2022 MID-YEAR INVESTMENT UPDATE

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Inflation and Economic Outlook

In our 2022 Outlook released in January, we wrote, "Persistent inflation will likely compel the Federal Reserve to tighten monetary policy this year. We believe this change will increase volatility in financial assets and limit returns." An aggressive change in Fed policy and instability in the stock and bond markets occurred in the first half of the year. High inflation on a global basis, exacerbated by geopolitical risk (the Russia/Ukraine war), has contributed to uncertainty about economic growth. We believe the trend in inflation remains the key factor in a possible recession and will likely continue to impact financial asset returns. Over the last few months the Consumer Price Index (CPI) has soared by more than 8% on an annual basis (9.1% in June), a level not seen since 1981.[1] Excluding food and energy, the Core CPI has increased around 6% year over year.[2] Our economic outlook is dependent on whether the core inflation rate decelerates below 4%. Price moderation to this extent would increase flexibility for the Federal Reserve in monetary policy and lower the likelihood of a recession. Unrelenting high inflation, however, could lead to further aggressive interest rate hikes in the Fed Funds rate, boosting the risk of a recession.

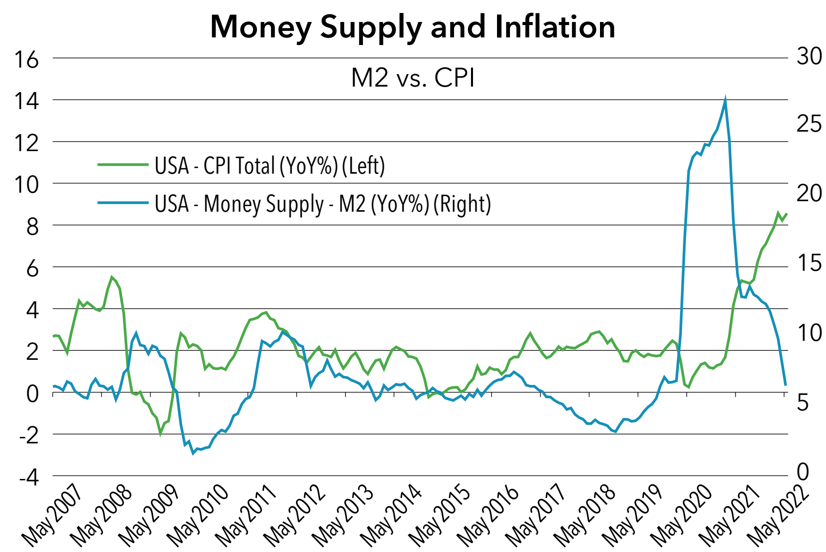
We see four primary factors determining whether inflation will moderate as this year progresses.

1. Liquidity: Money Supply and Federal Reserve Policy
2. U.S. Fiscal Policy
3. Consumer Demand: Employment, Income and Savings
4. Supply of Goods

Liquidity – Money Supply

Unlike Federal Reserve Chairman Jerome Powell, who opined that the connection between money supply and inflation ended 40 years ago, some economists believe inflation is linked to the creation of money.[3] We agree with the view that inflation occurs when the quantity of money grows faster than the rise in output.

M2 is a measure of money supply that includes cash, checking deposits and easily-convertible near money. It was persistently above 10% from 1975–1977 and in 1983 – two periods of high inflation. As illustrated in the "Money Supply and Inflation" graph, M2 spiked to nearly 27% in February 2021 with inflation rising sharply thereafter. Recently, M2 has fallen to 6.5% with further declines possible. We believe inflation will eventually moderate in response to lower money supply.

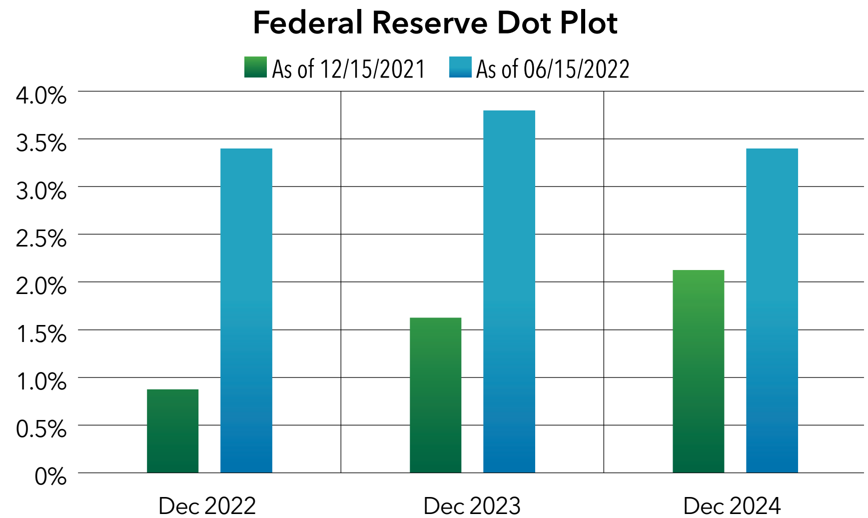


Source: FactSet; Data as of May 31, 2022

Liquidity – Federal Reserve Policy

One reason for the potential further decrease in money supply is the Fed's change in policy. In June, they increased interest rates by 0.75%, the largest hike since 1994.[4] The "Federal Reserve Dot Plot" chart is a Fed estimate of where the Fed Funds rate will end each year. They now anticipate a significantly higher rate over the next couple of years. Last December, the Federal Reserve forecasted the Fed Funds rate would end 2022 at less than 1%. Since then, they have increased interest rates by 1.5%, more than they previously forecasted for the entire year.

The Federal Reserve's goal is to lower inflation by reducing the demand for goods and services without causing a recession. To supplement rate hikes, they also announced a reduction of their balance sheet. In June, the Fed began reducing its holdings of Treasury and mortgage-backed securities by $47.5 billion per month. The total monthly reduction is expected to increase to $95 billion in September.[5] The impact of this "quantitative tightening" will likely reduce M2 and support the Fed's fight against inflation.

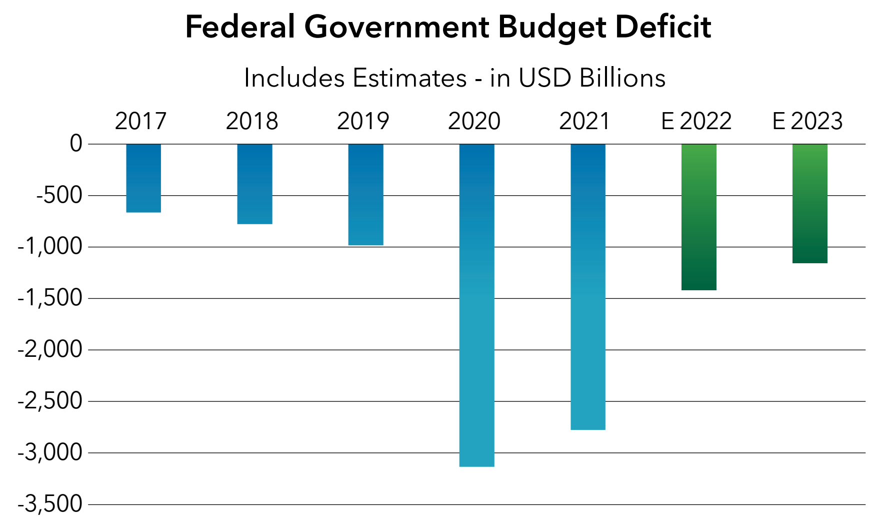


Source: Bloomberg as of 12/15/2021 and 06/15/2022

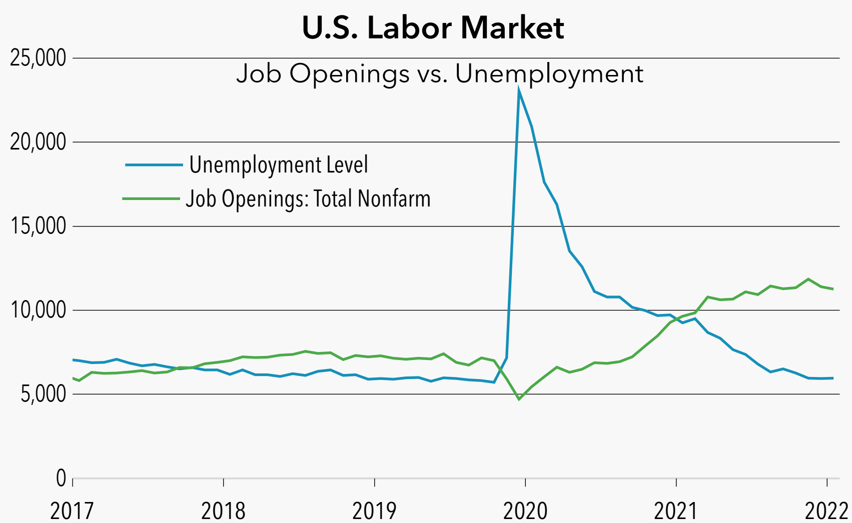
U.S. Fiscal Policy

U.S. government consumption expenditures and gross investment represented 17.2% of GDP in the first quarter.[6] As depicted in the "Federal Government Budget Deficit" chart, the government consistently ran a deficit over the last five years, reaching around $3 trillion in 2020 and 2021. We believe the prior excess stimulus contributed to inflation by artificially boosting demand beyond what supply could meet.

As we enter the third year of the pandemic, Americans are expected to receive significantly less federal aid. There are no plans for additional stimulus checks, and multiple programs have expired, including boosted unemployment benefits, guaranteed paid sick leave and expanded Child Tax Credit payments. The U.S. Office of Management and Budget expects the federal deficit to be $1.4 trillion less this year. While the decline in government spending may negatively impact economic growth, it will likely help combat inflation.



Source: FactSet Estimates, U.S. Office of Management and Budget, as of June 2022

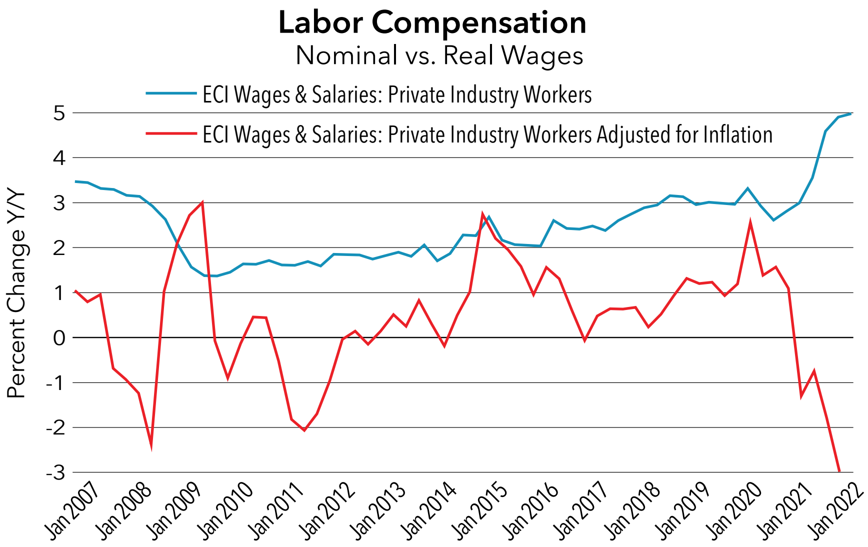


Source: FactSet; Federal Reserve Economic Data; U.S. Bureau of Labor Statistics as of May 2022

Consumer Demand – Employment

The U.S. economy's primary driver continues to be personal consumption expenditures with the consumer accounting for 68.6% of GDP in the first quarter.[7] Historically, there has been a high correlation between consumption and income created from employment. Strength in the labor market remains a major positive for the U.S. economy. As of June 2022, the unemployment rate had fallen to 3.6%, almost to the pre-pandemic level of 3.5%.[8]

As shown in the "U.S. Labor Market" graph, there are currently 11.3 million job openings, which far exceeds the unemployment level of 6.0 million. The gap between job openings and worker availability is at the highest level since data inception. The labor participation rate likely explains part of this difference as workers have not returned to the workforce as much as economists anticipated.[9] Companies continue to report that labor shortages are an impediment to growth.



Source: Federal Reserve Economic Data; U.S. Bureau of Labor Statistics as of First Quarter 2022

Consumer Demand – Income

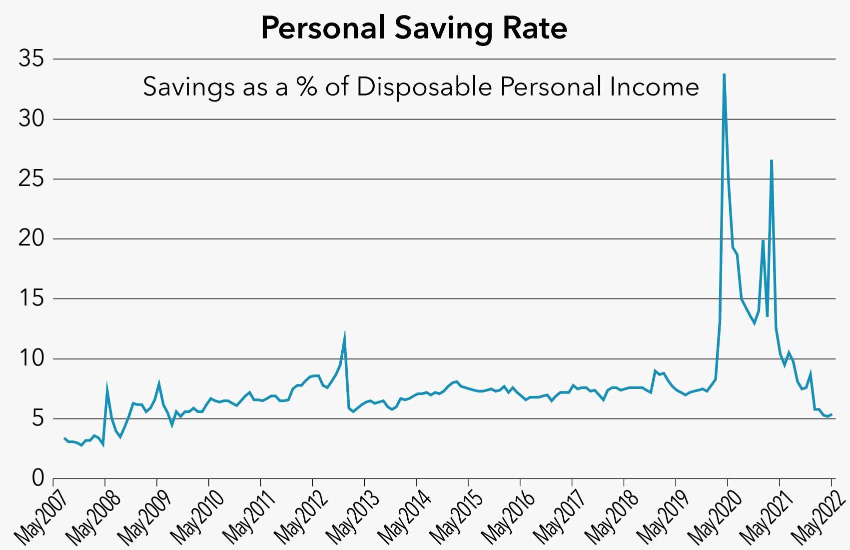
Tightness in the labor market has led to an acceleration in wages as companies strive to attract and retain employees. As illustrated in the "Labor Compensation" chart, the Employment Cost Index (ECI) increased by almost 5% in the first quarter. Companies typically try to pass on higher employment costs, leading to further inflation. There are mixed signals on whether wage inflation is starting to plateau.

Real wages, which measure the growth in compensation after subtracting inflation, suggest a different story. As portrayed in the chart, real wages are negative 3%. This means individuals have less income to spend on discretionary goods and services, in part due to increased prices of gasoline and groceries. A historic review of prior periods of negative real wages shows a dampening impact on economic activity.

Consumer Demand – Savings

In response to lower real income, consumers have dipped into their savings to finance higher spending. As shown in the "Personal Saving Rate" graph, the saving rate has declined to 5.4%. Prior to this downturn, personal savings had sharply risen, likely due to the extent of federal aid. Even with the recent dip in personal savings, the three-year average of 11.6% remains above the long-term average.[10] The excess savings may give the U.S. economy a cushion until income exceeds inflation.

Highly correlated with the use of savings is consumer credit. The percent change of total consumer credit has increased by an average of over 8% in the first five months of 2022, substantially above the 15-year average of 4%.[11] Following the pandemic-induced travel hiatus, there seems to be pent-up demand for leisure activities and travel. We expect this spending to remain resilient in the short-term. The impact of employment, income and savings on consumer demand will likely result in more modest spending, which is supportive of lower inflation.



Source: Federal Reserve Economic Data; U.S.Bureau of Economic Analysis, Data as of June 2022

Supply of Goods

China has implemented extreme policy measures in an effort to limit the spread of COVID-19. These policies continue to negatively weigh on global manufacturing and supply of goods, resulting in a decrease in exports leaving Shanghai for the U.S. and Europe. Certain industries, specifically automotive and trucking, continue to experience product shortages. As China reopens its economy and exports rebound, the supply of goods should increase.

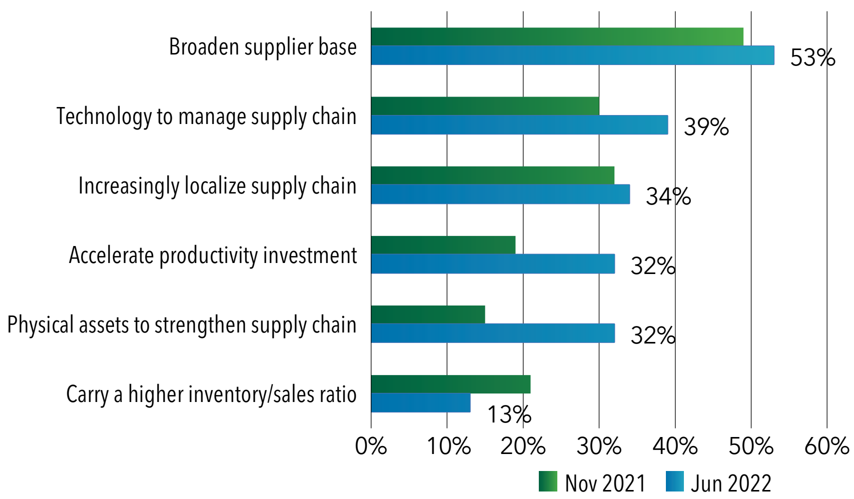
With supply chain problems and labor shortages affecting companies, investments are being made to address these issues. As depicted in the "Supply Chain Investment" survey, companies are changing suppliers and accelerating technology investments in both productivity and physical assets. At this point, firms are not planning to hold higher levels of inventory. Although investments will eventually help with the lack of product availability, supply issues are likely to persist, contributing to inflation.

Inflation – Commodities

In addition to the four primary factors contributing to inflation, the rise in commodity prices represents a risk to economic activity. The Russia/Ukraine war has affected oil and natural gas prices and the agricultural sector. As illustrated in the "Commodity Prices" graph, prices remain elevated and are close to 15-year highs. The persistent underinvestment in commodities has contributed to higher prices. Some commodities have weakened recently, with lumber and fertilizer prices leading the downturn.

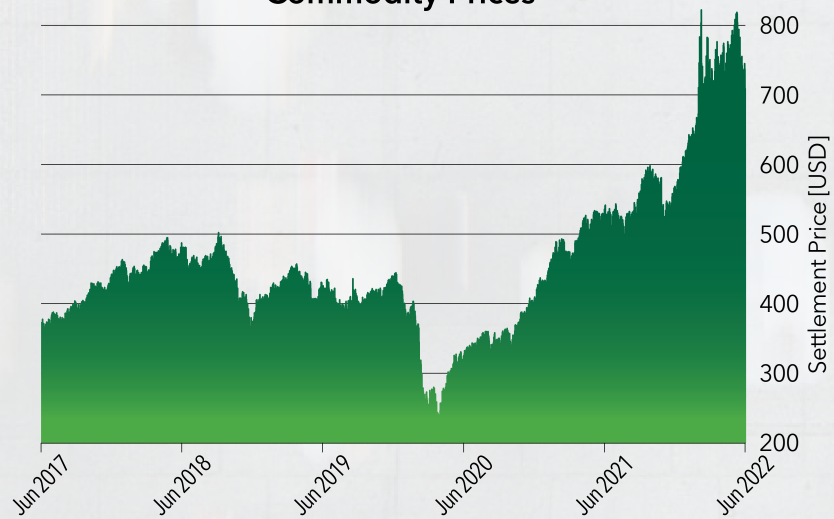
Many countries are experiencing a significant impact from food inflation. In May, the annual increase in food prices was 10.1%.[12] High-income countries, such as the U.S. and U.K., spend less than 10% of consumption expenditures on food. In low-income countries, however, food's share of consumption can exceed 50%.[13] This could cause geopolitical risk in some of the world's poorest countries. Agricultural commodities and food price increases may have more staying power as it relates to inflationary pressures.

Supply Chain Investment



Source: Evercore ISI Capex & Hiring Plans as of June 8, 2022

Commodity Prices



Source: FactSet; SP GSCI Commodity Index as of 6/30/2022

Inflation – Expectations

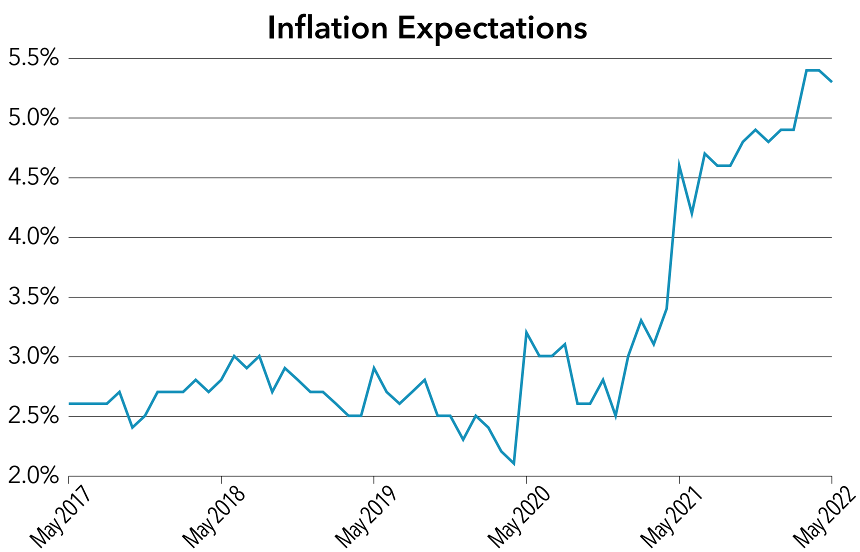
For much of this year, individuals expected the uptick in inflation to be temporary, with speculation around whether prices had peaked. In May and June, the CPI reports changed the story as inflation bumped higher than March and April. The "Inflation Expectations" graph shows that people surveyed by the University of Michigan expect higher inflation over the next year. This could be problematic as these expectations alone could lead to further price increases.

The Federal Reserve is likely concerned about the potential impact of the labor market on inflation. The Atlanta Fed Wage Growth Tracker shows that tightness in the labor market has persisted.[14] Although there are some indications that U.S. employment is starting to weaken with unemployment claims increasing over the last two months, the labor market remains challenging.

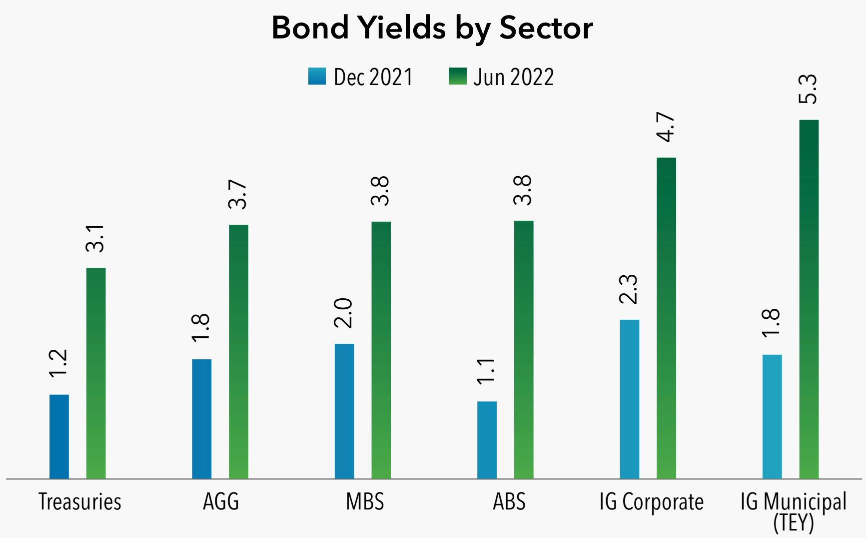
Bond Yields

Bond returns have historically been driven by the level of interest rates, not price changes. This year, high inflation and changes in Fed policy seem to have caused a rise in interest rates and a sharp decline in bond prices. As of June 30, the U.S. Aggregate Bond Index year-to-date loss was -8.3%.[15] On the positive side, interest rates are more attractive and investors will have more opportunities to generate income.

The "Bond Yields by Sector" table shows that absolute yields across credit sectors have reset higher. As the last market cycle was characterized by low interest rates and yield scarcity, the rise in yields may lead to renewed interest in fixed income. In the event of a recession, we believe interest rates will likely decrease, benefiting portfolios with a bond allocation.



Source: University of Michigan as of May 2022

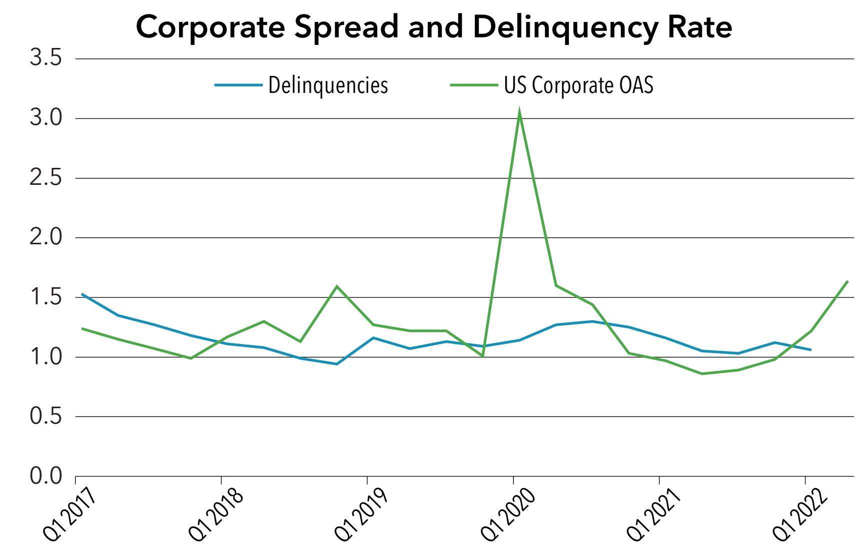


Source: Bloomberg Barclay's Index Services; Data as of June 30, 2022
* IG Municipal (TEY) is the tax-equivalent yield assuming a 39% tax rate

Fixed Income – Opportunities and Risk

Credit spreads on corporate bonds continue to trade at low levels compared to prior recessionary periods. As illustrated in the "Corporate Spread and Delinquency Rate" graph, delinquency rates on business loans remain modest and have not significantly increased this year. We believe this relatively benign credit environment reflects reasonable debt levels in corporate America and the high level of profitability. The Treasury yield curve does not appear to be forecasting an imminent recession, but does seem to be signaling an economic slowdown.

In analyzing the opportunities in fixed income, we have become more cautious in distressed credit and eliminated the position in high yield corporate bonds. Our institutional core fixed income team is focused on quality and liquidity in building bond portfolios. Although corporate spreads have increased, we expect better opportunities to add credit later this year.

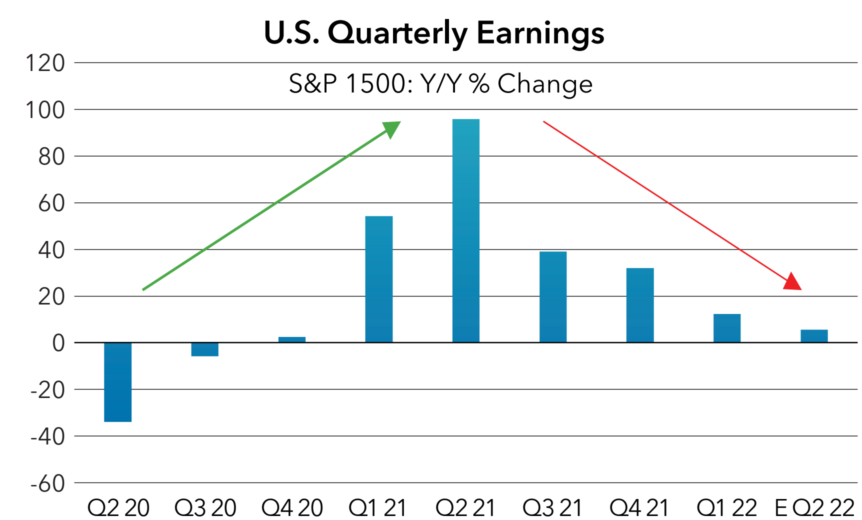


Source: Board of Governors of the Federal Reserve System; Data Available as of June 2022

Equities – Earnings

Stock prices are highly correlated with corporate profitability over time.[16] The macroenvironment of high nominal economic growth (real GDP growth plus inflation) has contributed to strong earnings expansion since the 2020 recession. As shown in the "U.S. Quarterly Earnings" chart, this trend began to shift over the last few quarters. The market is anticipating a 5.5% increase in the soon-to-be-released second quarter earnings, the lowest level since 2020.[17]

Of the 11 sectors, six are projected to report year-over-year earnings growth, led by energy, industrials and basic materials. The consumer discretionary and communication services sectors are realizing the most negative profit revisions. Corporate profit margins are forecast at 12.4% for the second quarter, which is higher than the historical average.[18] There is potential risk to second half earnings due to a likely deceleration in revenue growth and compression in margins.

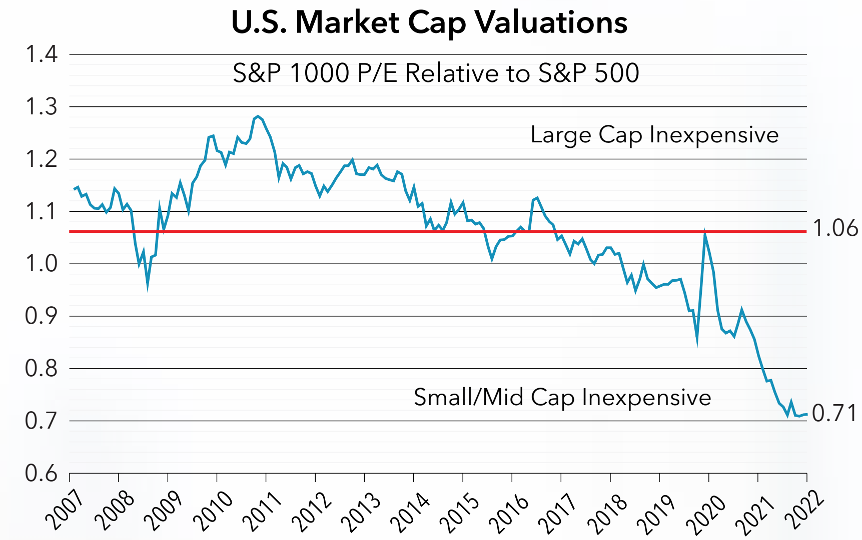


Source: FactSet as of June 30, 2022

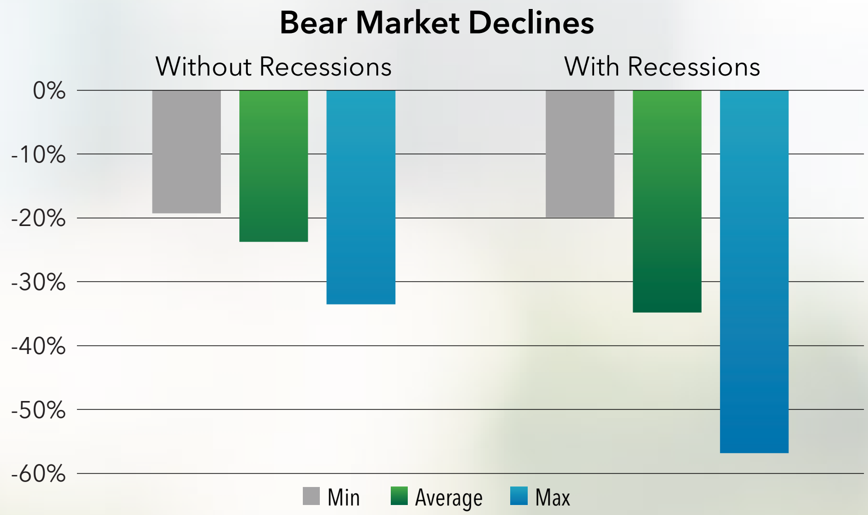
Equities – Opportunities and Risk

The stock market downturn this year has been a result of lower valuations rather than a profit decline. As of June 30, the S&P 500 was trading on a Forward Price to Earnings (P/E) ratio of 15.8x. For comparison purposes, the valuation multiple was above 20x for most of last year.[19]

Market opportunities may differ based on geography (U.S. and international), style (value and growth) and market cap (size). We believe there is an opportunity for long-term investors in small and mid-cap (SMID) stocks. As illustrated in the "U.S. Market Cap Valuations" graph, SMID cap stocks are trading at their largest valuation discount in the last 15 years. This valuation anomaly may require patience and a longer time horizon as this equity asset class will likely lag if a recessionary environment unfolds.



Source: FactSet as of June 30, 2022; P/E - Price to Next 12 Month Earnings



Source: LPL Research and FactSet as of May 13, 2022

Equities – Prior Bear Markets

In June, U.S. equities entered a bear market, which is defined as a 20% decline from the market peak, in January. A review of historical bear markets shows a distinct difference in returns and longevity based on the level of economic activity. As illustrated in the "Bear Market Declines" chart, the average price drop is more severe in a recession at -35% vs. -24% without a recession. Historically, the decrease in corporate earnings in an economic downturn often leads to additional price declines.

The length of a bear market also may vary based on the economic environment. In recessions, the market typically declines for an average of 15 months vs. a seven-month period in economic expansions.[20] In 2022, we have experienced a loss of -23.6% in the S&P 500 since the market peak.[21] Based on history, further price declines seem probable only if inflation stays persistent and a recession occurs.

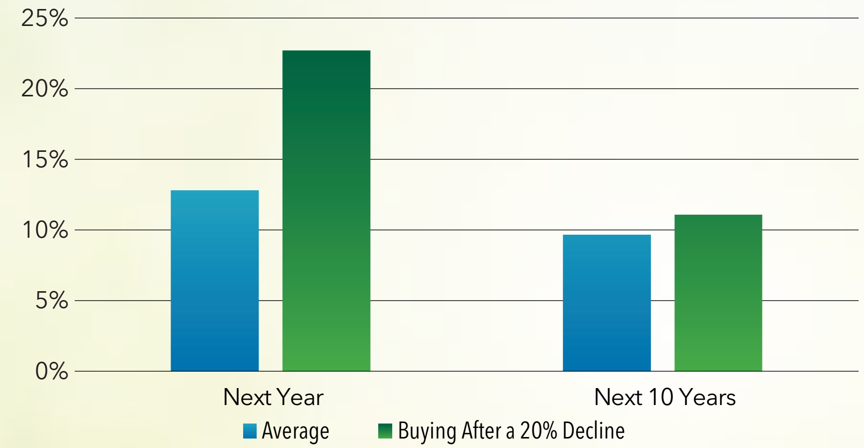
Asset Allocation

We believe there is considerable risk in the macroenvironment with high inflation and aggressive Federal Reserve monetary tightening. Consumer confidence and small business sentiment are at low levels as inflation impacts all individuals and companies. The risks are well-known, and the result has been a decline in bond and equity prices. Second half returns in both asset classes will likely depend on future economic data, particularly the outlook for inflation.

Investors often benefit from maintaining a disciplined approach in asset allocation and staying invested when risks are high. As shown in the "Buying After the Market Drops 20%" graph, investors have historically been rewarded by buying equities after a significant downturn. Although there may be more market risk if the U.S. enters a recession, long-term investors should consider adding equity exposure or, at the minimum, maintaining their current allocation. We believe the fixed income market is more attractive due to the increase in bond yields.

Buying After the Market Drops 20%

S&P 500 Annualized Total Return Since WWII



Source: Hulbert Ratings; June 15, 2022

We hope this year's Mid-Year Investment Update provides you with helpful insight. During times of change and volatility, we recommend checking in with your advisor team to discuss your financial goals and ask questions about the markets and portfolio strategy.

Kurt Spieler

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Chief Investment Officer
fnbo

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For 2022 Outlook asset class definitions, key terms and model definitions, please visit www.fnbo.com/outlookdefinitions.

Sources:

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18. FactSet; Earnings Insight as of June 10, 2022
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