viewpointe

A Horizon Trust & Investment Management Publication

HORIZON

ISSUE NO. 77, THIRD QUARTER 2022

Economic Review

The major story in the economy continues to be high inflation. The U.S. Consumer Price Index (CPI) rose 1.0% month-over-month and 8.6% year-over-year (a new high) in May. The U.S. core CPI, which excludes the more volatile categories of food and energy, rose 0.6% m/m and 6.0% y/y. These figures all surprised to the upside. Everyone reading this has assuredly experienced these price spikes firsthand at the gas pump and the grocery store. The May CPI report ended the idea that peak inflation had been reached, at least for now, and is forcing the Fed to ratchet up its monetary policy tools to stamp out inflation. For broad-based inflation to develop like it has, the Fed clearly erred by being late in the game. Fed officials have admitted that they were too slow to tighten and are now trying to front-load rate increases in the most aggressive policy shift in decades.

In his recent testimony before the Senate Banking Committee, Federal Reserve Chair Jerome Powell said that the American economy is very strong and well positioned to handle tighter monetary policy. He also acknowledged that while recession is a possibility, it is not the Fed's intended outcome at all. Chairman Powell stated that the Fed is not trying to provoke a recession, and the Fed does not believe it needs to provoke a recession to bring inflation down.

There are several indicators that point to a potential slowdown in the economy. The University of Michigan's gauge of consumer sentiment hit a record low in June. Mortgage applications have fallen sharply due in part to high home prices and rapidly rising mortgage rates. Lumber prices and vehicle sales also declined in May. Global supply shocks (COVID lockdowns in China, Russia-Ukraine conflict) are still in play as well.

There are some reasons for optimism however. U.S. labor market data continues to be strong. The U.S. economy added 390,000 jobs in May which was more than expected, and the unemployment rate held at 3.6%, just above the lowest level since 1969. Based on history, the U.S. economy doesn't typically go into a recession without weakness in the labor market. In addition, Americans are still sitting on $2 trillion in accumulated savings from previous stimulus funds. These factors make it difficult to see a sharp downturn immediately.

In summary, recession pressures are building. The economy is facing drags from the end of government pandemic aid, higher mortgage rates, and declining consumer confidence. In addition, the recent surge in recession talk could induce business caution, pushing the economy closer to a downturn. At this time, the odds of a recession in the US seem to be rising. However, if we do experience a recession it is likely to be mild, especially when compared to the two most recent recessions we have endured.

Market Commentary

The equity markets continue to be volatile. The S&P 500 entered a bear market on June 13th. A bear market is defined as a price decline of 20% or more in the S&P 500. There have been 26 bear markets in the S&P 500 since 1928 and the average duration has been 289 days, or about nine and a half months, from "peak to trough". More recently, the 14 bear markets since World War II have averaged 359 days, or close to a year. If the more recent scenario played out exactly according to the average, it would put the bear market bottom at the beginning of 2023, a year after January's peak. However, we know that things rarely go to plan when dealing with the market.

A bear market can often go hand in hand with a recession, but that is not always the case. In the 12 recessions since World War II, nine were accompanied by a bear market. However, there have been 26 bear markets since 1928 and only 15 recessions.

Market volatility has not spared the fixed income market. Bonds are typically negatively correlated to stocks. Fixed income assets usually provide protection to investors and act as a ballast in a portfolio when stock prices fall. However, in May, stocks and bonds entered a simultaneous correction (decline of 10% or more) for the first time in more than 50 years. This is a very unusual situation, but the combination of rising interest rates and record-high inflation has put significant pressure on both asset classes for the first time in decades.

The good news for bonds is that rising rates are starting to positively impact bond yields, but it takes time for the income component of bond return to offset the losses from price volatility. In the long term, income will always be the primary driver of bond total return.

In conclusion, we expect volatility to be present for the remainder of the year. Many of the sources we follow do not believe we have seen a market bottom yet on the equity side, though we may be closer to a bottom on the fixed income side.

Asset Allocation

After holding on to a larger cash position resulting from capital gains distributions received at the end of 2021, we decided to put that money to work in the second quarter. We performed a global rebalance in the second quarter, sticking with our current equity and fixed income targets but simply rebalancing accounts back to those targets. We wanted to take advantage of the double digit (percentage) decline in the market at that point and put that extra cash to work with the thought that no one has a crystal ball and it is impossible to predict when the actual market bottom will be.

On the individual stock portfolio front, we removed two names from our guidance list which no longer met our stock screen parameters. We replaced those names with a dividend-paying stock ETF. Dividend paying stocks have held up very well this year compared to the S&P 500 index and we liked the idea of adding to our dividend paying stock ETF as a stabilizer for the portfolio.

Opportunities in the individual fixed income space have improved. We have seen yields rise across the board in CDs and bonds. We have especially seen attractive opportunities in the investment grade corporate bond space.

Financial Planning – Establishing a Financial Safety Net

In times of crisis, you don't want to be shaking pennies out of a piggy bank. Having a financial safety net in place can ensure that you're protected when a financial emergency arises. One way to accomplish this is by setting up a cash reserve, a pool of readily available funds that can help you meet emergency or highly urgent short-term needs.

How much is enough?
Most financial professionals suggest that you have three to six months' worth of living expenses in your cash reserve. The actual amount, however, should be based on your particular circumstances. Do you have a mortgage? Do you have short-term and long-term disability protection? Are you paying for your child's orthodontics? Are you making car payments? Other factors you need to consider include your job security, health, and income. The bottom line: Without an emergency fund, a period of crisis (e.g., unemployment, disability) could be financially devastating.

Building your cash reserve
If you haven't established a cash reserve, or if the one you have is inadequate, you can take several steps to eliminate the shortfall:

- Save aggressively: If available, use payroll deduction at work; budget your savings as part of regular household expenses
- Reduce your discretionary spending
- Use earnings from other investments (e.g. stocks, bonds, or mutual funds)

Where to keep your cash reserve
You'll want to make sure that your cash reserve is readily available when you need it. There are several excellent vehicles you may use, each with unique advantages. For example, short-term CDs typically offer higher interest rates than savings accounts with the same FDIC insurance coverage.

It's important to note that certain fixed-term investment vehicles (i.e., those that pledge to return your principal plus interest on a given date), such as CDs, impose a significant penalty for early withdrawals. So, if you're going to use fixed-term investments as part of your cash reserve, you'll want to be sure to ladder (stagger) their maturity dates over a short period of time. This will ensure the availability of funds, without penalty, to meet sudden financial needs.

Review your cash reserve periodically
Your personal and financial circumstances change often -- a new child comes along, an aging parent becomes more dependent, or a larger home brings increased expenses. Because your cash reserve is the first line of protection against financial devastation, you should review it annually to make sure that it fits your current needs.