



Market & Economic Update

2022 3rd Quarter

July 15, 2022

Market and Economic Outlook – July 15, 2022

- The high inflation rate has led to a stock market sell-off, which has brought valuations down to levels that make long-term investment more compelling.
- Individual investors have begun reducing their allocations to more risky assets indicating a market bottom is not far away but have not brought allocations down to levels that would suggest “capitulation” or market bottom. That means lower valuations may still be coming.
- The Federal Reserve is now committed to reducing the demand created by the stimulus and keeping interest rates too low for too long. Engineering the so called “soft landing” by getting the stock market and housing prices to drop without causing a recession will be difficult.
- Labor and energy supply constraints remain, putting upward pressure on inflation.
- Recession fears are growing due to poor consumer sentiment but may be more indicative of an economy of haves and have nots. Strong retail sales are a positive sign for the economy. The interest rate yield curve has inverted flashing a recession warning sign, but that does not mean one is imminent.
- Household Net Worth indicates that the capacity to consume remains very high suggesting more growth may lie ahead. Industrial production has reached new highs indicating that U.S. manufacturers are overcoming supply chain constraints. Like retail sales, the return of airline travel to pre-pandemic levels suggests consumption remains robust even with higher prices.
- The elevated level of food prices globally and the steep appreciation of the dollar are two other issues to keep an eye on as either could also be economically disruptive.

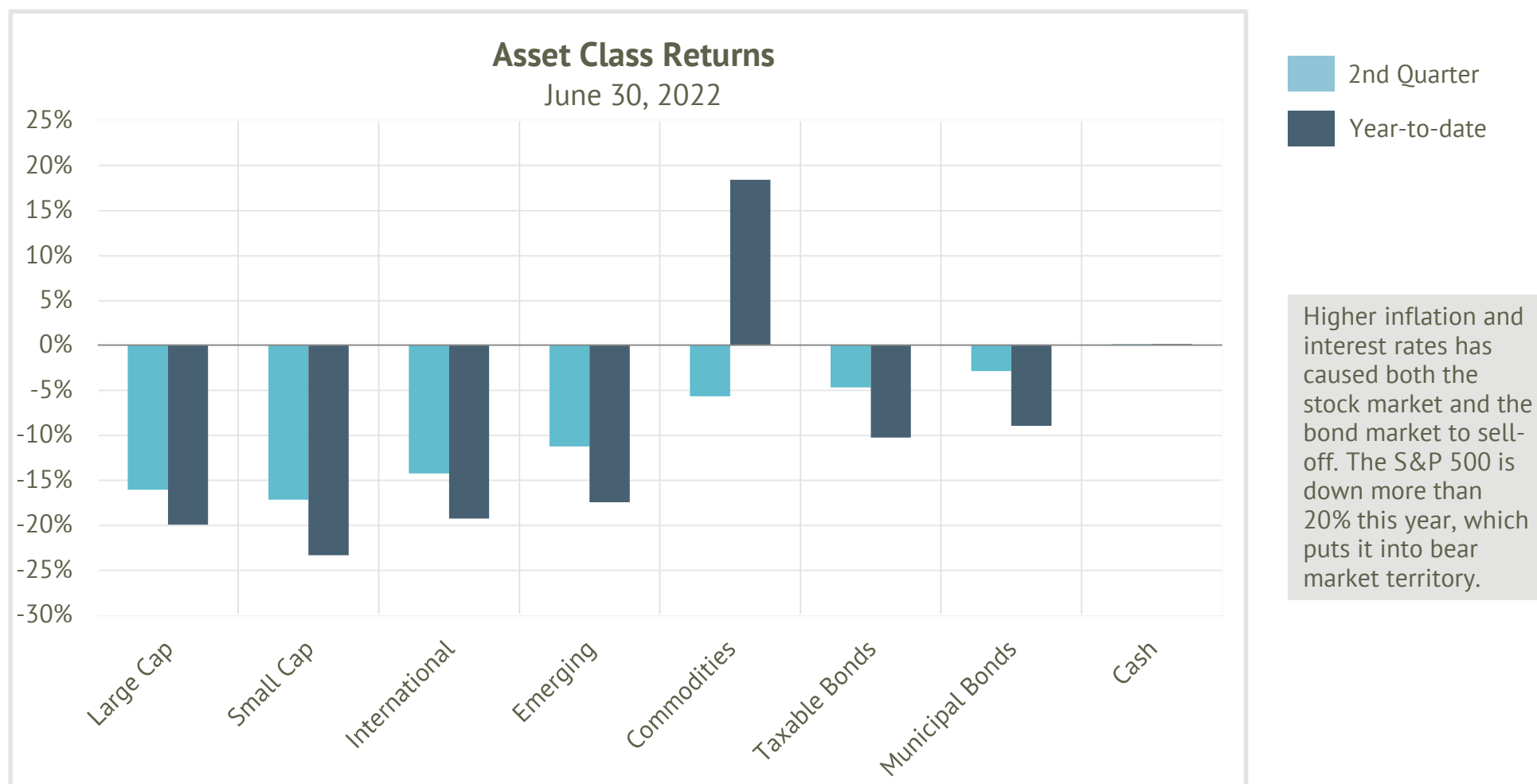


Conclusion: Given reasonable valuations, we suggest our clients gradually bring their more risky asset allocation up to their strategic target while keeping in mind the potential for further disruption and even lower valuations.

Apart from cash and equivalents, all the major asset classes were down significantly during the quarter.



Baird Family Wealth Group

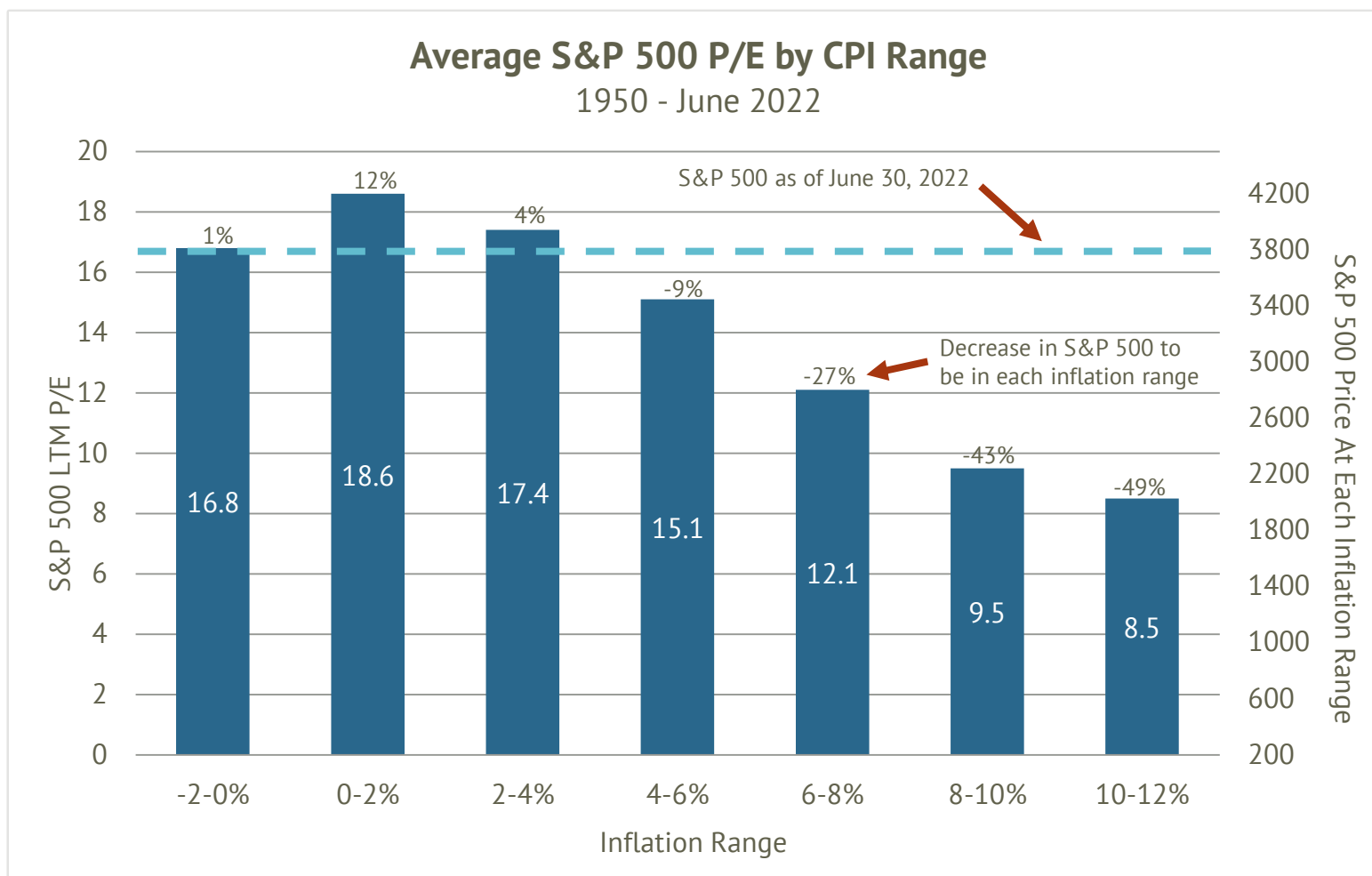


Source: Baird Market Chart Book. Data through June 30, 2022. More Risky asset classes: U.S. Large Cap is represented by the S&P 500 Index, U.S. Small Cap by the Russell 2000® Index, Developed International by the MSCI EAFE Index, Emerging Markets by the MSCI Emerging Markets Index, Commodities by the Bloomberg Commodity Index. Less Risky asset classes: Municipal Bonds by the Barclays Muni Bond Index, Taxable Bonds by the Barclays Aggregate Bond Index, Cash by the FTSE 3 Month T-Bills. See appendix for definitions. Past performance is not a guarantee of future results.

The high inflation rate has led to lower stock market valuations.



Baird Family Wealth Group



Based on 2022 earnings estimates, the stock market has become more reasonably valued assuming the inflation moderates to the 2 to 4% range.

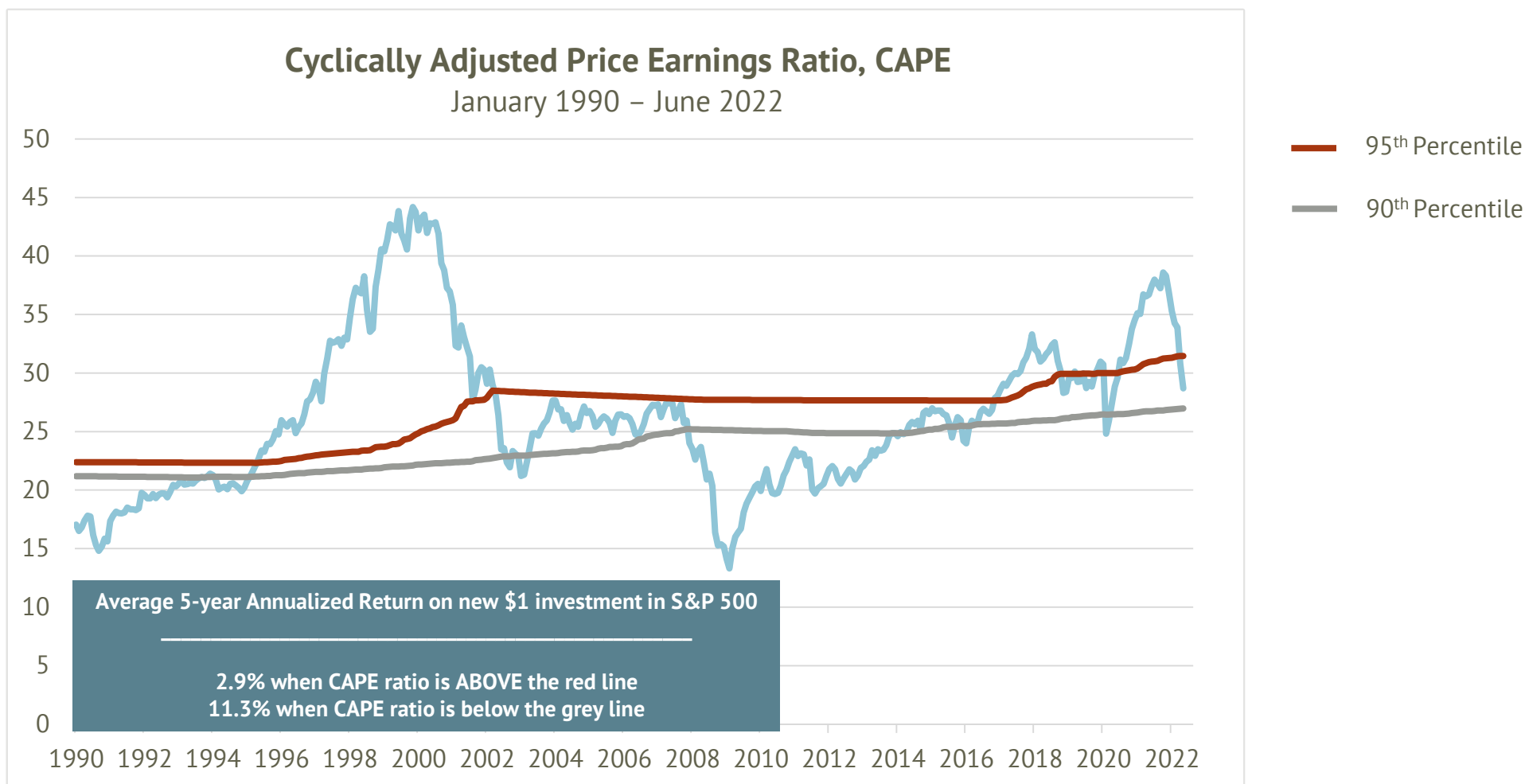
Should inflation persist at the current rate, a lower valuation would be warranted.

Source: Average S&P 500 P/E by CPI per Strategas Securities, LLC, a wholly owned subsidiary of Baird. Current PE and Current PE 2022 EPS Estimate per FactSet Earnings Insights, July 1, 2022.

The stock market sell-off has brought valuations down to levels that make long-term investment more compelling.



Baird Family Wealth Group

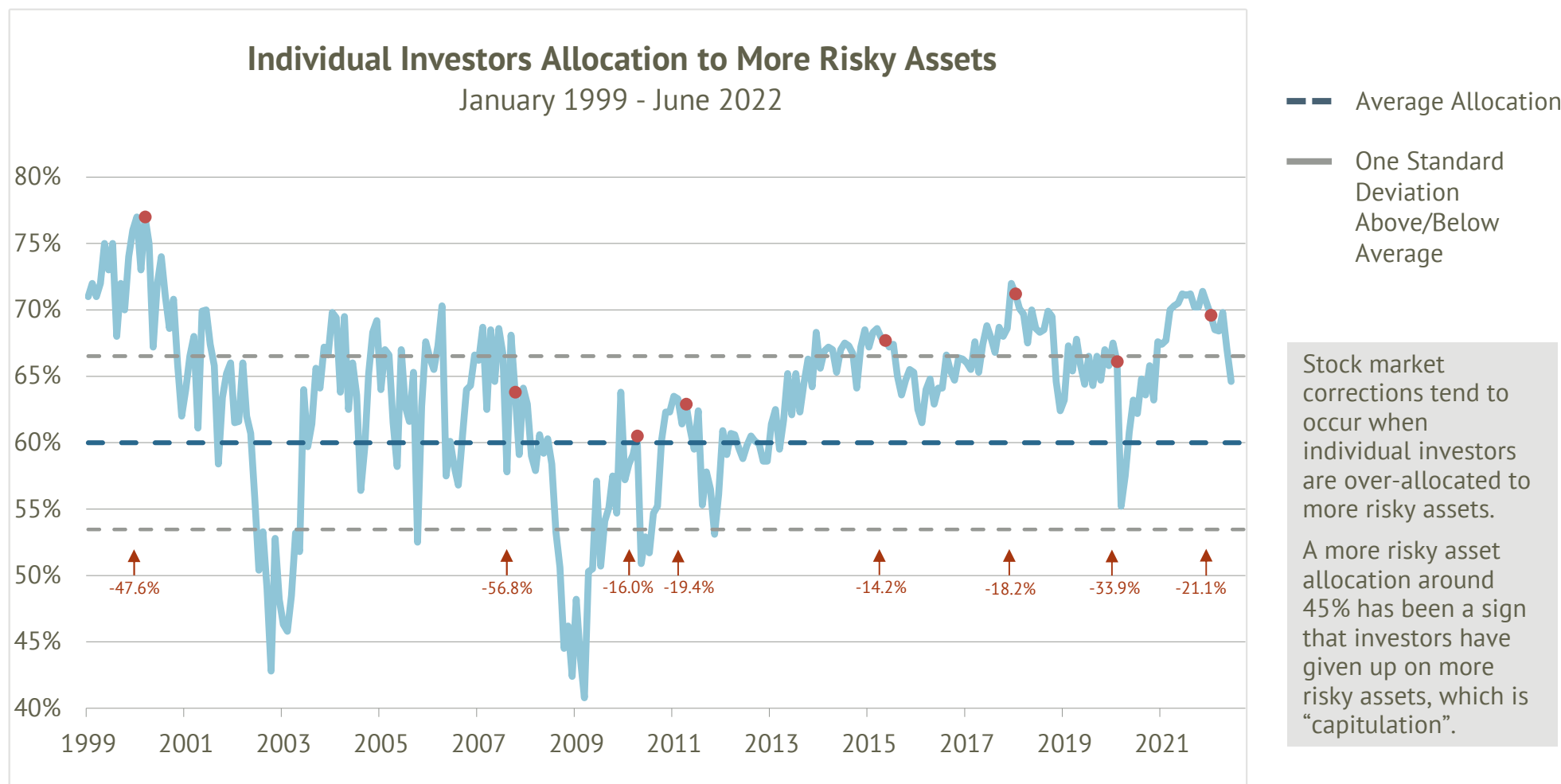


Source: Robert Shiller, Yale University, July 6, 2022. Analysis prepared by the Baird Family Wealth Group July 6, 2022.

Individual investors have begun reducing their allocations to more risky assets indicating a market bottom is not far away.



Baird Family Wealth Group

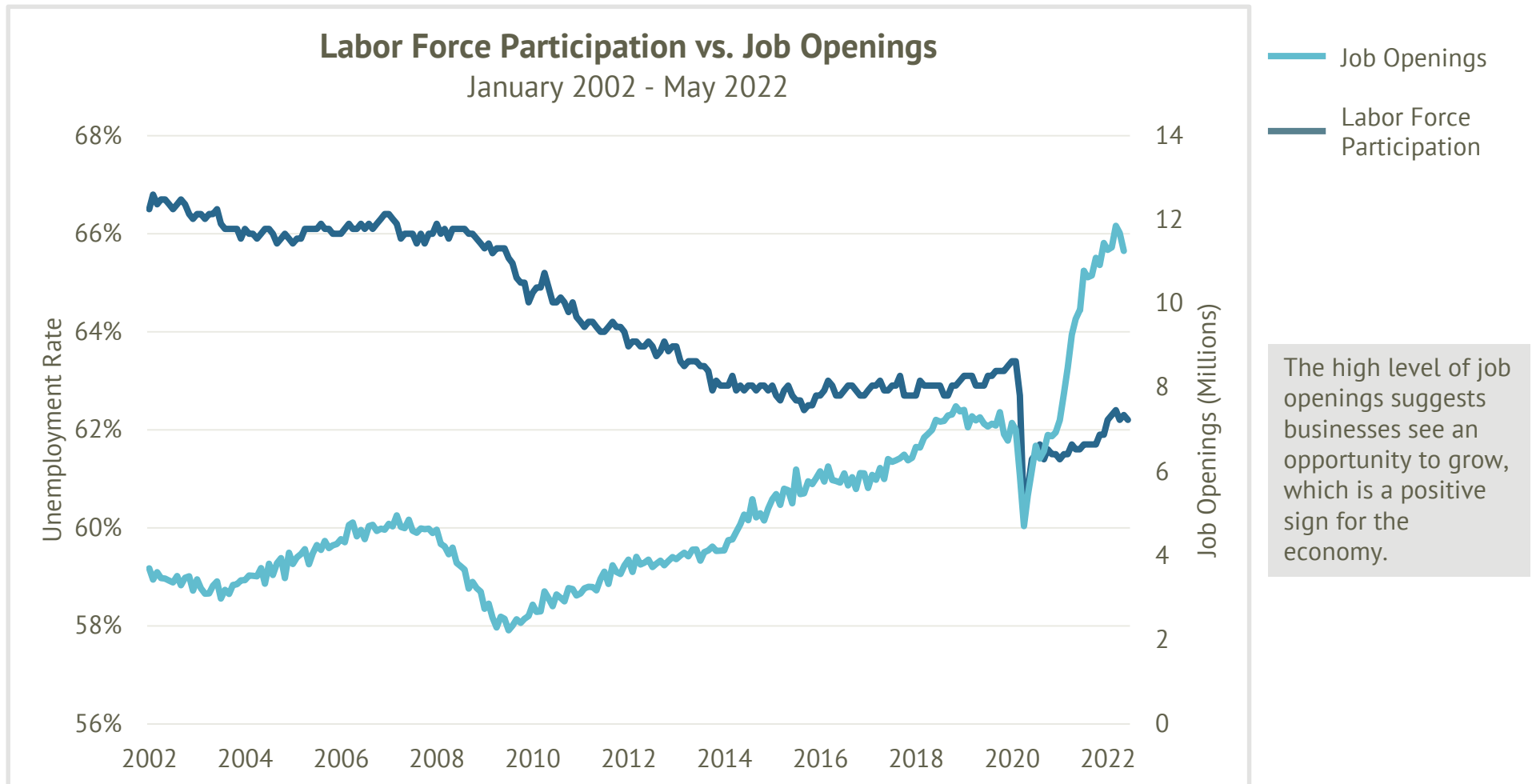


Source: American Association of Individual Investors Asset Allocation Survey, June 30, 2021. Analysis prepared by the Baird Family Wealth Group July 6, 2022. Stock market correction data retrieved from Yardeni Research, Inc. <https://www.yardeni.com/pub/sp500corrbeartables.pdf>

Labor supply has improved but remains below the pre-Pandemic level. Higher wages will be required to bring more people back to work, putting upward pressure on inflation.



Baird Family Wealth Group

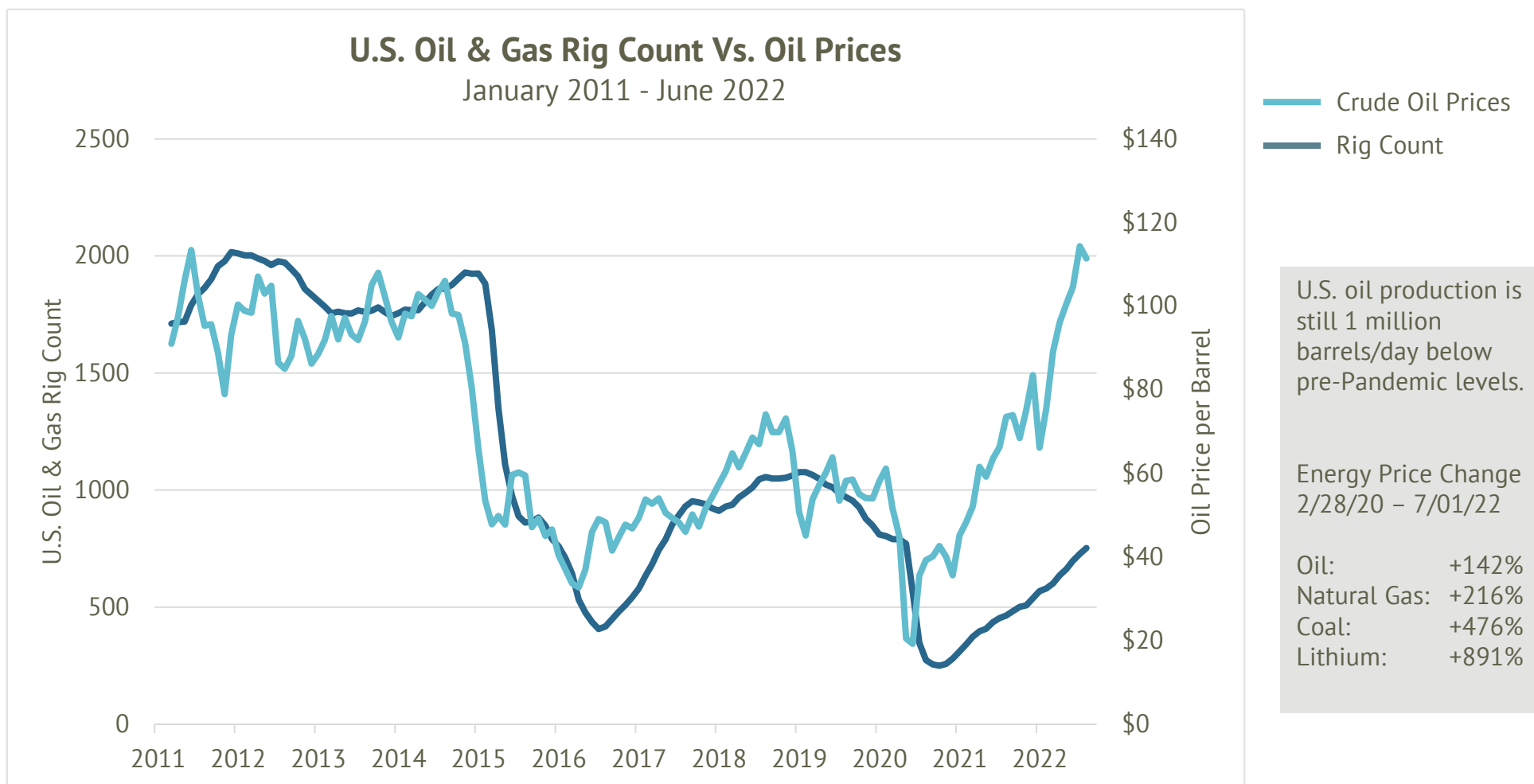


Source: U.S. Bureau of Labor Statistics, Job Openings: Total Nonfarm [JTSJOL], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/JTSJOL>, July 7, 2022. U.S. Bureau of Labor Statistics, Labor Force Participation Rate [CIVPART], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/CIVPART>, July 8, 2022.

Energy supply remains below pre-Pandemic levels putting upward pressure on inflation.



Baird Family Wealth Group

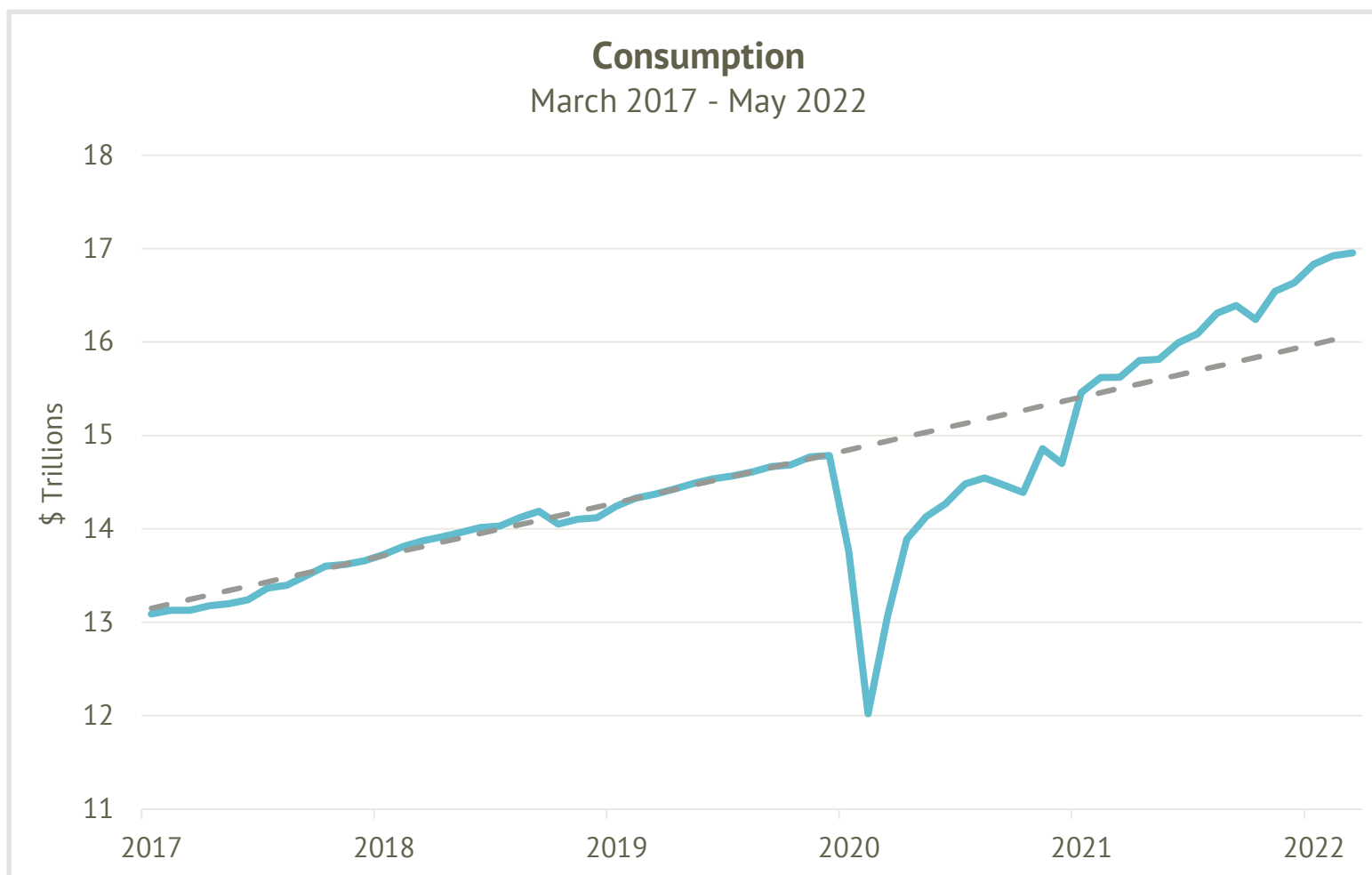


Source: U.S. Energy Information Administration, U.S. Crude Oil and Natural Gas Rotary Rigs in Operation (Count), retrieved from http://www.eia.gov/dnav/ng/hist/e_ertr0_xr0_nus_cm.htm. Crude Oil Prices: West Texas Intermediate (WTI) - Cushing, Oklahoma [DCOILWTICO], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/DCOILWTICO>, July 6, 2022. Commodity prices as of 6/30/2022 from Trading Economics

The Federal Reserve is now focused on reducing demand created by the pandemic stimulus money and the effects of keeping interest rates too low for too long.



Baird Family Wealth Group



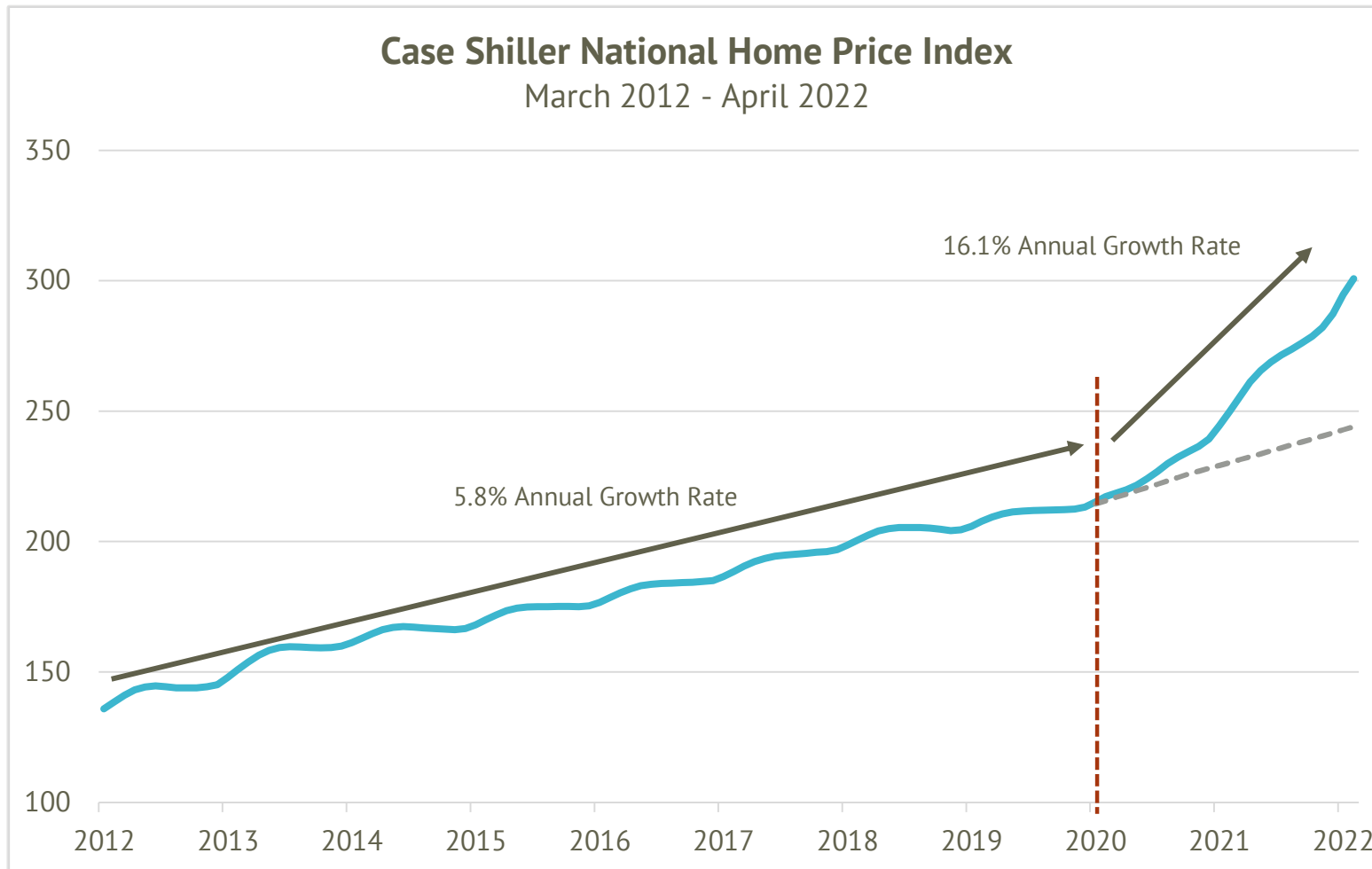
Consumption demand is about \$1 trillion higher than trend.

Source: U.S. Bureau of Economic Analysis, Personal Consumption Expenditures [PCE], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/PCE>, July 6, 2022.

Engineering the so called “soft-landing” by getting the stock market and housing prices to drop without causing a recession will be difficult to achieve.



Baird Family Wealth Group



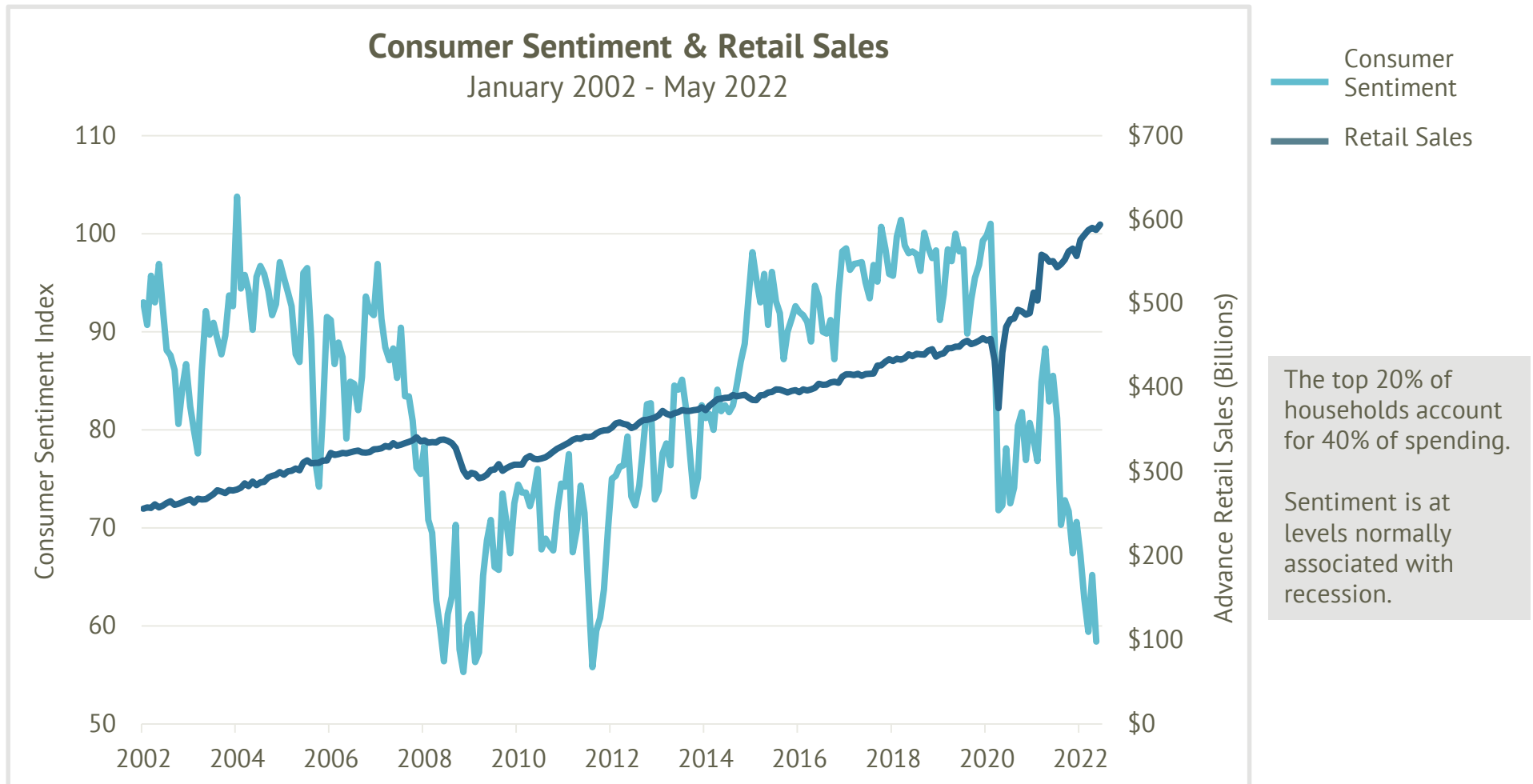
Based on the pre-pandemic growth rate of the Case Shiller National Home Price Index, the typical home price is 20% above where it would have been without the pandemic stimulus and interest rates being held too low for too long.

Source: S&P Dow Jones Indices LLC, S&P/Case-Shiller U.S. National Home Price Index [CSUSHPINSA], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/CSUSHPINSA>, July 12, 2022.

Recession fears are growing due to poor consumer sentiment but may be more indicative of an economy of haves and have nots. Strong retail sales are a positive sign for the economy.



Baird Family Wealth Group

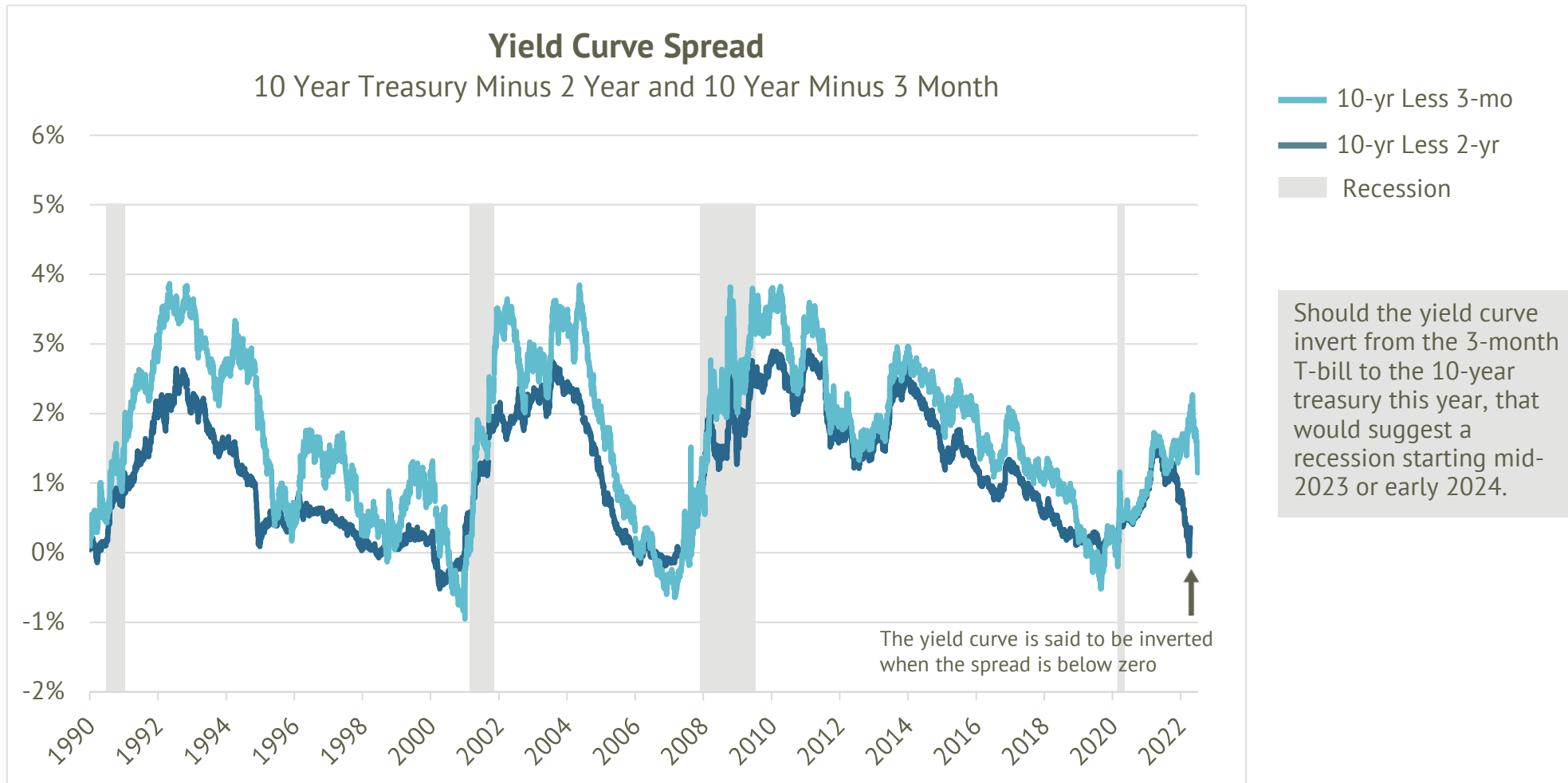


Source: U.S. Census Bureau, Advance Retail Sales: Retail Trade [RSXFS], retrieved from FRED, Federal Reserve Bank of St. Louis; [www.fred.stlouisfed.org](https://fred.stlouisfed.org), June 28th, 2022. University of Michigan, University of Michigan: Consumer Sentiment [UMCSENT], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/UMCSENT>, June 28, 2022.

The interest rate yield curve has inverted flashing a recession warning sign but that does not mean one is imminent.



Baird Family Wealth Group

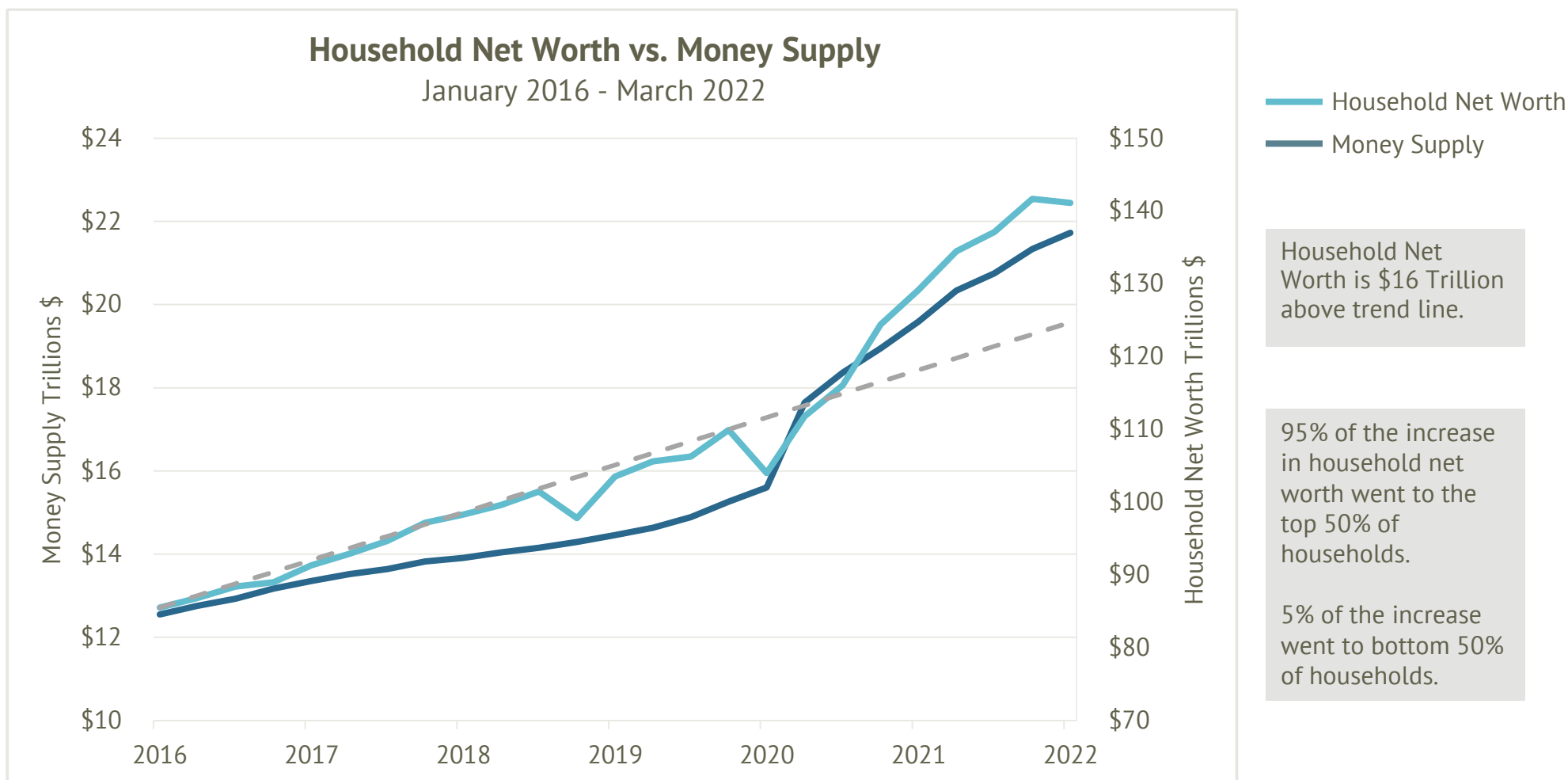


Source: Federal Reserve Bank of St. Louis, 10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity [T10Y2Y], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/T10Y2Y>, July 5, 2022.

Household Net Worth indicates that the capacity to consume remains very high suggesting more growth may lie ahead.



Baird Family Wealth Group

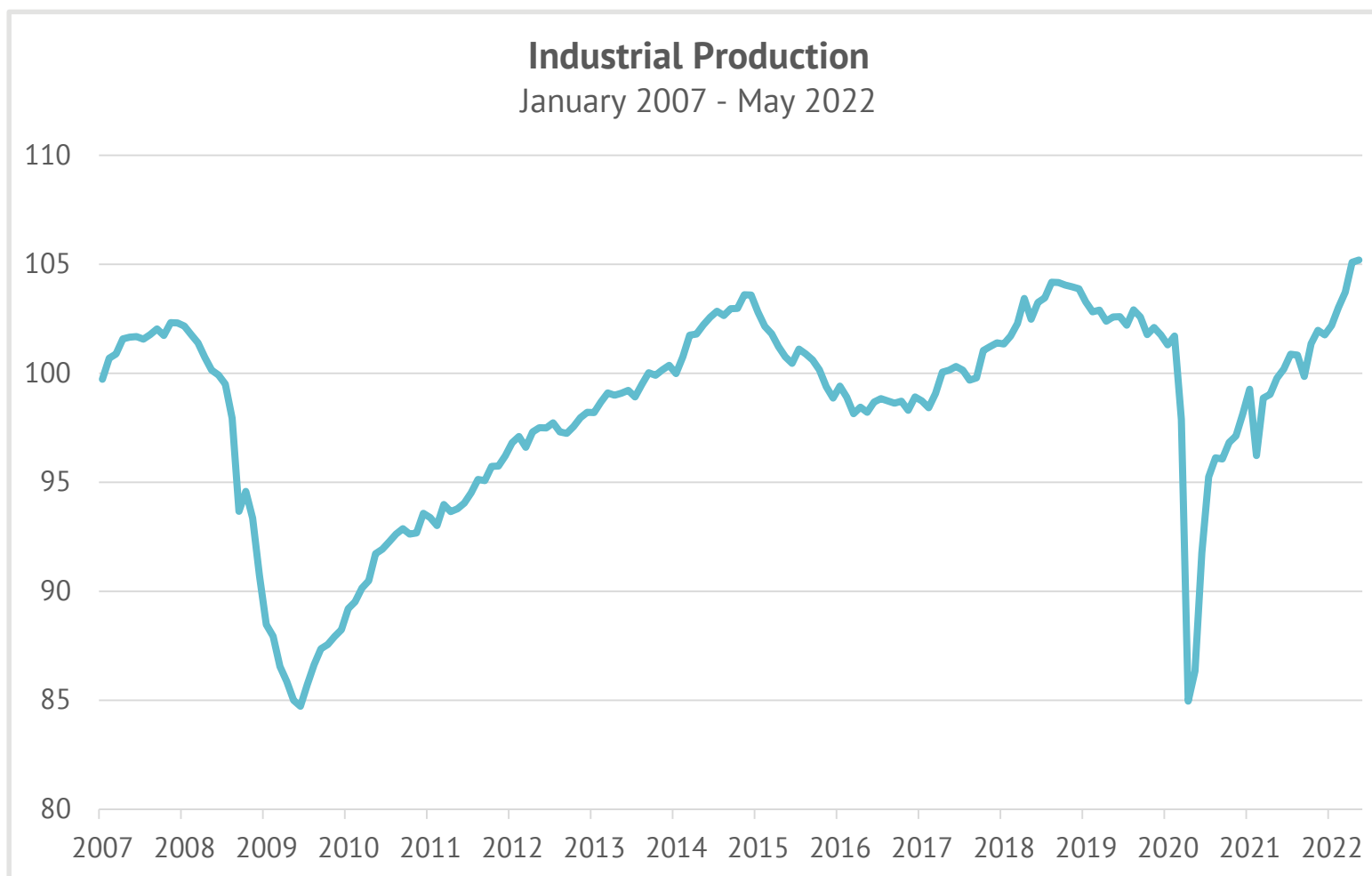


Source: Board of Governors of the Federal Reserve System, Households; Net Worth, Level [BOGZ1FL192090005Q], M2 [WM2NS], U.S. Bureau of Economic Analysis, Personal Consumption Expenditures [PCE], retrieved from FRED, Federal Reserve Bank of St. Louis; www.fred.stlouisfed.org, June 9, 2022.

Industrial production has reached new highs indicating that U.S. manufacturers are overcoming supply chain constraints.



Baird Family Wealth Group



Source: Board of Governors of the Federal Reserve System (US), Industrial Production: Total Index [INDPRO], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/INDPRO>, June 28, 2022.

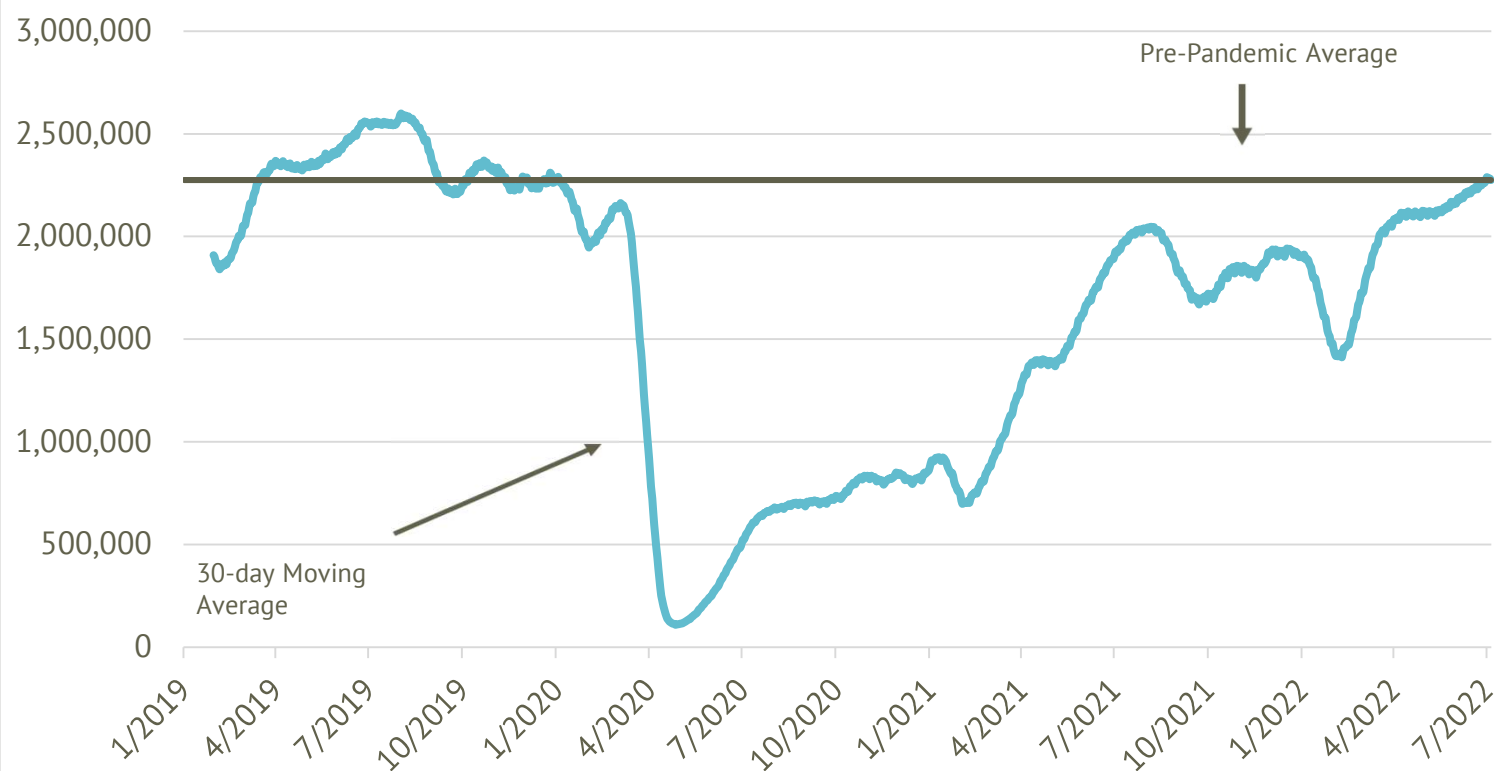
Airline travel has returned to pre-pandemic levels suggesting the consumption remains robust even with higher prices.



Baird Family Wealth Group

TSA Checkpoint Daily Passenger Travel

January 1, 2019 - July 5, 2022



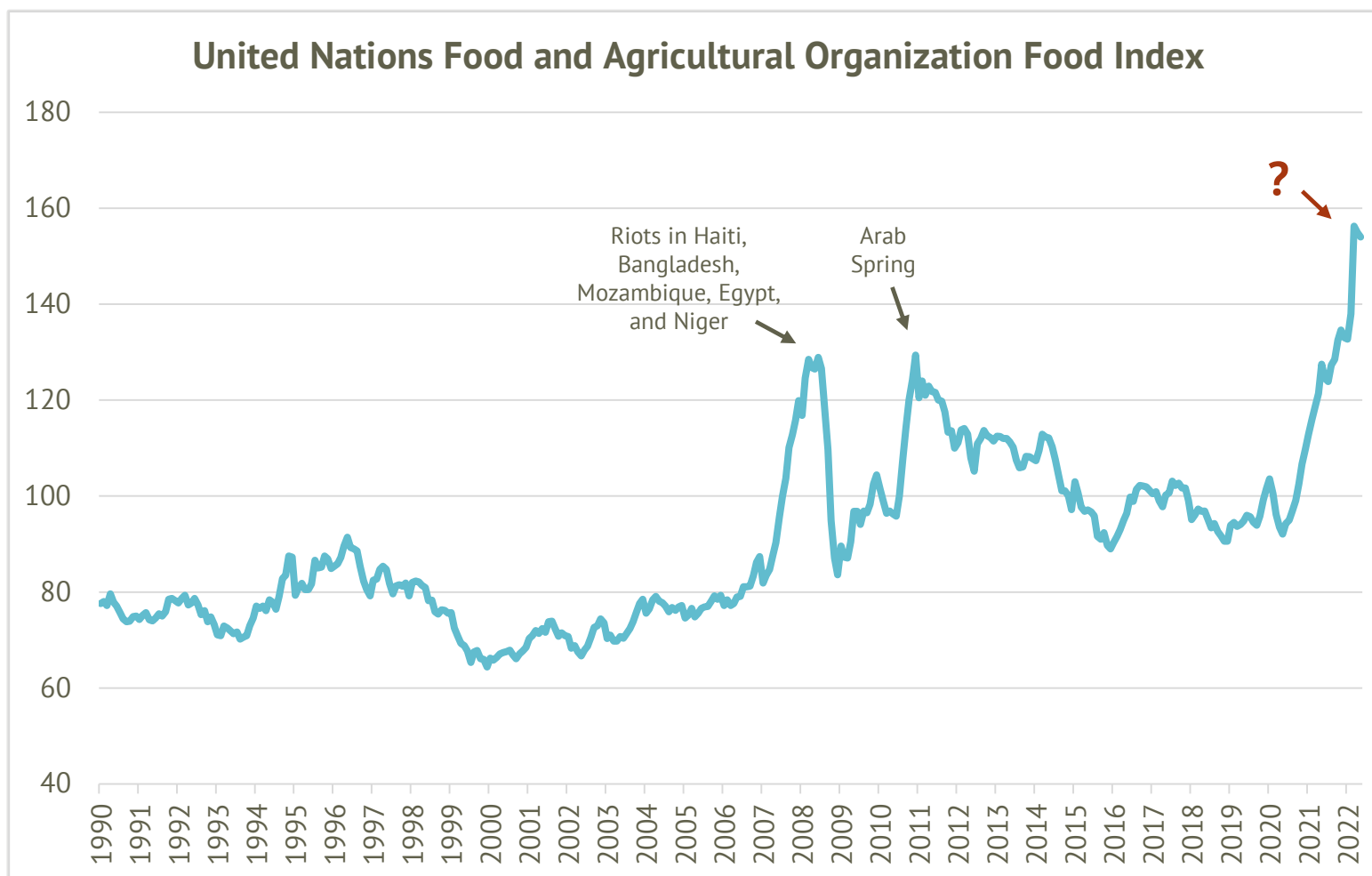
Average airfares are 25% higher than pre-Pandemic levels.

Source: TSA, July 6, 2022.. Airfares from U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: Airline Fares in U.S. City Average [CUSR0000SETG01], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/CUSR0000SETG01>, June 30, 2022.

The fall-out from very high global food prices could be very destabilizing and cause interruptions to the supply of commodities important to the U.S. economy.



Baird Family Wealth Group



Source: Food and Agriculture Organization of the United Nations. FAO Food Price Index. Retrieved July 6, 2022.

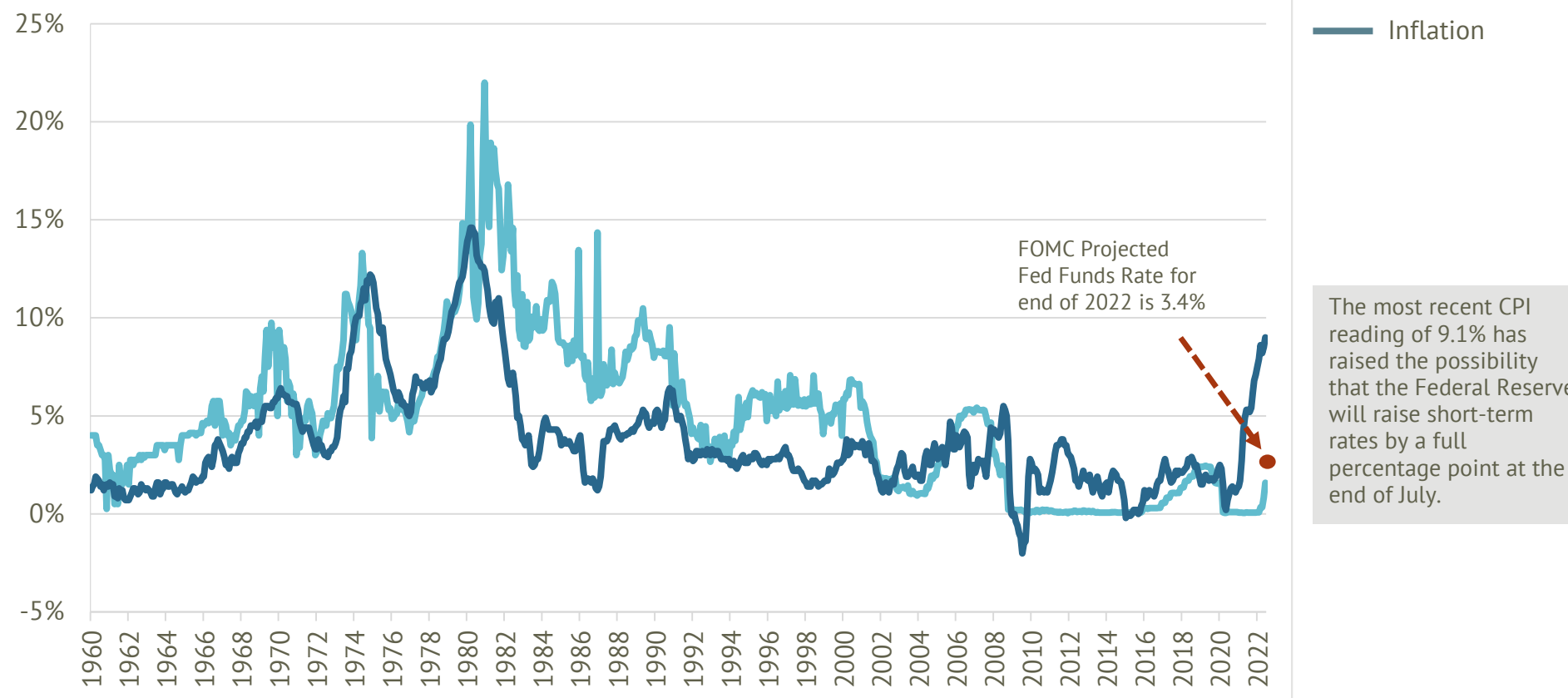
High rates of inflation and the potential for significantly higher interest rates are the main concern.



Baird Family Wealth Group

Inflation Vs. Federal Funds Rate

January 1960 - June 2022



Source: Board of Governors of the Federal Reserve System (US), Federal Funds Effective Rate [DFF], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/DFF>. Inflation is shown as measured by CPI. US. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average [CPIAUCSL], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/CPIAUCSL> July 13, 2022.

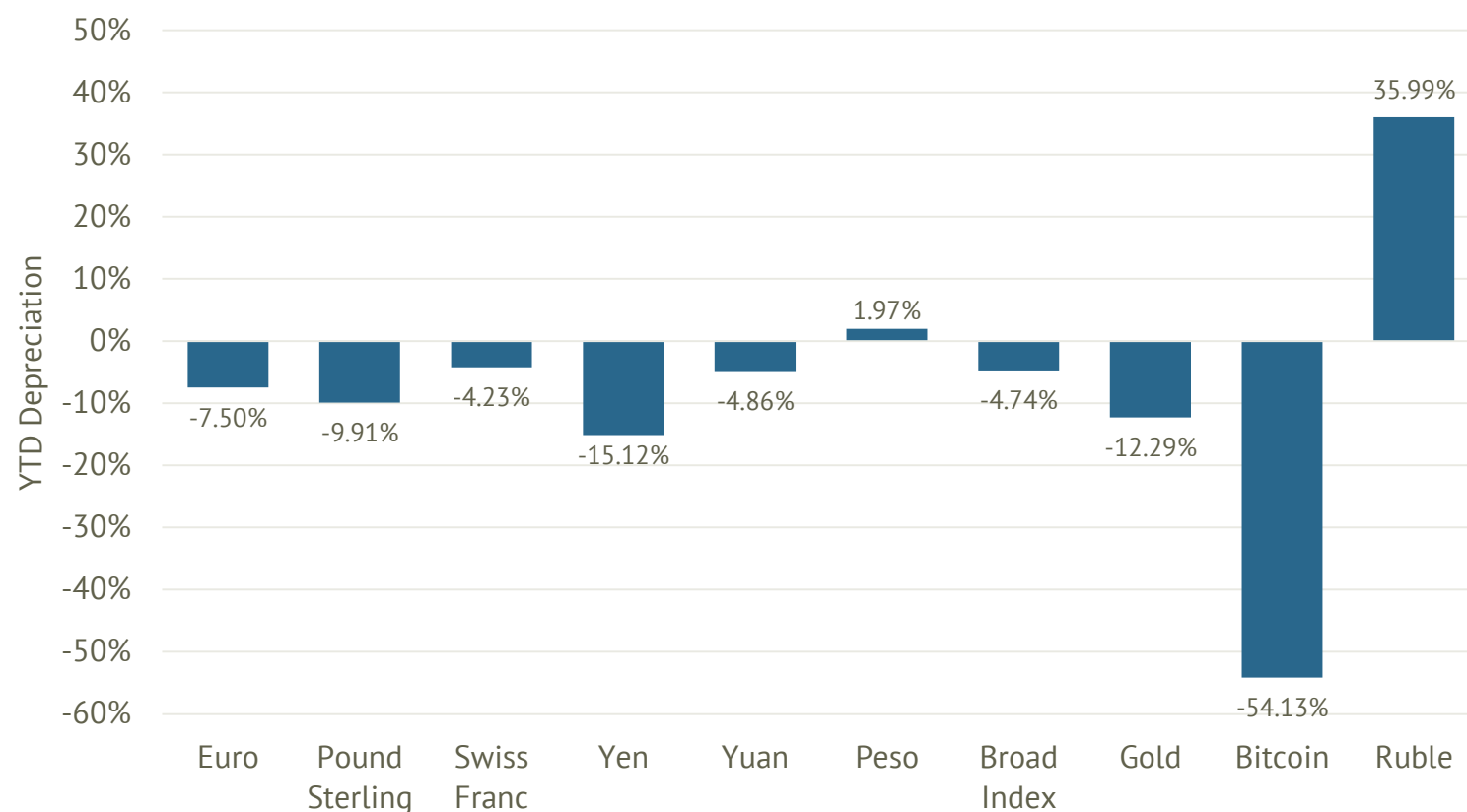
The dramatic depreciation of most major currencies against the dollar could trigger a ripple effect impacting U.S financial markets.



Baird Family Wealth Group

Foreign Currency Exchange Rates

YTD % Change as of June 30th



The global derivatives market is over \$600 trillion in notional value with about \$500 trillion related to interest rates and \$100 trillion related to currency.

Just as speculators were caught on the wrong side of cryptocurrency derivatives, it is likely some are caught on the wrong side of other currency.

Source: Board of Governors of the Federal Reserve System (US), Japanese Yen to U.S. Dollar Spot Exchange Rate [DEXJPUS], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/DEXJPUS>. U.S. Dollars to Euro Spot Exchange Rate [DEXUSEU], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/DEXUSEU>. Chinese Yuan Renminbi to U.S. Dollar Spot Exchange Rate [DEXCHUS], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/DEXCHUS>. U.S. Dollars to U.K. Pound Sterling Spot Exchange Rate [DEXUSUK], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/DEXUSUK>. Swiss Francs to U.S. Dollar Spot Exchange Rate [DEXSZUS], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/DEXSZUS>. June 30, 2022. Coinbase, Coinbase Bitcoin [CBBTCUSD], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/CBBTCUSD>, July 1, 2022. Russian Ruble/U.S. Dollar per Wall Street Journal. Data sourced from Factset. June 30, 2022. Commodity prices as of 6/30/2022 from Trading Economics.

Summary

- Weak equity returns as investors raise concern about continued inflation and potential recession
- Fixed income down on increased yields, due to inflation
- Poor consumer sentiment is more a sign of an economy of haves and have nots than it is of a recession.
- Growth softening but recession not seen as imminent
- Consumer remains strong with strong job market and household net worth
- The Federal Reserve has a ways to go to reverse the effects of stimulus and keeping interest rates too low for too long
- Keep an eye on global food prices and currency as sources of potential economic disruption

What to do now?

- Look for opportunity to invest cash opportunistically but cautiously
- Favor value stocks versus growth stocks as inflation hurts growth stocks more
- Favor energy, emerging markets, and precious metals as a hedge against inflation and potential dollar reversal
- Look for tax loss selling opportunities

Please call, or email
with any questions:

Chris Didier
O: 414-765-7095
C: 262-751-7001

cdidier@rwbaird.com