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### 3rd QUARTER OUTLOOK

#### It Matters

As we look into the second half of 2022, let's first review how we got to where we are. For decades clients have asked me "when will all the debt that this country has incurred finally come home to roost?" That's right, we have been concerned about the borrow and spend policies of the U. S. Government for as long as I have been in the business (38 years and counting). Having heard this question over and over throughout the years I developed a somewhat glib and tongue-in-cheek response – "it will matter when it matters." It has always been assumed that the borrower (the U. S. Government) can/will repay the debt and until now worries about massive inflation developing just never were validated. In fact, for years since the Great Financial Crisis of 2008 the Federal Reserve has been trying to create some inflation. Productivity, aided by technology was helping to keep labor costs down and supply of goods and services aided by globalization remained plentiful helping to keep costs in check.

*"But if inflation began to rear its ugly head...servicing the ever-increasing mountain of national debt would become troublesome for the U.S."*

Servicing this massive debt that the U. S. Government was continuously adding to was not considered to be an issue since interest rates seemed to be tethered to zero forever and inflation had been stifled for decades. But if inflation began to rear its ugly head and interest rates ever broke free of the zero bound clutches and began to rise, servicing the ever-increasing mountain of national debt would become troublesome for the U.S. So, the size of the debt does start to matter when the cost of servicing that debt becomes more difficult.

#### The Bear Market

Let's talk about what the catalysts were for the bear market that we now find ourselves in and how things unfolded over the past couple of years. As we entered 2020, the economy and the markets were for the most part in fairly good shape. Stocks were up in 2019, interest rates had moderated, and the unemployment rate was historically low. Then came Covid19 and the pandemic. Shutdowns occurred, stocks plummeted, and the world was becoming unglued. By the end of March 2020, stocks had fallen nearly 35% in just weeks. What happened next led us to where we are now.

#### 1. The Fiscal Response

The Government's response on the fiscal side to shutdowns and the effects of the pandemic was to give people money, trillions of dollars.

*"Essentially the first half of 2022 saw markets adjusting to an environment that had not been seen in decades."*

Certainly, many needed and many deserved compensation from the government for having their business shut down or their job taken away because a business shut down. But the money giveaways were massive and sloppy. Some help was warranted, but a series of non-discriminating handouts was potentially problematic.

## 2. The Monetary Response

While the fiscal response was massive, The Fed was not going to be outdone. Interest rates were set back to zero and quantitative easing was turned up to eleven. The Fed increased its balance sheet, buying securities to "support" the markets, by trillions of dollars. Thus, the monetary response was as hearty as the fiscal response. Certainly, action by the Fed was welcome and appropriate in April of 2020. The problem became that the Fed remained accommodating far longer than necessary. And, frankly, Fed governors who are appointed government officials, not elected by the citizens, decided to become social warriors in addition to their dual mandate of employment and price stability (inflation). Perhaps a noble undertaking, but simply put-it's not their job.

## 3. Supply Chains

Global shutdowns during 2020 and 2021 caused supply chains around the world to grind to a halt. Globalization, which had helped curb inflation in the past was now becoming an inflationary spark for countries that had to depend on others for goods and raw materials. When demand reemerged the supply of good and materials was not there to meet it causing prices to surge.

## 4. The War in Ukraine

When Russia invaded Ukraine earlier this year, energy and food prices around the world felt the shock. Energy prices are a big cost for families and a huge input cost for companies. Shortages at the grocery store and restaurants were exacerbated by the agricultural destruction in Ukraine, causing pressure on prices.

## 5. Globalization

Globalization over the past 30 years has had a massive influence on inflation. The ability to get goods produced cheaper around the world helped keep prices down for decades. But the pandemic and war have exposed the flaws in globalization and the result has been like adding fuel to a fire.

We have talked about headwinds since late last year, and what we have seen develop was actually more like a perfect storm. Massive Government spending, easy monetary policy, pandemic caused supply chain destruction, the war in Ukraine and the potential collapse of globalization have all combined to produce the inflationary environment we find ourselves in at the moment. The surge in inflation caused the Fed to reverse course and begin to raise interest rates. With the Fed raising rates and reducing their balance sheet (taking away liquidity) asset prices needed to be adjusted. Bonds had been in a secular bull market for 40 years (that's a long time) while stocks had been for the past 12 years. Thus, the headwinds that we began identifying since Thanksgiving 2021 when the Fed announced their pivot to fight inflation. Essentially the first half of 2022 saw markets adjusting to an environment that had not been seen in decades.

## What's In Store for the Second Half of 2022?

There are a couple of narratives that could play out in the second half of 2022. First, inflation could remain stubborn causing the Fed to continue to accelerate rate hikes. Higher rates would likely stem the tide of inflation at some point, but how much damage to the economy and markets would result? The markets have priced in a move to about 3% on the Fed Funds rate, but if the FOMC has to move faster and further, another round of repricing would likely be in cards.

Another scenario that could play out in the second half of 2022 would be one were the Fed's actions have already begun to break the back of inflation. Indeed, many commodities are already 20% or more off their recent highs. But this scenario can go in a couple of different directions. For one, we could see the Fed's actions cause enough economic damage that we slow ourselves into a recession (I have mentioned that we could already be doing that now). In this scenario bond prices would move back up (lower rates) and stock prices would once again likely have another leg down.

*"Stocks will start moving back up when investors detect that most of the bad news has been discounted."*

Both of the previous scenarios, whether it be inflation persists or recession develops, likely result in stocks moving lower before they eventually recover. But what if there is a third alternative? A new and different narrative if you will. What if we have already priced in where the Fed is going with interest rates? What if we have already priced in the possibility of economic

slowdown or even recession? What if the "stock market," which is traditionally a 6-month leading indicator has already been predicting the actual economic conditions that we find ourselves in at the moment? Is it possible that stocks down 20%-30% depending on which market average you track, is the bulk of the repricing that was needed to establish "fair" value given the economic environment?

We don't want to appear sanguine at the moment. Challenges certainly lie ahead as we move into the second half of 2022. So many questions will need to be answered and those answers are likely to take some time to ascertain. But remember, markets often move in an anticipatory fashion. Stocks will start moving back up when investors detect that most of the bad news has been discounted. So, the question market participants have to ask themselves with regards to timing is when will all the bad outcomes already be reflected in the prices of assets. Longer term investors do not have to worry about the timing as much as traders do. If new monies are available and prices are lower, long-term investors have a wonderful opportunity.

### Summary

After a very difficult first half of the year investors are faced with a number of different scenarios for the second half of 2022. The Fed is firmly fighting inflation by raising interest rates and tightening liquidity. It appears that, though policy typically takes a while to work through the system, the psychological effects of the Fed's commitment has affected the economy already.

Market narratives switch from day to day, but one that keeps reappearing is that the Fed's actions will actually cause a recession. Higher prices and Fed jawboning certainly is beginning to have an effect on consumer behavior. We will find out soon whether we are already in a recession or at least an economic slowdown. More importantly for the markets we will be finding out how companies are dealing with inflation and challenges of a possible slowdown as we enter earnings season.

Most importantly, we are going to find out if the markets have accurately priced in the economic scenarios that may develop in the second half of the year. Do today's stock and bond prices accurately reflect the possibility that inflation has not yet been tamed and the Fed has a lot more work to do? Do stock and bond prices accurately reflect the possibility that the Fed will overshoot and send the economy into recession? Or finally, do stock and bond prices accurately reflect the possibility that we have seen the peak of inflation and that the Fed will be able to back off its hawkish crusade in time to avoid any recession at all? For market participants these are the questions that matter.

As always, we appreciate that you entrust us to manage your money and guide you on your road to financial success. We strive to keep you informed and to provide you with the best service in the industry. These are difficult and confusing times, but hopefully our daily updates are helpful and provide you some comfort. Do not hesitate to contact us with any thoughts or questions. If you feel that we can help someone you know and love, and help guide them through these times, please let us know. As we've laid out, there will be a lot of questions that likely will be answered in the coming months. We'll be here to guide and explain along the way. Stay tuned.