PENOBSCOT
FINANCIAL ADVISORS

MARKET COMMENTARY

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MARKET REVIEW

The specter of hot price inflation, a tightening Fed, continued supply-chain issues and (still) a global pandemic weighed on capital assets again this quarter. Wall Street has suffered one of its worst six-month stretches in decades. The S&P 500 registered its worst first half since 1962. Ten-year Treasury yields climbed from 2.37% at the beginning of the quarter to over 3.00%, sending bond prices down along with stocks, and making it difficult to find shelter from the market angst.

For the first time since 2015, each of the benchmark indexes lost value for two consecutive quarters. They also posted losses for June, marking three consecutive down months for the tech-heavy Nasdaq, its longest losing streak since 2015. Investors watched for signs of an economic deceleration in the U.S., with inflation continuing to run at multi-decade highs, and monetary policymakers maintaining a firm stance that their priority remains bringing down prices even if it means slowing economic growth.

The dollar is on pace for its best quarter since 2016. Consumer spending slowed for the first time this year, possibly indicating that the economy is indeed weakening. Consumer sentiment fell to its lowest level since 2021. Crude oil prices rose marginally in the quarter, spiking at $123.18 per barrel in early June, ultimately settling at around $105.00 by the end of the quarter. Gold prices declined each month of the quarter as investors weighed rising interest rates against fears of a recession. According to AAA, as of June 30, the average price for regular gasoline was $4.857 per gallon, $0.90 less than the previous week but $1.80 per gallon more than a year ago. As prices for crude oil and gasoline increased, demand waned, helping to pull prices lower. In addition, OPEC+ agreed to increase output in July and August to compensate for the drop in production due to the sanctions placed on Russia.

Stocks fell sharply in April as some disappointing earnings data from companies like Wal Mart and Target added to investor worries about rising inflation and the possibility of a recession. The Nasdaq dropped the most since October 2008, falling nearly 24.0% from its peak as it entered bear territory. The S&P 500 notched its worst month since the beginning of the pandemic, dragged lower by heavy losses in communication services, consumer discretionary, and information technology. Bond prices also lagged as yields increased in anticipation of rising interest rates as part of the Federal Reserve's plan to quell inflation. One factor helping to drive inflation higher was strong wage growth propelled by a tight labor market. Weekly jobless claims fell to their lowest level since 1970, while the unemployment rate dropped to a pre-pandemic 3.6%.

May proved to be a month of market swings. Stocks lost value for the first three weeks of the month. However, a late rally helped the benchmark indexes close the month relatively flat, with the exception being the tech-heavy Nasdaq, which followed April's sharp declines by falling another 2.0%. Early in the month the Federal Reserve raised interest rates by half a percent and announced plans to start reducing its balance sheet in June. The Fed's hawkish pronouncements in its effort to curb rising inflation furthered worries of a recession, despite solid economic data from the prior month.

Stocks soured in June as a slowdown in consumer spending, which accounts for nearly 70% of economic activity, added fuel to recession worries. Unexpectedly hot inflation data for May prompted a Fed Funds rate increase of .75%. Despite a surge mid-month, each of the benchmark indexes ended June in the red. Crude oil prices fell in June, the first monthly decrease since November. The dollar advanced, while gold prices slid lower.

ECONOMIC REVIEW

Employment: One prominent feature of the second quarter was growing tightening in the labor market. Employment rose by 390,000 in May, and despite economist expectations for a slowing to 250,000 in June, that number came in even higher. Notable job gains occurred in leisure and hospitality, in professional and business services, and in transportation and warehousing. Despite the increase, employment is down by 822,000, or 0.5%, from its pre-pandemic level in February 2020. The unemployment rate has remained steadily around 3.6% the period. The number of unemployed persons was essentially the same at 6.0 million. By comparison, in February 2020, prior to the COVID shutdowns, the unemployment rate was 3.5%, and the number of unemployed persons was 5.7 million. Among the unemployed, the number of workers who permanently lost their jobs was unchanged at 1.4 million in May. The number of persons who were unable to work because their employer closed or lost business due to the pandemic fell to 1.8 million. The labor force participation rate increased 0.3 percentage point to 62.3% in May. The employment-population ratio increased by 0.3 percentage point to 60.2%. and average hourly earnings rose by $0.10 to $31.95.

FOMC/interest rates: Following its meeting in June, the Federal Open Market Committee increased the federal funds target rate range by 75 basis points to 1.50%-1.75%. In support of its decision, the Committee noted that it is "highly attentive to inflation risks" and that it "is strongly committed to returning inflation to its 2.0% objective."

GDP/budget: Largely due to a record surge in the trade deficit, Gross domestic product decreased 1.6% in the first quarter of 2022. Exports dropped 4.8%, while imports, a negative in the calculation of GDP, increased 18.9%. Also dragging GDP lower was a 6.8% decrease in federal government spending. Consumers slowed spending on goods such as clothes, home furnishings, and food sending personal consumption expenses to a growth rate of 1.8%, down from 2.5% in the fourth quarter of 2021.

The Treasury budget deficit came in at $66.2 billion in May, 50.0% smaller than the $132.0 billion shortfall in May 2021. Through the first eight months of fiscal year 2022, the deficit sits at $426.2 billion, 79.0% lower than the deficit over the same period in fiscal year 2021 as outlays dropped 19.0%, while receipts increased 29.0%. So far in this fiscal year, individual income tax receipts have risen 46.0% and corporate income tax receipts have increased 17.0%.

Inflation/consumer spending: The Consumer Price Index increased 8.6% for the 12 months ended in May, the largest 12-month increase since the period ending December 1981. The Consumer Price Index climbed 1.0% in May after climbing 0.3% in the previous month. The May increase was broad-based, with advances in prices for shelter, gasoline, and food being the largest contributors. The gasoline index rose 4.1% in May, prices for food rose 1.0%, and the index for shelter increased 0.6%. According to the latest Personal Income and Outlays report for May, both personal income and disposable personal income rose 0.5%, the same

increase as in the previous month. Consumer spending increased 0.2% following a 0.6% jump in April. Consumer prices climbed 0.6% in May after advancing 0.2% in April. Consumer prices have risen 6.3% since May 2021.

Housing: According to the latest survey from the National Association of Realtors®, home sales have essentially returned to the levels seen in 2019, prior to the pandemic, after two years of exceptional performance. Sales of existing homes retreated for the fourth consecutive month in May, falling 3.4% from the April estimate. Year over year, existing home sales were 8.6% under the May 2021 total. The median existing-home price was $407,600 in May, up from $395,500 in April and 14.8% more than May 2021 ($355,000). Unsold inventory of existing homes represents a 2.6-month supply at the current sales pace. Sales of existing single-family homes also fell, down 3.6% in May. Sales of existing single-family homes have fallen 7.7% since May 2021. The median existing single-family home price was $414,200 in May, up from $401,700 in April and up 14.6% from May 2021 ($361,300).

Manufacturing: Since May 2021, manufacturing has risen 4.8%, mining has jumped 9.0%, while utilities increased 8.4%. Industrial production increased 0.2% in May following a 1.4% increase in April. In May, manufacturing output declined 0.1% after three months when growth averaged nearly 1.0%. The indexes for utilities and mining rose 1.0% and 1.3%, respectively, in May. Total industrial production was 5.8% higher than it was a year earlier. May saw new orders for durable goods increase $1.9 billion, or 0.7%, marking the seventh monthly increase out of the last eight months.

Imports and exports: Import prices rose 0.6% in May after advancing 0.4% in April, according to the U.S. Bureau of Labor Statistics. Higher fuel prices offset lower nonfuel prices to account for the overall May increase. Fuel import prices rose 7.5% in May, with higher petroleum and natural gas prices both contributing to the increase. The price index for import fuel rose 73.5% over the past year, the largest 12-month advance since increasing 87.0% in November 2021. Prices for nonfuel imports declined 0.3% in May, the first monthly decrease since November 2020. Prices for U.S. exports advanced 2.8% in May following a 0.8% rise the previous month. Higher prices for both nonagricultural and agricultural exports contributed to the export price rise in May. Export prices have risen 18.9% since May 2021, the largest year-over-year rise since September 1984.

International markets: The United States is not the only country seeing rising costs. Several European nations, plus Israel and South Korea, have seen surges in inflation since the start of the pandemic. Germany, France, Spain, and Italy have seen inflation spike recently. South Korea's inflation reached a 13-year high in April, while Israel, which had maintained low inflation rates through 2021, saw inflation jump 25.0% from the first quarter of 2020 to the beginning of 2022. Inflation rates in the United Kingdom hit a 40-year high in May, up 9.1%. Several countries have taken various measures to try to curb inflationary pressures, from freezing the price of gas and electricity ("tariff shield"), to transfers to the most vulnerable (e.g., energy vouchers), temporary tax reductions or discounts on fuel prices, and price regulation. Of course, several countries have also tightened monetary policy by raising interest rates. Overall, for the markets in June, the STOXX Europe 600 Index declined 5.7%. The United Kingdom's FTSE slid 2.7%. Japan's Nikkei 225 Index fell 2.4%, while China's Shanghai Composite Index rose 5.6%.

Consumer confidence: The Conference Board Consumer Confidence Index® decreased in June following a decline in May. The index stands at 98.7, down from 103.2 in May. The overall index is at its lowest level since February 2021. The Present Situation Index, based on consumers' assessment of current business and labor market conditions, declined to 147.1 in June, down marginally from 147.4 in May. The Expectations Index, based on consumers' short-term outlook for income, business, and labor market conditions, declined to 66.4 in June (73.7 in May), its lowest level since March 2013.

LOOKING FORWARD

The second half of 2022 kicks off with many market and economic indicators in uncharted territory. Job openings exceed the number of unemployed candidates by almost two to one. Inflation is at levels not seen in decades and is proving to be much more stubborn than many economists and policy makers originally assumed. To prevent runaway inflation, the Fed is aggressively raising interest rates and reversing its expansionary bond buying. Meanwhile, COVID shutdowns continue to roll in China, slowing the global recovery from supply-chain challenges – and the Russian invasion of Ukraine seems to be pushing toward an ongoing war of attrition.

It is becoming difficult to find an economist who doubts that, given all these issues, sees anything but an economic slowdown in the upcoming months, not just in the US but globally. The central questions, it seems, are

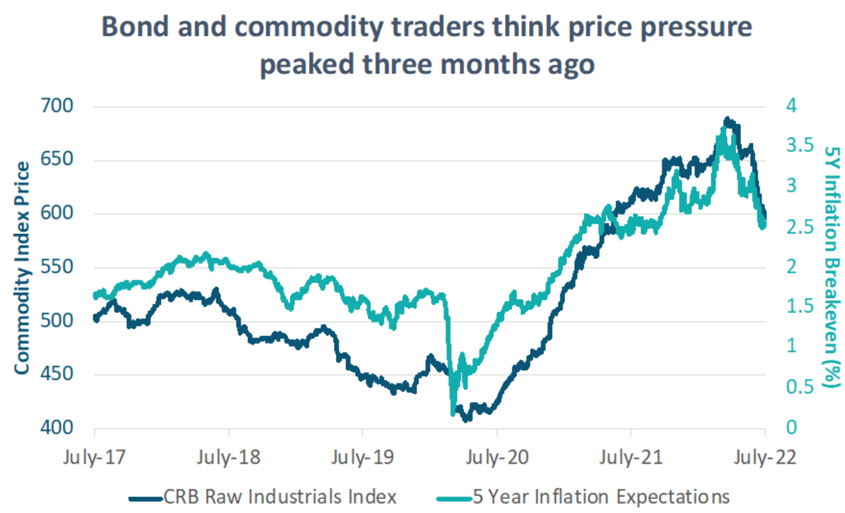
- Can central banks slow the economy enough to bring inflation back in line with targets, but not so much that it results in a recession?
- If we DO experience a domestic and/or global recession, will it be short and mild, or extended and harsh?
- What scenarios have markets already priced in?

With some notable exceptions, corporate earnings and employment have held up for the first half of 2022. As such, the poor performance in capital markets during this period can logically be assumed to reflect expectations that conditions will deteriorate in the future.

PEAK INFLATION?

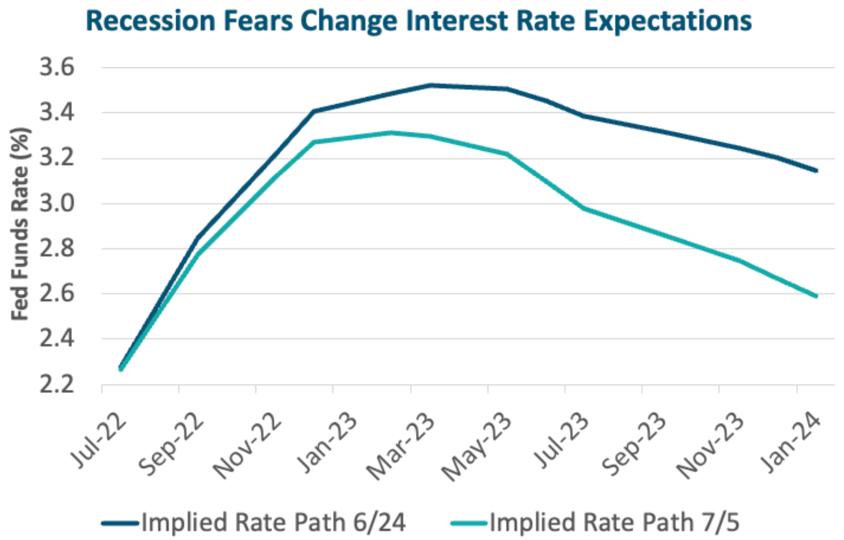
Even though inflation seems to consistently be surprising economists and analysts to the upside, some of the data emerging over the past few months gives hope that we may soon be seeing price pressures begin to abate. Beyond oil price decreases over recent weeks, two data series that show some promise in this area are indicating a reversal in the upward trend. One of these is breakeven 5-year yield on Treasury Inflation Protected securities, which tends to be an indicator of where the bond markets see things going. The Commodity Research Bureau Raw Industrials index, known as the RIND, which follows traded commodities that aren't available on the futures market and is regarded as a good pure measure of inflationary pressure in industry, has shown nearly the same picture.

Global expectations around inflation follow the same trend as in the US. Europe and the UK are more subject to uncertainty due to energy costs and the Russo-Ukraine conflict. It's important to point out that most models don't see long-term trend targets for inflation being reached until 2024 at the earliest.



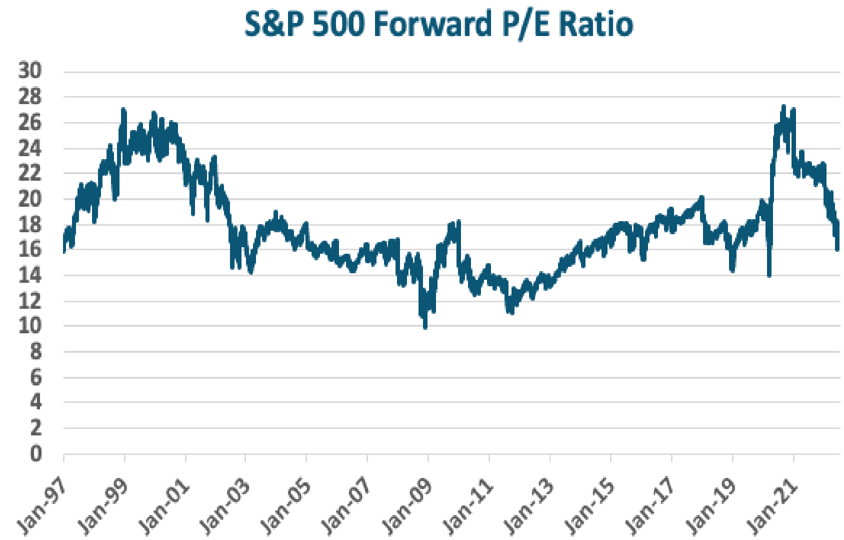
QUICKLY CHANGING FED LANDSCAPE

Futures on the Fed Funds rate reflect market expectations for what the fed will do. While the expectation is that the fed will continue to hike rates through 2022, the expectations of how far they'll go changed substantially over the end of the quarter, reflecting an expectation that the Fed will actually start to LOWER rates in 2023. This reflects growing consensus that the impact of higher rates will likely slow the economy to a recessionary (or nearly recessionary) level, resulting in the need for future support.



STILL NOT 'CHEAP'

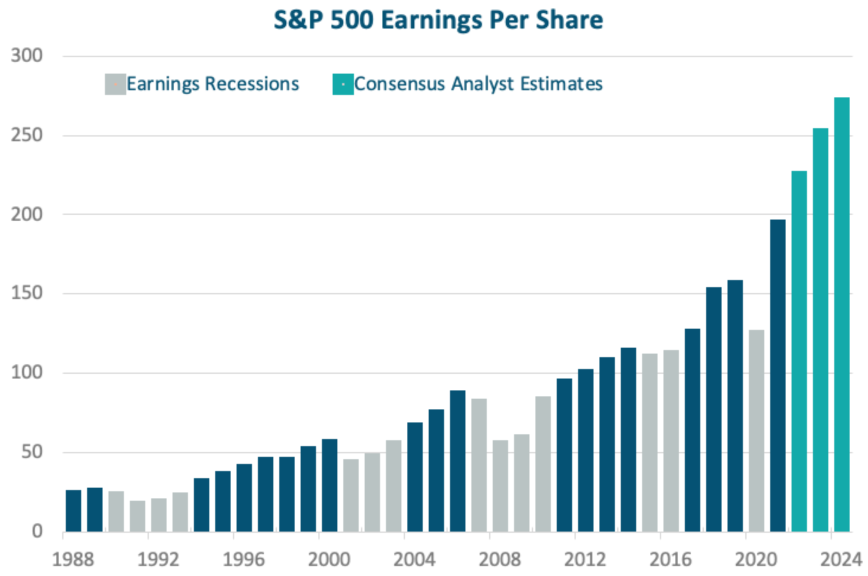
Stocks are poised at price multiples that are below the 25-year average, but valuations are still high, relative to the levels seen in the 2008 Global Financial Crisis.



S&P 500 Valuation Measures		
Description	**6/30 Value**	**25-YearAverage**
Forward Price to Earnings	15.94x	16.85x
Price to Book	3.36x	3.10x
Price to Cash Flow	12.14x	11.16x
Dividend Yield	1.76%	1.99%

EARNINGS ESTIMATES

This could be, in part, because analysts aren't projecting an earnings recession. If earnings can maintain reasonable levels, any recession may be mild and valuations may not drop as far as they did during that crisis. Meanwhile, 'value stocks' seem far cheaper, relative to 'growth stocks'.



THE STRESS ON CONSUMERS

While wages have seen some improvement, consumer prices, especially for shelter (rents, mortgages, and housing) have gone up faster. This stands to put some stress on consumers, who make up 70 percent of economic activity in the US. This also has the potential to limit how much further these prices are likely to rise.