V A N L I E W T R U S T C O M P A N Y

as we see it

Holiday 2022

THOUGHTS FROM OUR CHAIRMAN

If a country must have a problem, do not count a modest inflation rate as one of them. Actually, it can be a good thing for the economy. It is excessive, runaway inflation, that is a problem. Most central banks have the ability to effectively manage inflation, yet, if overdone potential deflation may arise and put a country's economy at a standstill. In the US, adjustments of federal funds, interest rates, and buying and selling of our government debt have historically been successful tools to deal with inflation.

Our associate Wade Walbrun, in this issue, explains why we at Van Liew are cautiously optimistic that our Federal Reserve and its current interest rate strategy may, this time, have it right.

Alfred B. Van Liew

The End of the Tunnel?

Wade M. Walbrun

The proverbial light at the end of the tunnel - is it an exit from the darkness or is it a train barreling toward you in a head-on collision course? Many investors on Wall Street opine it is the latter regarding the US economy and stock markets. Not too surprising really, considering historic levels of inflation, high interest rates, and a bear market in stocks experienced this year. Yet, things have changed from the first half of the year. Are investors being too negative in the current environment? The Bull/Bear ratio of investor sentiment in October showed bearishness on Wall Street outpaces bullishness at levels last seen during the recession of 2008-09. Might there be reason for a more optimistic outlook? We think so, and here are a few.

The Fed could be done soon. The Federal Reserve has increased interest rates 375 basis points, to 4.00%, over the last year predominantly through a steady diet of 75 basis point rises in an effort to slow down demand in the US economy as a way to tame inflation. The pace and scale of such actions by the Fed are unprecedented in recent history. One must harken back to the 1970s during the Paul Volker era of the Federal Reserve for comparable moves. Many Wall Street analysts think the Fed will eventually lift interest rates to around 5% then foresee the Fed sitting on the sidelines and evaluating the reaction within the US economy. We are already starting to see a slowdown effect resulting from the Fed's efforts and, considering the long lag time it takes rate increases to filter through the economy, we expect additional data may keep the Fed activity to a minimum after December.

Commodities peaked. On June 9th of this year the price of the CRB Index, a basket of 19 energy, agricultural, industrial and precious metals commodities peaked at +41% year-to-date, but has since pulled back to +24%. Driven up by the war in

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Ukraine and supply chain issues, commodity prices have fallen primarily on the expectations of weak global economic growth and its effect on demand. High commodity prices disrupt the cost structure of goods manufacturers affecting operating margins and profit. Producers often make up for this higher cost structure by raising prices on their goods, thereby adding to inflationary pressures. We expect lower commodity prices to make a meaningful impact on inflation, but recognize company contracts with commodity suppliers are somewhat long-term in nature and may take a while to see their full effect in broader inflation gauges.

Housing activity has slowed. Over the last 12 months, 30-year mortgage rates have risen from 3% to 7% putting a real damper on the housing industry. New Home Sales are down 27% from highs seen in January 2022 and Existing Home Sales are down 23% from last year at this time. Additionally, the Monthly Supply of New Homes, a gauge of the inventory levels, has risen from a 2020 low of 3.4 months equivalent of annual sales to the current 9.4 months, a sign more homebuyers are sitting on the sidelines. Comprising around 17% of US GDP, the housing industry slowdown affects demand in a vast array of areas in the economy, from lumber and building materials, to furniture, paint and appliances, and the labor market, too.

Supply constraints have loosened. The supply-demand imbalance that plagued much of the previous two years and caused significant pricing pressure of goods has improved markedly given the easing of demand at a global level. The backup of container ships off the coast of California, so emblematic of the supply chain problem, has effectively disappeared. With over 100 ships at peak levels in January 2020 waiting to unload, the current number of ships has remained under ten for the last few months. Additionally, shipping rates from China to the US that increased almost ten-fold from early 2020 to mid-year 2021 have fallen back dramatically to mid-year 2020 levels. Likewise, non-auto retailer inventory has returned to pre-Covid levels. With supply chain pressures easing as rapidly as they increased, the move down in CPI Core Goods prices from over 12% year-over-year to 7% may not be finished.

The last holdouts have fallen. The S&P 500 Index pulled back 27% from its high in January to the recent lows seen October, yet not all stocks fared the same. The mega-market capitalization stocks in Information Technology, Communication Services and Consumer Discretionary, which led the market participants higher in the previous two years, have performed better than others in this bear market. Many investors viewed these market leaders as defensive in nature and were loath to sell. Yet, some opine the fall in the stock markets could not be finished until the mega-cap holdouts capitulate and are sold off, too. We agree. In the last few weeks, weak earnings reports showed significant strain in the mega-caps' business models. Coupled with weak forward earnings guidance by their managements and layoff pronouncements the mega-caps finally saw significant drops in their stock price with many making new 52-week lows. Additionally, we view the 27% pullback in the stock market as comparable to the historic 35% average drawdown of stock prices during a recession. In essence, we think stocks have seen the extent of their damage.

While growth in the US economy and stock markets often correlate, at this point in the economic cycle and as long as there is continued progress reducing inflation, we think equity markets are likely to look beyond any near-term economic weakness toward recovery. In turn, stocks may react positively in the face of such weak reports though we think upside could be limited until the Fed confirms further rate increases appear unwarranted.