Trust & Financial Services

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QUARTERLY MARKET INSIGHTS – SECOND QUARTER 2022

To the Clients and Partners of Hilltop Trust and Financial Services:

If I were to ask you how you feel about the economy, your personal finances, and business conditions in general, would you tell me you feel better about them now than a year ago? What about conditions a year in the future?

I expect that for most, your response would be somewhere between "No" and a resounding "No". You would be far from alone.

Among the hundreds of data points that we observe here in the Trust Department are surveys of consumer sentiment. Most recently, one such survey has reported that the US consumer is as pessimistic about the state of our present and future economy as they have been since records started being kept in the 1950's.

That's a pretty interesting result when you consider some of the economic crises we've faced over that period. For example, it includes the 1973 oil crisis and resulting recession, which saw widespread rationing and the price of a barrel of oil nearly quadrupling. It includes the last time the economy experienced significant inflation, during the 1980s, when Headline CPI reached nearly 15% and unemployment topped out at almost 11% (vs. 8.6% inflation and a historically low unemployment rate of 3.6% today). It includes the Great Financial Crisis where there were serious concerns about our financial system ceasing to function and markets fell 57% in 17 months.

So, are we correct to be so negative?

What to Expect When You're Expecting (a Recession)

There is more than one way to measure whether a recession has started. The simplest method, and I suspect by the time you read this the one which will have made headlines, is two consecutive quarters of negative Gross Domestic Product (GDP) growth. Officially, however, a group called the National Bureau of Economic Research (NBER) has the task of determining when a recession has started and ended. The NBER looks at a number of criteria, in combination, to make that determination. Generally, those criteria are declines in production, spending, income, and employment.

First, a negative growth rate of GDP would mean production is declining, by definition. Most signs point to this being our current state of affairs. Currently, manufacturers are reporting a decline in new orders, although they still have a backlog to work through. This is bad news for future demand prospects as it means there may be less manufacturing production in the future, but good news for the supply chains that have been fouled-up for the last two years. Suppliers have been able to improve delivery times, and fewer items will be as hard to find as they have been. On the larger services side of our economy, demand is still expanding but the rate is slowing as companies continue to report an inability to hire enough workers.

Second, as you have felt personally, the price hikes that make up our significant inflation issue have dampened consumers ability and inclination to spend. On a month-over-month, inflation-adjusted basis, real consumer spending was down -0.4% in May, after two consecutive months of 0.3% increases, and far below January's 1.3% increase. Retailers such as Target, Walmart, and Macy's have reported slashing prices on thousands of products as they attempt to get rid of excess inventory nobody's buying.

Third, on the income front, after inflation and taxes real disposable income fell -0.4% in March, rose 0.2% in April, and fell -0.1% in May, meaning a decrease over the course of the past three months. Year-to-date real personal disposable income is down -1.9%. As you might expect from consumers who are so gloomy about the future, the savings rate rose from 5.2% in April to 5.4% in May as folks start thinking about saving for lean times ahead.

Fourth and finally, on the employment front we arrive at why, if we are headed for a recession, it may be different than those in our recent past. Reports of layoffs have started to trickle out, especially in those hard-hit sectors of the economy such as technology and mortgage origination. However, the four-week moving average of initial jobless claims has risen by just 750 to 232,500 early in July. As mentioned above, our unemployment rate sits at a historically low rate of 3.6% and employers actually added 390k jobs in May, and 3.03 million jobs in the past six months. We still have over 11 million job openings, or two jobs for

every unemployed person still in the labor force. While employment numbers tend to lag other indicators (you don't let good employees go before you have to), there is still a significant backlog of open positions.

Add it all together, and what we have are signs of a slowing economy, driven down by high inflation and the Federal Reserve's uncompromising fight against it. Demand seems to have peaked for the cycle as interest rates increase and wages fail to keep up with inflation. Improving supply chains could help, but a war in Ukraine, COVID shutdowns in China, and labor negotiations at home are slowing progress. Finally, consumers that have come to expect a recession will cut back spending on their own if they can, which only decreases demand further, raising the specter of recession as a self-fulfilling prophecy. This is the environment that has led to the worst first half for equity markets since 1970, and a substantial negative drawdown in bonds.

Does this weakening economy mean markets are destined to continue their descent? Since 1980, in 21 of the last 41 calendar years (more than half of the time) the S&P 500 has seen an intra-year double-digit pullback. In 13 of those 21 instances (62%), the market ended the year with a net positive return. Specifically on the topic of sentiment, since 1987, when less than 20% of investors report being bullish as is the case now, the S&P has averaged a return of 19.7% in the subsequent 12 months.

While we are six months into a bear market, which have an average length of 14 months since 1929, at some point the wisdom of the crowd becomes anything but.

Market Psychology and a Long-Term Perspective

When it comes to markets, I like to think of the average participant as the most optimistic pessimist you know. Things are never so good they can't get better, and things are never so bad they can't get worse. This mentality leads to all kinds of distortions, such as the dotcom bubble, housing prices in 2006-07, or perhaps even the 75% gain in the S&P 500 from March 15, 2020 until the very first trading day of 2022. It's also at play in the 19.3% loss which that same index has experienced so far this year, and present in our consumer survey data.

For long-term investors, one trick I frequently recommend when trying not to join in the crowd psychology is simply this: open up a chart of whatever index you favor, and trace its current level back to the last time the index touched that level. As I write this, the S&P 500 is at the same level it sat on March 1, 2021. Did you feel particularly dire about the state of your investments on that day? I can't recall that I did. Take it another year back from there, and most of us had yet to even hear the name COVID-19. If I asked on March 1, 2020, would you be content with a 30% increase in the S&P over the ensuing twenty-eight months? You would likely lock-in that rate of return every time if you could, regardless of the path it took to get there.

Hopefully that little exercise can provide some perspective in times of volatility like these.

Lastly there's a story, probably apocryphal, that a young man walking down Wall Street one day found himself lucky enough to be standing in front of the venerable J.P. Morgan. Hoping to take advantage of the chance encounter, the young man asked him for a prediction on the markets. In response, the elder Mr. Morgan twirled his cane and replied "I can tell you exactly what the market will do. It will fluctuate".

Best,

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