten supply chains and add to inflationary pressures.
- **Timing of Shelter Pricing in the CPI** - The shelter index comprises 32.8% of the Consumer Price Index. The two components of the shelter index are rental cost of a primary residence and owner equivalent rent. Owner equivalent rent<sup>1</sup> calculations are slow moving.

## Given the Big Moves in Markets, What Are Actions to Consider?

- For certain cash heavy investors, it may make sense to gradually add equity exposure at these lower levels with an emphasis on commodities, particularly energy.
- Investors may consider a move from money market funds to short term treasuries to take advantage of their higher rates versus money market and CD yields.
- Investors may consider rebalancing energy exposure in portfolios after latest selloff.
- The equity market selloff provides opportunities to do tax-loss harvesting in taxable portfolios.

## The Elephant in the Room

After reading the recent issue of the Economist, we thought one of our research letters made an interesting point...

*'The Economist has printed what many must have been thinking. A well-intentioned effort to address a global problem was, to quote the Economist, "Three Letters That Won't Save the Planet." If this is the end of the beginning for ESG, the question now arises, what next? The world is in the midst of an energy related crisis in part as a result of ESG's constraint, by exclusion from their indices, on committing capital to nuclear energy [and] fossil fuel related companies ranging from oil producers to refiners to coal production. The result is higher prices and an inflation problem which spread to the thousands of items we use every day.'*<sup>2</sup>



Given our view on energy, we want to be clear that we are not climate naysayers. We do our best to help by installing solar panels on our houses and driving electric cars. The extremely hot temperatures in Europe, melting ice caps, rising oceans and California wildfires should give everyone pause. We believe renewable energy will eventually dominate, but the transition will not be smooth as we continue to experience the push and pull of energy demand, dislike of fossil fuels and insufficient availability of clean energy sources. It is kind of like dating, there is no perfect match - one must be willing to make some trade-offs.

[1] Owners' equivalent rent (OER) is the amount of rent that would have to be paid in order to substitute a currently owned house as a rental property.

[2] Market Intelligence Report from The Institutional Strategist, TIS group, July 25, 2022.

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