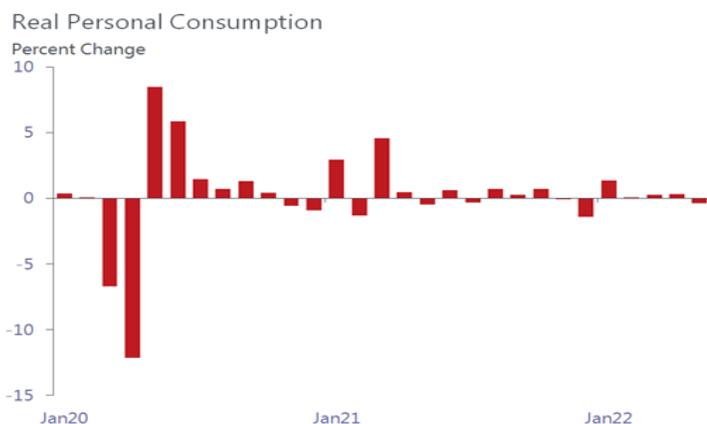


Following the winter doldrums, the usually hopeful spring brought nothing but the blues for investors and policymakers in the just-concluded second quarter. The stock market turned in another dismal performance, resulting in the worst first half for the S&P 500 since 1970. Fixed income investors fared a little better; their losses were shallower than the stock market, but their negative returns were still the deepest in modern history for the first half of the year. Simply put, except for commodities and cash, there's been virtually no place to hide in 2022. And given the loss of purchasing power over the period, holding cash was not a rewarding option.



The dismal performance in the financial markets mirrors an economy that underperformed just as badly over the year's first half. Not only did the underperformance in the first quarter turn out to be worse than previously thought, but the second quarter is also poised to end with a whimper. No hard data of broad significance for June has been released yet – the first major report, the all-important jobs release, will become available next Friday. But April and May were mostly downbeat, and the soft data for June suggests the quarter is ending on a pessimistic note. Consumer confidence plummeted, regional Fed surveys of business activity have been uniformly weak, and some tracking models, including the Atlanta Fed's GDPNow gauge, are forecasting a contraction in GDP during the second quarter.

Stubbornly high inflation and the Fed's steadfast commitment to bring it down through demand-curbing interest rate hikes underpin the deepening sour mood on Wall Street and Main Street. No doubt, households are in a good position to withstand these headwinds for a while, given the solid job market and their healthy balance sheets. But their resilience is waning, and the economy's main growth driver, consumer spending, downshifted significantly in May, as personal consumption edged up by a slim 0.2 percent, the weakest showing this year. Notably, that increase in nominal dollars bought fewer goods and services as inflation accounted for all of the increase and then some. Adjusted for inflation, consumer spending fell by 0.4 percent, erasing over two-thirds of the gains made over the previous two months.

The consumer pullback in May punctuated a long string of reports for the month that came in weaker than expected, heightening fears that the economy will not survive the Fed's aggressive rate-hiking campaign. The one source of good vibes this week – a solid increase in factory orders for durable goods in May – was abruptly vanquished on Friday when the Institute of Supply Management reported that its index of manufacturing activity plunged 3.1 points in June to the lowest level since March 2020. The most discouraging aspect of the report is that new orders tumbled from 55.1 in May to 49.2, signaling a complete reversal of the ISM gain. Again, this is a soft data point that has yet to be confirmed by actual factory behavior. Still, it adds to the disconcerting evidence suggesting the economy is limping into the third quarter.



Not surprisingly, recession fears are gaining traction, influencing market behavior and spurring widespread downgrades of economic forecasts; indeed, an increasing swath of the forecasting community believes the economy is on the cusp of a downturn, if not already in one. The bond market is swiftly embracing that sentiment, as the bellwether 10-year Treasury yield has fallen like a stone over the past week.

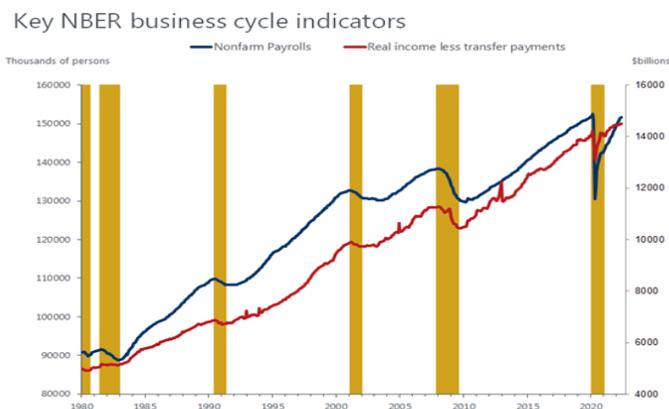
After climbing to a decade-high 3.50 percent in mid-June, fueled by surging inflation and escalating Fed rate-hike expectations, the yield retreated to under 3.0 percent this week, trading at just below 2.90 percent on Friday. The downward move, echoed among shorter-term yields, indicates that market participants expect the Fed to start moving in the opposite direction sooner rather than later as a weakening economy pulls forward the beginning of a rate-cutting cycle.

But while bad economic news is, in time-honored fashion, good news for the bond market, it is not so for stocks. The prospect of an economic downturn has ominous implications for corporate earnings. For one, recessions and sagging demand go hand in hand, resulting in falling revenues. For another, sagging demand means less business pricing power, making it harder for companies to protect the bottom line from encroaching labor and sticky overhead costs. That, in turn, sends companies into a defensive cost-cutting mode, leading to worker layoffs, which reinforces a downward spiral in economic activity.

With growing evidence that GDP may contract in the second quarter – highlighted by the Atlanta Fed's tracking model – the list of adherents believing a recession has already begun will undoubtedly expand. A contraction in the second quarter would be the second consecutive quarterly decline in real GDP, which meets the unofficial definition of a recession. But while every two-quarter contraction in GDP has occurred during recessions, it is not the barometer that the National Bureau of Economic Research uses to determine when a recession begins and ends. The NBER looks at a range of economic indicators to determine whether a downturn in activity is pervasive, severe, and prolonged enough to satisfy its definition of a recession. A contraction in GDP in any given quarter may reflect an outsized drag from one sector of the economy that has not spread to others and, hence, would not meet that criterion.

Importantly, while the NBER looks at six broad indicators of economic activity to determine when recessions start and end, it notes that "In recent decades, the two measures we have put the most weight on are real personal income less transfers and nonfarm payroll employment." By that standard, proclamations that a recession has already begun would be premature. With the latest personal income and spending report in the books, these two measures remained in positive growth territory through May. That observation says little about prospects, but it strongly signifies that the economy remained afloat in the second quarter.

To be sure, the May figures are subject to revision, and the personal income indicator is wobbling precariously around an inflection point, having eked out a slim 0.3 percent gain since the end of last year. There is little question that households are struggling to keep pace with inflation. If taxes are thrown into the mix, their plight seems grimmer, as real after-tax incomes fell in three of the first five months of the year and are down nearly 2 percent over the period. But while the tax bite took a more significant toll on incomes this year, it probably put a bigger dent in the wallets of wealthier households who incurred sizeable capital gains liabilities than those further down the income ladder. The haircut from higher taxes is not likely to have meaningfully deterred spending among the wealthier cohort.



Indeed, the sluggish spending report for May masks compositional changes in purchasing habits that reveal respectable increases in discretionary spending on services. People are traveling more and increasing spending on recreational activities and healthcare, outlays more likely to be carried out by wealthier individuals. Durable goods purchases, in contrast, fell, but that may reflect in part supply shortages (autos) and the increased desire to engage in outdoor activities as the economy reopened. Meanwhile, the job market continued to generate a healthy increase in paychecks, as wages and salaries grew by a solid 0.5 percent in May, and households added to their savings buffer, as the savings rate increased to 5.4 percent from an upwardly revised 5.2 percent in April.

Most importantly, the key inflation gauges the Fed monitors continued to increase at an elevated pace, with the headline personal consumption deflator advancing at the same 6.3 percent rate as in April. The core PCE deflator did slow from 4.9 percent to 4.7 percent in May, but the month-over-month increase held at 0.3 percent for the fourth consecutive month. The Fed will need to see more progress on the inflation front before it throttles back its tightening campaign. Despite mounting recession fears and growing market expectations of an earlier reversal in policy, the Fed is still expected to follow through with another 75 basis point increase at its upcoming meeting in late July.

FINANCIAL INDICATORS				
INTEREST RATES	July 1	Week Ago	Month Ago	Year Ago
3-month Treasury bill	1.67%	1.66%	1.18%	0.04%
6-month Treasury bill	2.48	2.49	1.65	0.05
3-month LIBOR	2.29	2.20	1.63	0.14
2-year Treasury note	2.84	3.08	2.68	0.24
5-year Treasury note	2.89	3.19	2.93	0.86
10-year Treasury note	2.89	3.13	2.94	1.44
30-year Treasury bond	3.12	3.26	3.09	2.05
30-year fixed mortgage rate	5.70	5.81	5.09	2.98
15-year fixed mortgage rate	4.83	4.92	4.32	2.26
5/1-year adjustable rate	4.50	4.41	4.04	2.54
<b>STOCK MARKET</b>				
Dow Jones Industrial Index	31097.26	31500.68	32899.70	34786.35
S&P 500	3825.33	3911.74	4108.54	4352.34
NASDAQ	11127.85	11607.62	12012.73	14639.43
<b>Commodities</b>				
Gold (\$ per troy ounce)	1810.10	1828.10	1853.90	1788.2
Oil (\$ per barrel) - Crude Futures (WTI)	108.40	107.08	120.26	75.08
<b>ECONOMIC INDICATOR</b>	<b>Latest Month/Quarter</b>	<b>Previous Month/Quarter</b>	<b>Two-Months/ Qtrs Ago</b>	<b>Average-Past Six Months or Quarters</b>
Personal Income (May) - % change	0.5	0.5	0.6	0.5
Personal consumption (May) - % change	0.2	0.6	1.2	0.6
Durable Goods Orders (May) - % change	0.7	0.4	0.7	0.8
Consumer Confidence Index (June)	98.7	103.2	108.6	105.7
ISM Manufacturing Index (June)	53.0	56.1	55.4	56.3

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