Email Body 7-6-2022

**Summer Happenings, Economic Turmoil, and a Stock Market Roller Coaster**

I am sure glad the first six months of this year are over. The stock market put in the worst first half of a year performance in 50 years, gas is at $6.00 per gallon in SoCal and don’t get me started about the grocery store. Covid continues to be in the background in most of the developed world except for China, which continues to persist in zero-Covid policy. In California case levels peaked in early June and have been declining since then. Clearly, covid is no longer the deterrent it once was. Despite some in the financial press claiming a recession is imminent, you could not tell it based on my local observations. Lots of people are shopping, driving, flying going to local attractions and I see lots of AZ, NM, OR, NV and other assorted car license plates here in sunny San Diego. Must be that time of year.

THE ECONOMY AND WHAT IS A RECESSION

There is a lot of talk about “recession” but hardly anyone ever tells us what constitutes a recession. Historically, a recession was defined as two consecutive calendar quarters of economic decline as measured by GDP. However, the National Bureau of Economic Research (NBER), which officially declares recessions, says that is no longer the case. Recessions are a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale/retail sales.

Most modern recessions have occurred in response to one or more elements including, rising interest rates, higher energy/commodity costs and fiscal contraction (i.e., lower government spending, higher taxes, or both). Today, we clearly have climbing interest rates and higher energy/commodity costs. Does that portend a recession? The answer is, it depends. We have an unusual situation economically speaking, in that we are coming out of a pandemic environment that saw unusually high levels of money creation combined with significant production/supply chain disruption. The result, unprecedented overall aggregate demand fueled by unusual amounts of money creation meeting reduced or delayed aggregate production of goods and services. Throw on top of this declining demographic trends in developed countries and you have fewer workers resulting in reduced productivity. In other words, demand is greater than supply and rising prices are the result.

The typical response to a “hot” economy with increasing inflation is for the Federal Reserve to raise interest rates to slow aggregate demand by making things more expensive. However, one difference this time is if the U.S. and the rest of the developed world can quicken the pace of fixing supply disruptions by adopting policies that encourage employment, investment in new production capability (i.e., local manufacturing, gas refineries, etc.) and energy resource development. Unfortunately, policies such as these are long-term in nature and dependent on the political environment.

My view is that the Federal Reserve response (e.g., rising interest rates, reducing liquidity) will be the main tool used to fight inflation. This necessarily increases the risk that a recession, however it is defined, will occur in the near future. Further, given the amount of money creation, I expect inflation to be higher over the next ten years (e.g., 3%-4% annual) compared to the last ten years e.g. (1%-2% annual). The good news is that if a recession occurs, I expect it to be mild compared to 2008-2009. Unemployment is low, consumer spending is rising despite reduced consumer confidence and interest rates are still low on a historical basis. While recessions can be painful, they do provide a necessary brake on excessive economic activity.

THE FINANCIAL MARKETS

Both the stock and bond markets took significant hits in the first half of this year. The stock market initially dropped because of some excessive valuations resulting in a normal correction environment (i.e., 10% or more decline from the last high). However, with the pop in inflation in April and May along with the Federal Reserve accelerating its plan to raise interest rates, recession fears began to take hold. U.S. and International stock indices have been in and out of bear market territory (more than 20% decline) over the last month. The bond markets more than 12% decline in the first six months of this year is the result of the Federal Reserve transparency in revealing just how far they intend to raise interest rates. Specifically, they said they would raise interest rates from 0.25% to between 3.25% and 3.50% over the course of eighteen months. The markets priced in the full 3.00%+ rise virtually immediately. Bear markets do not necessarily presage a recession. Since 1929 there have been twenty-one bear markets but only eleven of them accompanied a recession. Post-WWII, recessions average about twelve months in length.

The key to watch here is how inflation reacts to the Federal Reserve’s interest rate policy. Risks are plentiful in that if the Federal Reserve raises rates too fast or far, it may result in aggregate demand being driven into a ditch which creates a recession. Alternatively, not raising rates far enough or fast enough may result in inflation becoming embedded in consumer psychology reducing saving and investment which reduces our standard of living. Threading the needle is not the Federal Reserves strong suit.

For now, the stock market appears to have priced in a mild recession in the near future and is currently moving in a trading range as it digests new information over the next few weeks and months. Whether its next move is up or down depends on how successful the Federal Reserve policies are at mitigating inflation. Hopefully, supply side constraints are loosened or removed to also help.

I continue to recommend that for long-term oriented investments, maintain your current allocation strategies if your risk profiles and time horizons remain long (i.e., 4-5 years or more) and not subject to unexpected changing circumstances.

As I have previously said, make sure that funds you know you will need in the short-term are safe to relatively safe from volatility and that your long-term oriented investments are well diversified and subject to risk and volatility levels you are able to be comfortable with. If you have any questions or concerns about these things, please call me to discuss them further.

I have attached a brief commentary on the current situation by Brad McMillan. Brad is managing principal and chief investment officer at Commonwealth Financial Network®, where he chairs the Investment committee and is the primary spokesperson for the firm’s investment divisions. Check out the attachment to this email.

I am always available to you via phone, zoom conference or in person. I look forward to talking with you over the next few weeks. If you have any questions or if we can be of any help, please do not hesitate to contact Linda or me.

*Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results.*

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