MARKET OBSERVATIONS
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SCHLINDWEIN ASSOCIATES
INVESTMENT COUNSEL

Into the Fog

Forecasting future economic activity always is shrouded in fog. At this particular time, the fog seems thicker than usual. The contributing factors weighing on forecasts are relatively clear – ongoing supply chain disruptions, labor shortages, virus-induced China slowdown, energy price pressure, rising interest rates. Slower growth, higher inflation and rising interest rates each have implications for financial market outcomes. For stock markets, levels of earnings and price multiples are impacted. For bond markets, interest rate risk and credit risk are affected. A review of recent trends and current forecasts can provide perspective for investing into the fog ahead.

PERSPECTIVE

Recent trends and current forecasts for real economic growth are shown in Chart I. The extremes from the pandemic are notable as is the robust bounce back in 2021. A much different picture has emerged since with quarterly declines in each of the first two quarters this year. Well-below growth rates are forecasted for the balance of 2022 and for all of 2023. Growth is projected to rise slowly but the resulting full year increases of 0.0% and +1.0% for 2022 and 2023 respectively leave little room for error and an outright recession. Indeed the odds of a recession in the period ahead are above average for the U.S. and average for the global economy.

High inflation at levels not seen in over four decades has brought new concerns and pressures around the world. Individuals are under siege as wages have not kept pace. Some businesses have been able to offset the impact of rising input costs, but others have not and the task has become more difficult. Prices at sufficiently high levels beget demand destruction, i.e., lower sales resulting in lower profits let alone lower margins. While attention has been focused on the Consumer Price Index, the broader measure of inflation in Chart II tells the economy-wide story. The persistence of higher inflation to date now is reality. The forecasted material decline ahead is made amidst much current uncertainty.

Focus is on central banks around the world who are charged with maintaining price stability while fostering employment and growth. Many, including the U.S. Federal Reserve, were slow to react with policy changes in the face of rising inflation. As inflation turned from transitory to persistent, the Fed has quickened the pace of tightening monetary policy with consecutive increases in its policy rate. Chart III shows the rate increases from pandemic lows and the expectation that rates will level off in 2023. Two challenges are at hand: raising rates sufficient to cover inflation; and slowing inflation without triggering a recession. Adding to the fog for the Fed is its quantitative tightening with uncertainty as to the impact on either inflation or growth.

CHART I

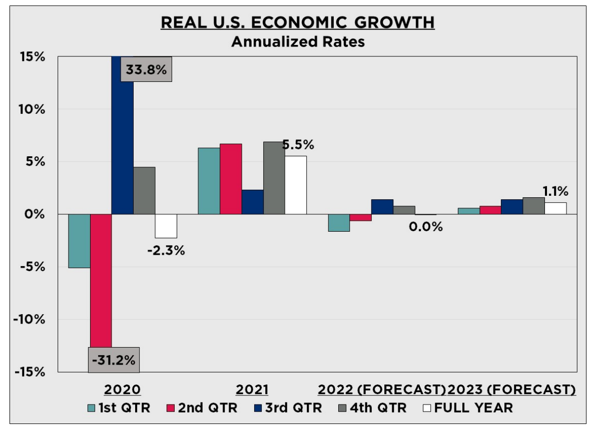


CHART II

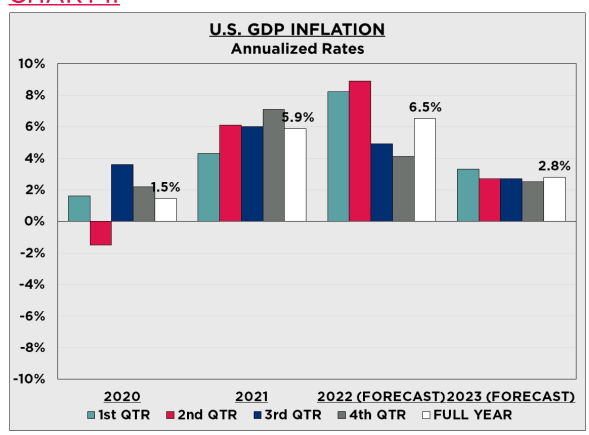
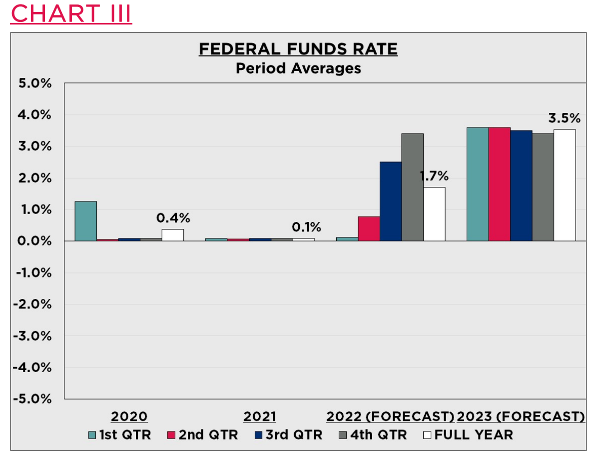


CHART III



INVESTMENT IMPLICATIONS

Looking into the fog of an uncertain future is the plight of investors. Amidst such uncertainty are multiple outcomes, each of which must be assessed with clear-mindedness. No matter the level of uncertainty, investment outcomes have low odds of success with fogginess about how and why one is investing. There should be no uncertainty over proven investment disciplines and their application. Nor should there be lack of clarity over investment goals, time horizons or risk tolerances. Then one can look into the fog with confidence.