Introduction

The stock market experienced significant volatility in the first half of the year with the S&P 500 down 20.6%. Much of these downward trends can be attributed to a combination of Federal Reserve rate tightening and declining investor confidence. Even after the recent rout of tech stocks (the tech-heavy NASDAQ is down 29.5%), the top 6 holdings in the S&P 500 still make up 22% of the index, and 5 out of 6 of those holdings (TSLA is the only "non" technology stock out of those 6) are technology names, which typically experience a relatively high negative correlation with interest rates due to their terminal values representing a higher proportion of overall enterprise value. Despite the interest rate headwinds for the "growth" style, it is still overvalued compared to its 20-year average. Currently "growth" is at a current P/E of 21.3 as compared to the 20-year historical average of 18.5. Comparatively, "Value" is at a discount with a current P/E of 12.9 as compared to the 20-year historical average of 13.7.

Current P/E vs. 20-year avg. P/E

	Value	Blend	Growth
Large	12.9 / 13.7	15.9 / 15.5	21.3 / 18.5
Mid	12.4 / 14.4	14.3 / 16.3	19.9 / 20.3
Small	13.6 / 16.9	17.1 / 21.4	22.9 / 35.4

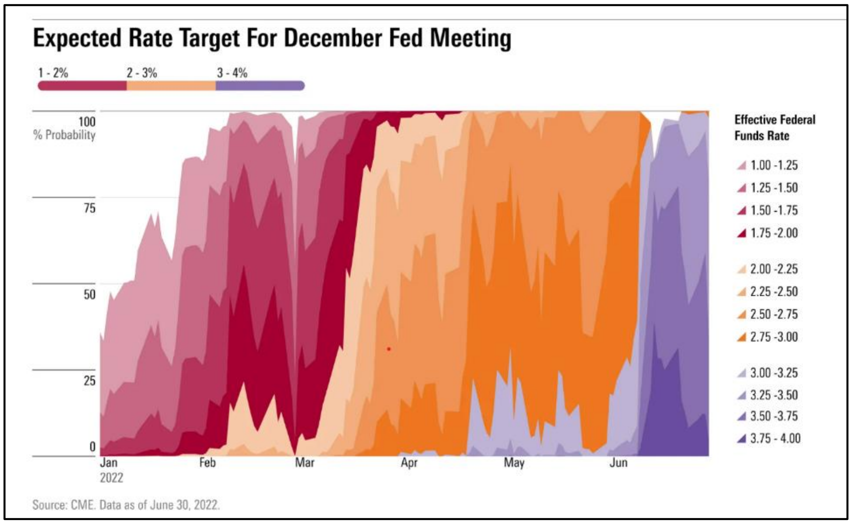
Current P/E as % of 20-year avg. PE

	Value	Blend	Growth
Large	94.0%	103.1%	114.9%
Mid	86.3%	87.7%	98.2%
Small	80.2%	80.0%	64.8%

There has been a great deal of debate on whether the US is moving towards a recession, or even if it is already in one. The US economy unexpectedly contracted in the first quarter of 2022 and overall market consensus, as well as numerous projections based on intra-quarter data, suggest the second quarter will contract as well. The Atlanta Federal Reserve recently published a preliminary projection of -2% GDP growth for the second quarter of 2022. Despite these negative headlines, there is still some hope for a "soft landing". The market in the second half of the year will be driven largely by the ability of the US economy to execute the "soft landing" and by midterm elections. We decompose the driving factors of this below.

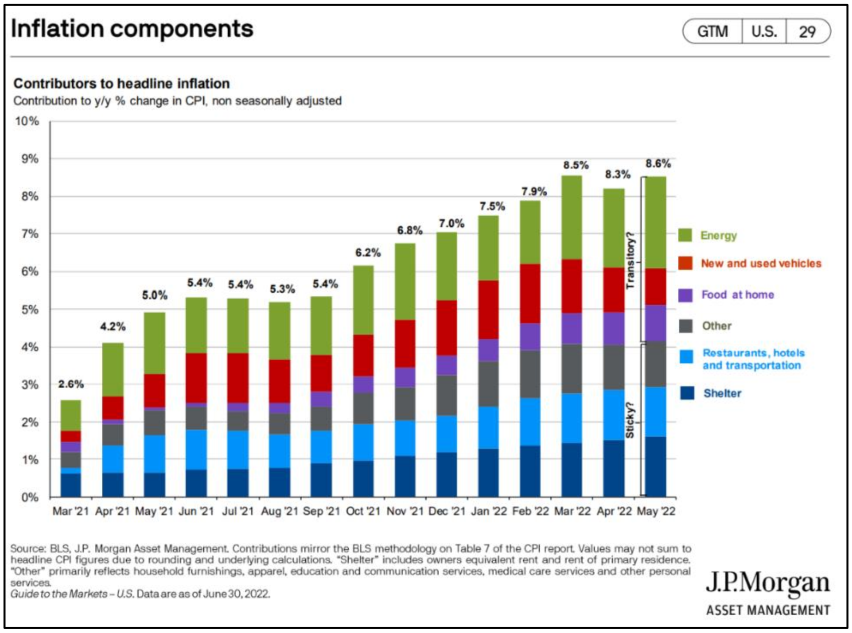
Rate Uncertainty Making a Challenging Forecasting Environment for Market and Capital

The federal reserve acted aggressively in the June FOMC meeting, raising the fed funds rate by 75 bps, the largest increase since 1994. As Fed officials have confronted surging inflation, they have flagged the relative stability of longer-term expectations as a sign of public confidence that, eventually, the Fed will get price pressures back to targeted levels. The challenge is threading the needle in the short term by raising rates to quell inflation by precipitating a cyclical slowdown while not throwing the economy into a full-blown recession. However, there is little consensus among Fed and Fed observers on how to achieve this goal. Fed officials have signaled the central bank is on track for another large rate increase at the end of July. The heat map above shows the large deviations in the Fed's expected rate target by the end of this year, starting the year decidedly dovish between 1-2% and by June moving to 3-4%. Regardless of whether a soft landing is successful, the volatile rate environment is causing uncertainty in the economy and the market due to the important role that the cost of capital plays in capital investment plans.



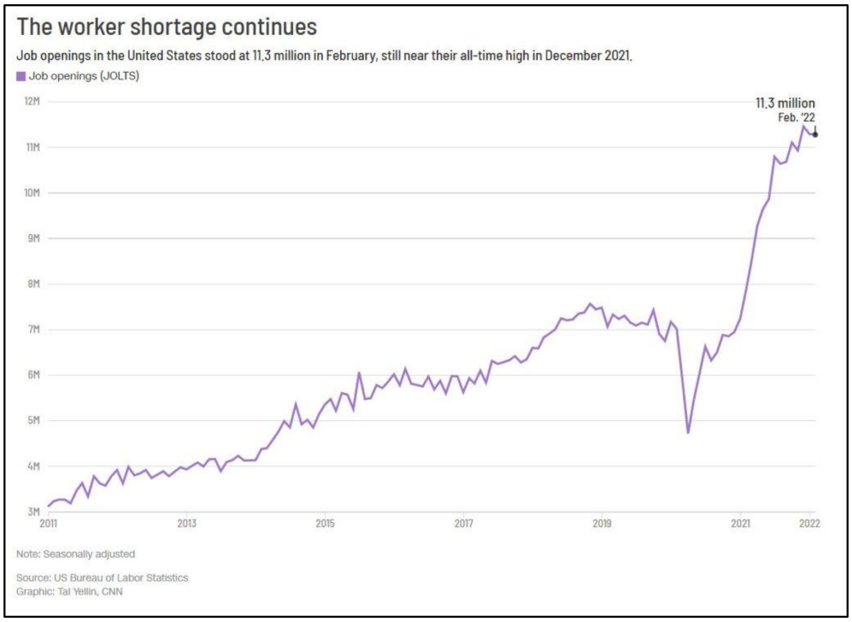
Rates are Less Effective in Combating Supply-Driven causes of Inflation

Inflation is caused by a supply-demand imbalance; historically, this imbalance has been centered around demand, with money supply as the main driver. However, many of the factors skewing the supply-demand balance in the current wave of inflation are supply driven, which the rate environment will do little to moderate. Over half (4.6%) of May's inflation is attributable to more transitory categories that are largely unaffected by federal reserve action: 1) the war in Russia impacting global energy, 2) idiosyncratic supply chain disruptions from China, and continued lockdowns impacting new and used cars prices and 3) food at home impacted by the war in Russia, labor shortages, supply chain disruptions, energy prices, and other factors. Approximately 3% of May's 8.6% inflation is attributable to more structural inflation categories, including Shelter (lack of supply) and Restaurants and Entertainment (labor constraints).



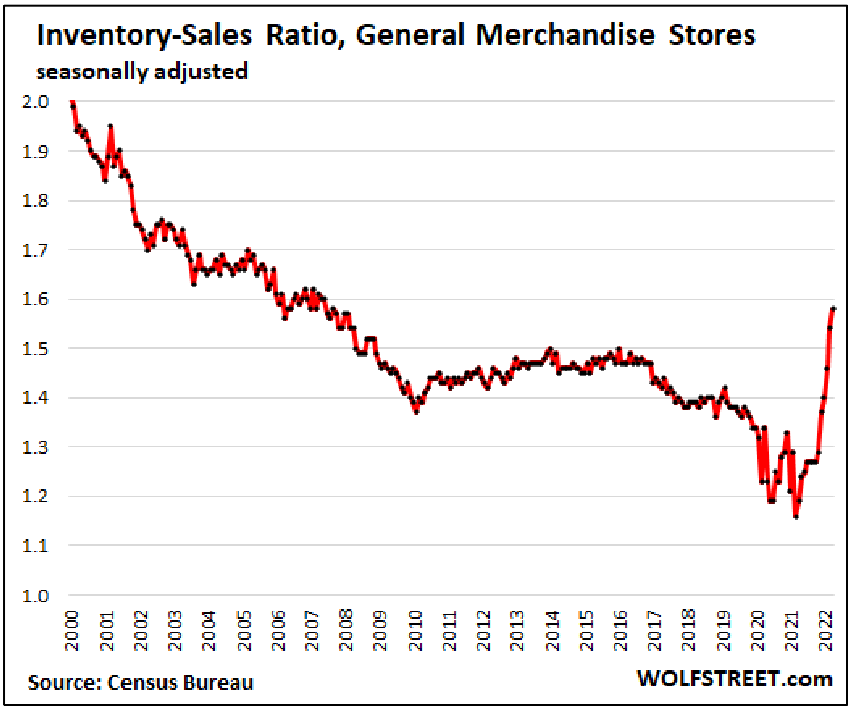
Labor Market Provides some Recession Cushion

One of the defining features of a recession is widespread layoffs that result in the unemployment rate spiking up. Currently, there are still 2 open jobs for every one person looking for work. This is a key factor in differentiating the current situation and supporting the possibility of a soft landing, as the excess of open jobs provides a substantial cushion that should insulate the unemployment rate from lower labor demand. This would be the “ideal” soft landing scenario, where labor demand lessens such that the ratio of job openings to unemployed normalizes, reducing upwards pressure on wages, while the unemployment rate remains low, protected by the job openings cushion. The labor shortage has indirectly contributed to inflation as workers can demand higher wages and businesses then raise prices to offset. This wage growth has been more substantial in service-based sectors, such as leisure & hospitality, and retail, where wages make up a larger percentage of a business’s budget as compared to construction or manufacturing. Layoffs have already been announced by technology companies and interest-rate-sensitive industries like mortgage financing. Employment recruiters have found solace in the fact that more workers are becoming available and have been actively searching for candidates through layoff databases that some states provide. As jobs get eliminated from certain sectors from higher interest rates, this will free up workers to transition to sectors where there is a labor imbalance and thus reduce upward wage pressure and help tame inflation that way.



Inventory Levels and Consumer Sentiment will Help Ease Inflation

Core inflation (ex-food and energy) seems to have already peaked in the US (6.0% in May and 5.8% in June), which is a positive sign that the primary drivers of inflation have started to ease. The alleviation of wage pressures mentioned above will help reduce costs and slow price increases throughout supply chains with additional relief in consumer-facing prices coming from elevated inventory levels. Retailers have accumulated record levels of inventory as they significantly overshot demand. In 1Q22, there was a significant ramp in retailers' orders to suppliers as they attempted to catch up to significant goods demand; at the same time, consumer sentiment began its plunge to an all-time low. As a result, these retailers are starting to cut prices on typically high-margin goods such as furniture, televisions, and apparel. Big box retailers like Walmart, Costco, and Target have already started advertising these discounts to consumers. As we wrote about last quarter, the American consumer still has significant levels of excess savings from the pandemic. With pent-up savings and discounted prices, consumption should be more resilient than it would during a "traditional recession," as a decline in savings rates can compensate for slowing wage growth, which provides an additional buffer that will allow for a "business slowdown" rather than a full-blown recession.

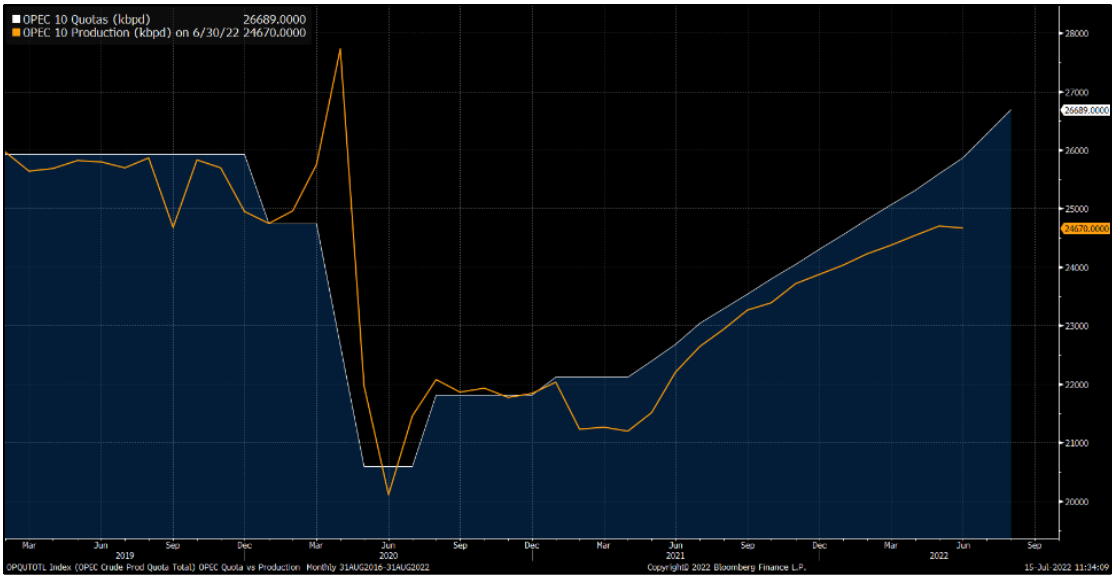


Energy Capacity

With 40-year high inflation dictating FOMC policy, consumer sentiment, and even political polling numbers, it is essential to put inflation drivers under the microscope. Headline inflation prints continue to accelerate at a quicker rate than both market and Fed expectations. However, it seems that core inflation has peaked—with Y/Y increases slowing from 6.2% in April to 6.0% in May to 5.8% in June. As energy continues to elevate the headline number, it is key to note that the surge in energy prices this year has been, and continues to be, driven by supply-side pressures.

These pressures are present at multiple points along the energy stream. Focusing on upstream, specifically crude oil production, years of global underinvestment have resulted in production growth slowing significantly. This is particularly relevant as OPEC+ continues to ratify production hikes. While Saudi Arabia and the UAE appear to have sufficient spare capacity, other members of the cartel have struggled to meet production quotas. OPEC 10 production has been consistently below quotas since the beginning of 2021. This is likely indicative that the spare capacity of OPEC+ members outside of the Arabian Peninsula is significantly overstated. Tight global inventory levels and overstated production capacity, combined with the reluctance of Western majors to significantly increase CapEx, will likely result in persistent supply-based tightness in global energy markets in the medium term.

White = Quotas   Orange = Actual Production



Conclusion

Inflation has been the driving force behind the market and the global economy. Higher rates have shaken equity markets and major US stock indices entered bear market territory halfway through 2022. Core inflation seems to have peaked and the labor market and inventory levels will provide some cushion in the economy as the Fed gets more aggressive in fighting inflation. Energy production will remain constrained as under-investment and capacity issues have been far from resolved. A recession has been priced into the market and with inflation starting to crest, equity markets could end the year higher than where they are today. With that being said, volatility will remain high which presents a good opportunity for stock pickers to set themselves apart from the overall market. Quality companies with sound balance sheets and superior management teams could capture more market share and set themselves apart from their peers during volatile times and the Brookmont team works hard to identify these companies for our investors.

BROOKMONT CAPITAL MANAGEMENT

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