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Economic and Market Outlook

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Linear Thinking

*I will tell you the secret to getting rich on Wall Street.
You try to be greedy when others are fearful.
And you try to be fearful when others are greedy.*
- Warren Buffett

Section I. Introduction

The Oracle of Omaha expresses the true nature of being a successful investor by recognizing the cyclicity of markets in the above quote. Unfortunately most people suffer from what we refer to as “linear thinking”. When the stock market is going up people can’t wait to invest because they believe it is going to continue to go up. This is called greed. When the stock market falls, as it has recently, then people are convinced that it will continue to fall for an extended period of time and they want to get out. That is called fear. Fear and greed are emotions that cause people to buy high and sell low.

To be a successful investor you need patience and a long term view. While the media loves to talk about the possibility of a bear market, history shows us that over time the stock market will invariably go higher in the long term.

Section II. Inflation

Inflation continues to be an issue. The readings for inflation have continued to increase. Currently the Consumer Price Index (CPI) is 8.6% on an annual basis, and core CPI, which excludes food and energy, is at 6.0%. Both readings are for May 2022. The CPI reading has leveled off and the core rate actually peaked a few months back at 6.4% This is still well above the Federal Reserve’s 2% target. With the pandemic

waning, consumers with cabin fever have spent some of their savings that they accumulated during the lockdown on travel and other services. Chart #1 is the personal savings rate for the U.S. After averaging about 7% from 2000 to 2019, it peaked in April 2020 at 33.7%, right after the beginning of the Covid-19 lockdowns. The reading for April 2022 is down to 4.4%, which should mean an eventual reduction in demand causing inflation to ease.

Commodities have been big contributors to inflation. We might be seeing some light at the end of the tunnel though. From their respective peaks in the last year to the writing of this report, natural gas is down 32.9% (Peak 9.32, Current 6.25), crude oil is down 13.2% (119.78,104.00), lumber is down 58.8% (1464.00,603.00), copper is down 23.1% (4.89,3.76), wheat is down 26.6% (12.77,9.37) and beef is down 5.0% (22.19,21.08). Housing may also be peaking because of rising mortgage rates.

Energy continues to be a large contributor to inflation because of Green energy policies in the US and Europe's questionable decision in the past to become reliant on Russian energy. The Ukraine war added to global supply chain disruptions. Exploration, infrastructure, logistics and a qualified work force are very capital intensive and time consuming endeavors. Unfortunately we can't just "turn on a spigot" and immediately increase global supply. This will further prolong the inflation problem, but the situation seems to be moderating. This is probably because one cure for high prices is high prices. Once the cost of an item reaches a certain point people tend to change their habits so that they consume less of that item. This reduces demand and hence brings down price.

The "ease" with which goods move around the world has started to improve. Most of the inflation we are experiencing is a mismatch of supply and demand caused first by Covid-19 fears and lockdowns, then continuing supply chain issues and now the Ukrainian War. Factory shutdowns caused a shortage of semiconductors, food stuffs, lumber etc. Thankfully China is starting to end their Covid-19 lockdowns, which should lead to their factories resuming production.

At the same time, consumers flush with cash increased demand for these same goods. Without continued stimulus consumers will have less to spend, lowering demand.

Wages continue to rise in an effort to lure people back into the workforce. These wage increases will not roll back and it is unsure how much further they will need to rise.

Other areas of inflationary pressure will eventually prove to be transitory but will take longer to work out than the Federal Reserve originally expected. Semiconductor chip shortages affect many parts of the economy from vehicles to technology. Bringing production to full capacity at factories is still difficult, creating shortages for many goods. The war in Ukraine creates the possibility of grain shortages next year. In addition, the lack of enough longshoremen and truck drivers is exacerbating the supply chain situation.

The key concern for inflation is persistent price hikes. The good news is that Industrial Production plus Productivity gains thanks to technology will eventually lead to disinflation. In addition, the Producer Price Index (PPI) is beginning to reflect some moderation. That is why we believe inflation will not be a long term problem but it will last longer than Federal Reserve first believed.

Section III. The Federal Reserve and Interest Rates

Because of inflation the financial media has become more focused on interest rates. We have been spoiled by ultra-low rates during the pandemic. Historically, rising interest rates accompany a strengthening economy. Chart #2 shows rate hike and rate cut cycles since 1989. The market rose 80% of the time during rate hike cycles and only 67% of the time during rate cut cycles. Ken Fisher of Fisher Investments points out in his February 18th, 2022 newsletter that stocks and interest rates have a slightly positive correlation, meaning rising rates usually mean rising stocks. In addition, the ultra-low rates we have experienced have hurt savers and retirees.

The Federal Reserve has adjusted monetary policy. Federal Reserve Chairman Jerome Powell raised the Fed Funds rate by 0.75% at the last meeting. This was taken as a sign that the Federal Reserve is finally starting to aggressively fight inflation and not be so far behind the curve. They also have started to let \$90 billion in bonds roll off the Fed balance sheet each month. Both actions will tighten money supply which once again means lessening consumer demand.

We still believe the rise in interest rates will continue. We expect another 0.75% rate hike at the next Fed meeting. Historically, the stock market will climb until a third rate hike. After that, things can get bumpy if they have to continue to fight inflation. A 3% 10-year Treasury note yield is still very low historically, and there are other factors that still exist that should limit the climb moving forward. Currently the Fed Funds rate is still only 1% and if we are correct will rise to 1.75% at the next meeting. St. Louis Fed's James Bullard would like to see the Fed Funds rate at 3.5% by year end, to help "nip inflation in the bud before it gets entrenched in the economy."

Rates in most European 10-year bonds are rising along with the U.S., but the U.S. 10-year bond remains more attractive to international investors. The U.K. 10-year yields 2.30%, German 10-year yields 1.44%, France 10-year yields 1.96%, Italian 10-year yields 3.56% and Swiss 10-year yields 1.30%. These compare to our 3.12% 10-year yield. Part of this rise is contributed to a combined central bank effort to fight inflation globally.

Section IV. Recession

There are many different indicators that analysts follow to predict a recession. We have our own model which will be discussed in the next section. First let's review a few others.

The definition of recession:

A period of temporary economic decline during which trade and industrial activity are reduced, generally identified by a fall in GDP in two successive quarters

We already had one quarter of negative GDP. Looking into the data of the first quarter reveals a unique fact. Many companies were double ordering during the pandemic because of the uncertainty of actually receiving inventory. When the extra inventory arrived, these companies found themselves overstocked. Orders fell off a cliff causing the negative GDP all by itself. Some of these items were seasonal. Expect discounts on many large items (Appliances, Electronics, Furniture) coming in the summer. The point is that the double ordering is a one time or "black swan" event caused by the pandemic supply chain disruptions, which brings this GDP measurement of a recession into question.

Some analysts like to use the yield curve as a predictor of recession. This is because it helps us understand finances and bank activity which are the lifeblood of economic growth. The problem is most media pundits look at the 2-year to 10-year yield spread, which did invert about a month ago and is barely positive now. They should be looking at the 3-month to 10 year yield because that is more indicative of how banks lend. They collect short term deposits (savings accounts) and make long term loans. The spread on this metric is nowhere near being negative meaning banks should continue to lend.

Another historic indicator is the price of copper, or "Dr. Copper" as it is sometimes referred to. Before every recession in the last 30 years copper has entered a bear market. Recall earlier in our report that from its peak copper has drop 23.1% by our calculations. Copper is important because it is used across many industries.

Section V. The Recession Model

We just discussed 3 different historic indicators of recession that gave us different results. As we have discussed in past reports, earnings and the economy are the true long term influences on the stock market. Recessions, or fear of recessions, are the major reason we experience corrections of more than 10%. Corrections of less than 10% are just part of normal volatility and can happen multiple times each year.

At Clutinger, Williams & Verhoye we have developed what we view as a recession indicator which tracks 5 data sets on a monthly basis. If 3 of the 5 indicators are negative and the S&P 500 is below its 40 week moving average, it is a very strong indication that a recession is near or may already be underway.

Indicator number one compares the current monthly unemployment rate to its 12 month moving average. As of May, the unemployment rate was 3.6% and the 12 month moving average was 4.38%. By being below the moving average this indicator is positive.

Indicator number two is represented in Chart #3. This represents the year over year percentage change of Advance Real Retail and Food Service Sales. This is one method to measure the strength of the consumer. As you can see, the Covid-19 shut down had a major effect on this index in early 2020. Re-opening is also having a major effect. This indicator bottomed in April 2020 at -20.2% and had recent high of 45.2% in April 2021. Currently the reading is -0.4% for May, so this indicator is negative. Any reading above 0 is positive. The reading is also normalizing which should relieve some inflation pressure and it also reflects less money in consumers pockets.

Indicator number three is represented in Chart #4. This shows the year over year change in Industrial Production. This indicator bottomed in April 2020 at -16.3%. This indicator is positive. It currently sits at 5.8% for May 2022. This number improving could help lower inflation. Higher production leads to greater supply.

For indicator number four (Chart #5), we look at Total Nonfarm Payrolls divided by the Civilian Labor Force Level on a year over year percentage change basis. This indicator has moderated because of the difficulty companies are having hiring in the last couple of months caused by Covid-19 and stands at 2.23%. A zero reading represents neutral therefore this indicator is still positive.

Indicator number five (Chart #6) represents the Average Weekly Hours of Production and Nonsupervisory Employees-Manufacturing on a year over year

percentage basis. Once again, this indicator bottomed back in April 2020 at -7.69%. Currently the reading is only -0.5%, so this indicator is negative and reflects how supply chain issues have caused a slight slowdown the economy in the last few months.

Currently three of the five indicators are positive but the S&P 500 Index is 16.66% below its 40-week moving average in the recent correction. Even though the S&P 500 is below its forty week moving average this model does not give any recession warning signs because 3 of 5 indicators are still positive. We will be closely monitoring these indicators in the coming months.

The above indicators are only updated on a monthly basis. To offset this situation we also track two other indicators. They are both indicators that are updated more frequently (on a weekly or daily basis) and we consider them as early recession indicators. Both are somewhat volatile so we track three month moving averages. These two indicators are separate and independent of the first five and either one can indicate the possibility of recession on its own.

The first one is the Aruoba-Diebold-Scotti Business Conditions Index which is updated on a daily basis and published by the Philadelphia Federal Reserve. The 91 day moving average, after pulling back two reports ago to 0.05, rebounded and is at 0.43 currently. The divining line for entering and exiting recessions is -0.8.

The second indicator for recessions is the Chicago Fed Business Activity Index. It is reported weekly and the divining line for entering recessions is -0.7. The three month moving average slightly weakened and sits at 0.20.

In summary, the two "early warning signs" are not predicting recession at this time, but have weakened somewhat in the last three months.

Section VI. Market Psychology

For decades we have measured market psychology using price and volume data in the short and long term from the Dow Jones Industrial Average as well as a 17 week moving average of advancing and declining stocks on the New York Stock Exchange.

Currently 8 of 12 of our price/volume indicators are negative. This is reflective of the recent correction in the 20% range.

Our advance/decline line has dipped slightly below 42%, once again reflective of the recent pullback. Our model that measures the first and second derivative on price

and volume is currently negative but looking like it will likely improve. We have developed this model to recognize patterns and spot buy and sell signals from reviewing years of historical data. When data looks this negative a turnaround is typically near.

Section VII. The Economy

Indexes that measure manufacturing data have weakened. The Philly Fed Manufacturing Index hit a nearly 50 year high in April 2021 with a reading of 50.2 (0 is the line for growth or contraction). The reading for June 2022 was -3.3. The Empire State Manufacturing Index hit a high in July 2021 of 43 (0). June's reading improved but was disappointing at -1.2. The national ISM manufacturing index remained elevated at 56.1% in May and the ISM services index is at 55.9% (above 50 is considered growth, above 55 is considered exceptional growth). Multiple Wall Street and Federal Reserve predictions for GDP have been lowered because of the war in Ukraine and inflation for 2022. GDPNow currently estimates GDP at 0.0% annualized for the second quarter. These economic indicators paint a bit of an opaque picture moving forward and are part of the indication to us that the market could be bottoming.

Section VIII. Conclusion

Corrections and bear markets alike prey on "first-and-worst" catastrophic fears, convincing investors that temporary headwinds are insurmountable. They take fortitude to fight. However, though the emotions corrections provoke feel real, the forces behind them are false.

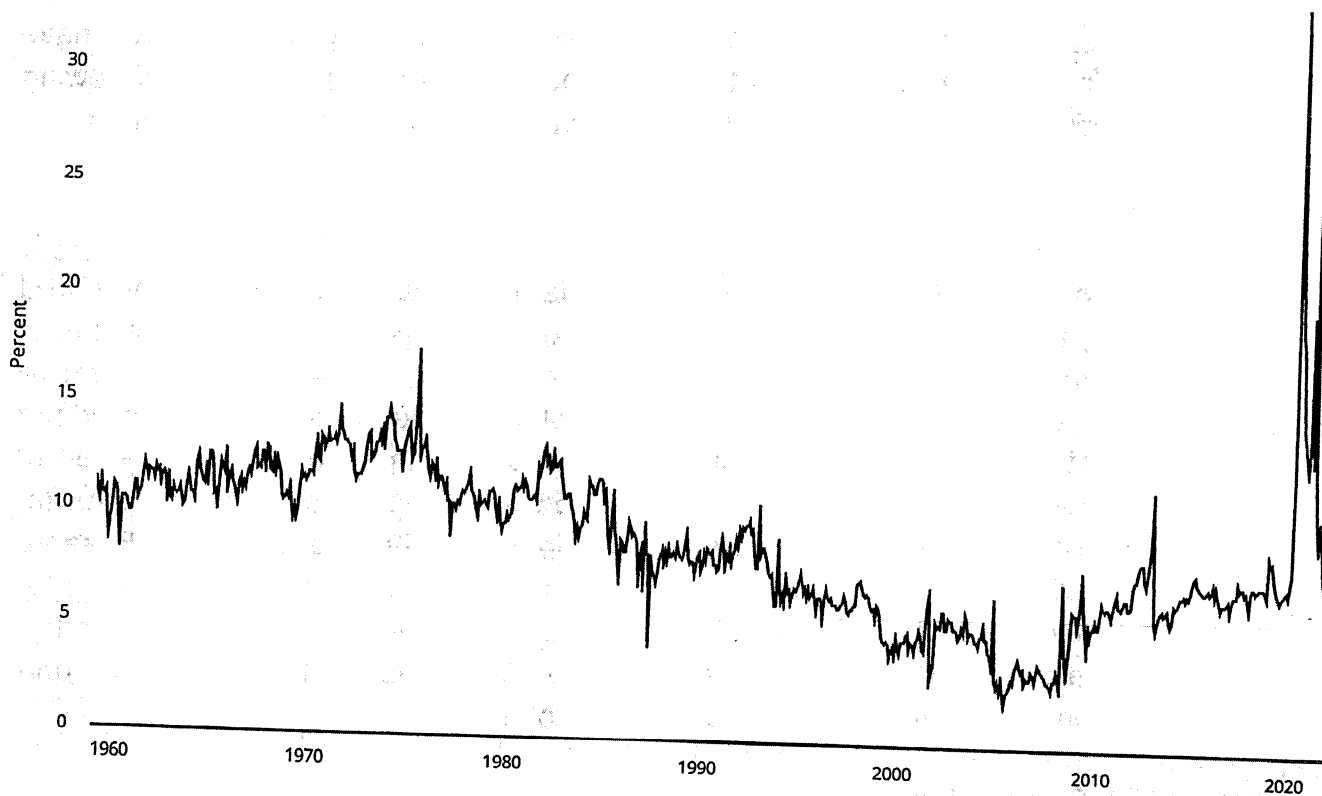
We have been cautious on the markets and feel they are now close to a bottom with the S&P down 21% at this writing. Even if we are incorrect in the short term, purchases in the near future should prove very profitable in the years ahead based on the cyclical nature of the economy and the stock market.

We hope this report finds you in good spirits and good health!

Happy 4th of July!!

Scott B. Williams, CFA, CFP
Kent Stone

Chart 1



Source: U.S. Bureau of Economic Analysis

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Chart 2

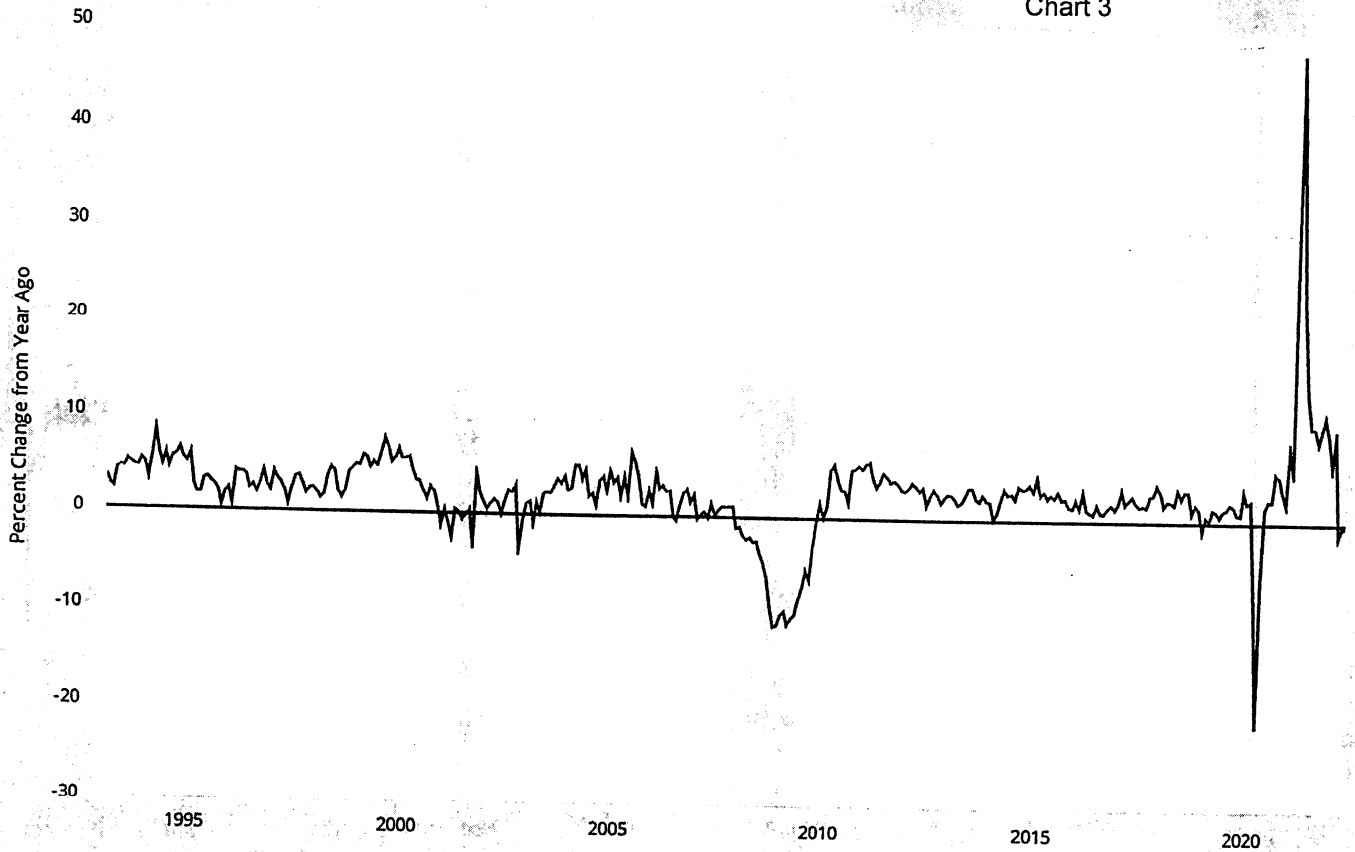
Rate Cut Cycle Start	Rate Cut Cycle End	DIA	S&P 500	Nasdaq Composite
5/31/1989	2/3/1994	50.0%	50.0%	78.8%
7/5/1995	3/24/1997	49.6%	44.5%	31.9%
9/28/1998	6/29/1999	33.4%	28.9%	51.9%
1/2/2001	6/29/2004	2.2%	11.5%	11.2%
9/17/2007	12/15/2008	36.1%	41.2%	41.6%
7/31/2019	1/14/2022*	33.5%	56.2%	81.9%
Average %		23.0%	21.2%	32.0%
Median %		33.4%	36.7%	41.9%

Source: Dow Jones Market Data

Rate Hike Cycle Start	Rate Hike Cycle End	DIA	S&P 500	Nasdaq Composite
2/3/1994	7/5/1995	16.3%	13.3%	18.1%
3/24/1997	9/28/1998	17.4%	32.6%	40.0%
6/29/1999	1/2/2001	-1.6%	-5.0%	-13.3%
6/29/2004	9/17/2007	28.7%	30.0%	26.9%
12/15/2008	7/31/2019	113.7%	143.1%	142.0%
Average %		54.9%	62.9%	102.7%
Median %		17.4%	30.0%	26.9%

Source: Dow Jones Market Data

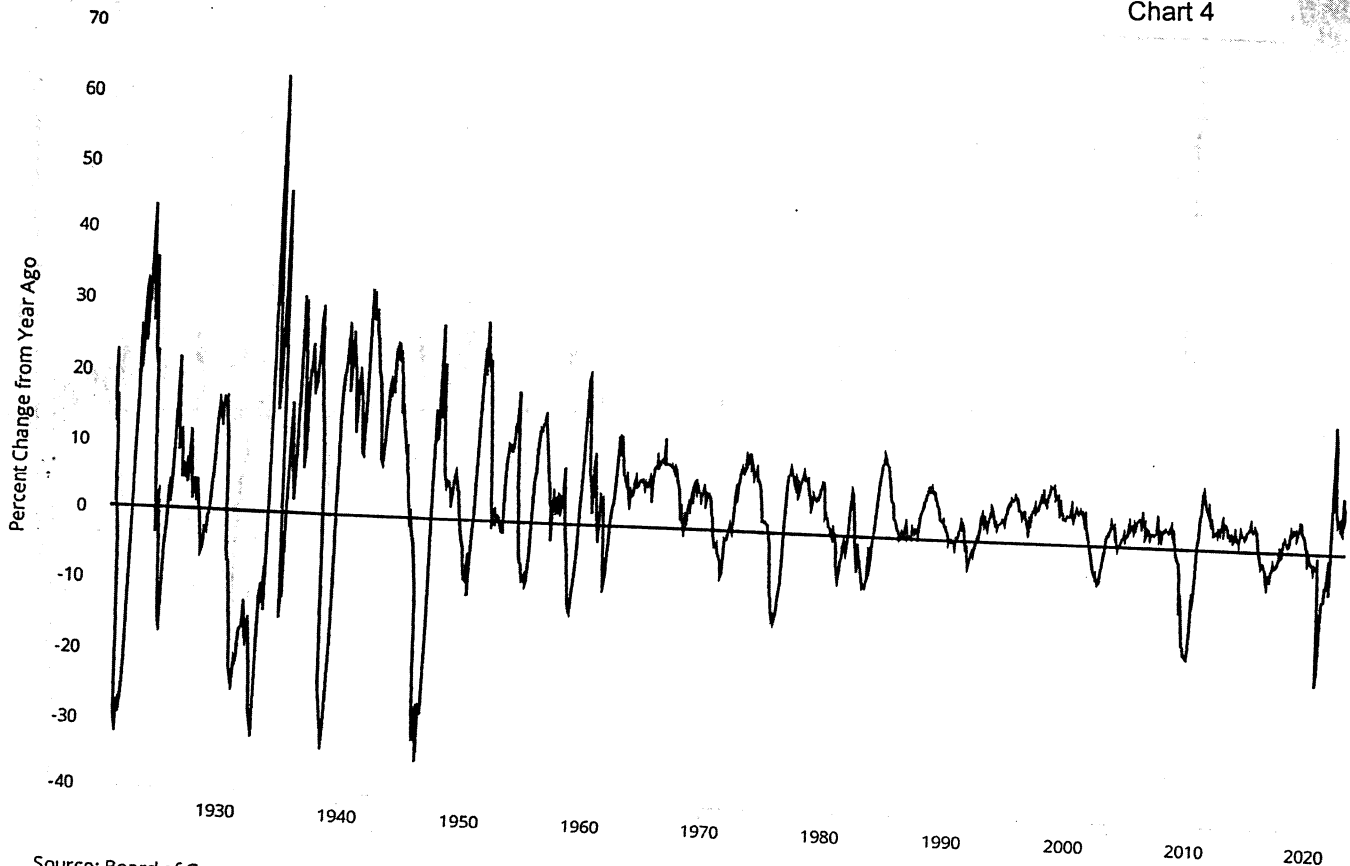
Chart 3



Source: Federal Reserve Bank of St. Louis

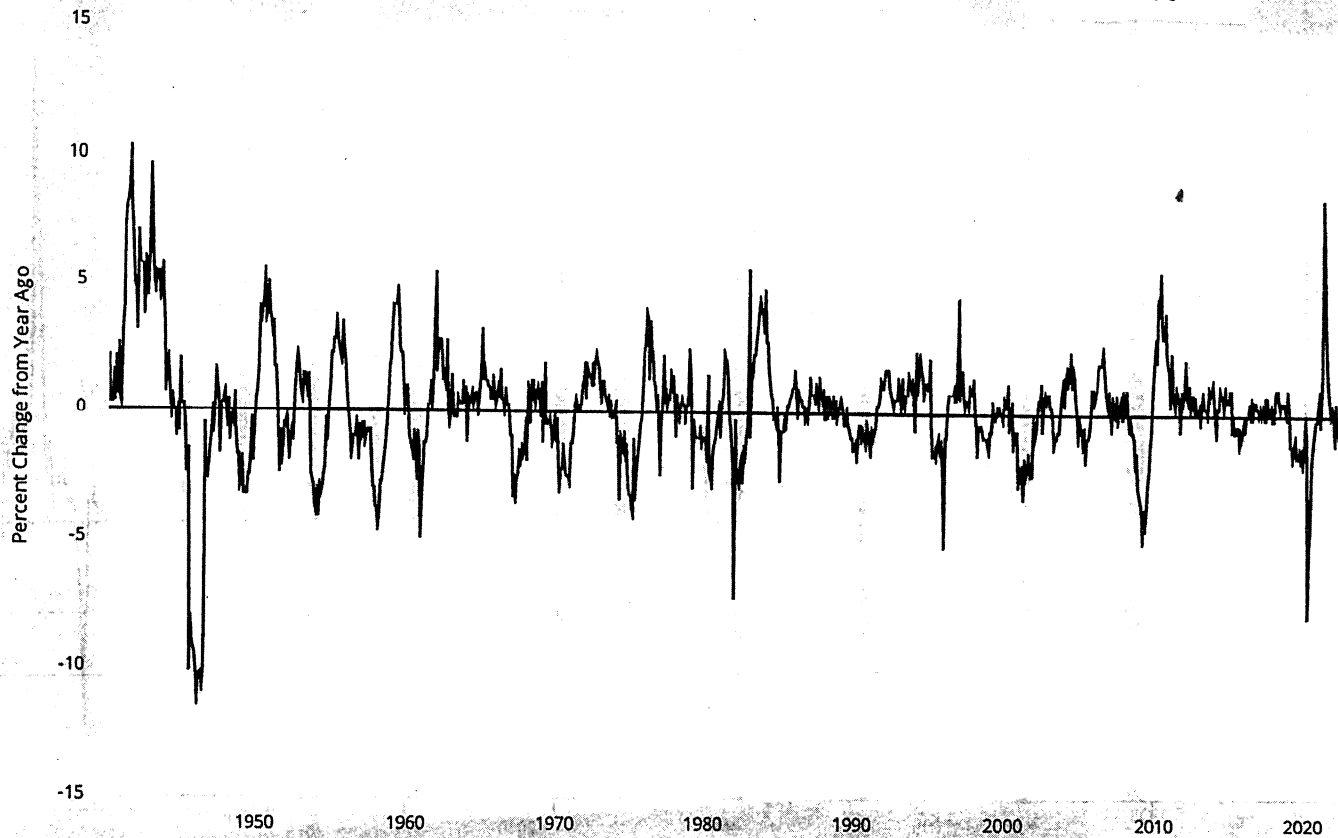
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Chart 4



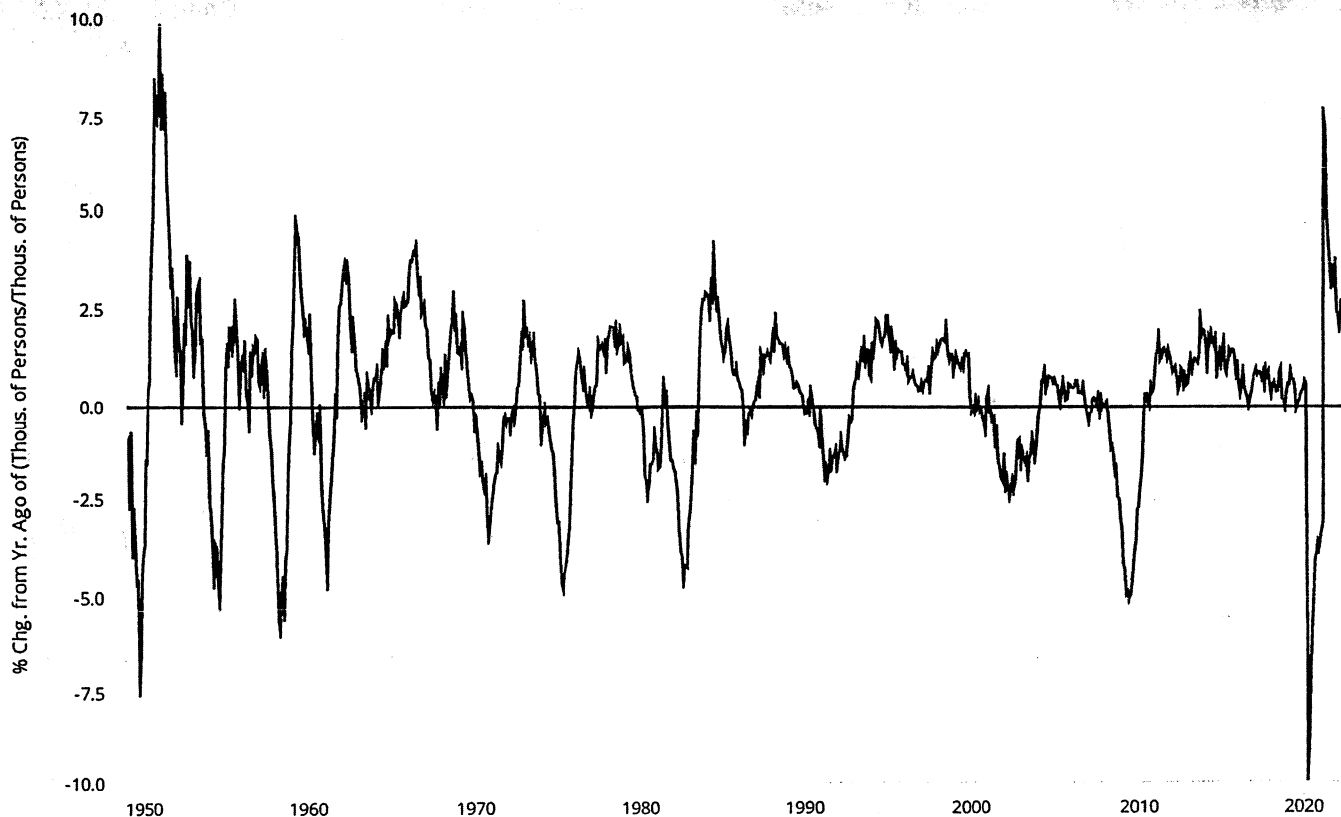
Source: Board of Governors of the Federal Reserve System (US)

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Source: U.S. Bureau of Labor Statistics

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