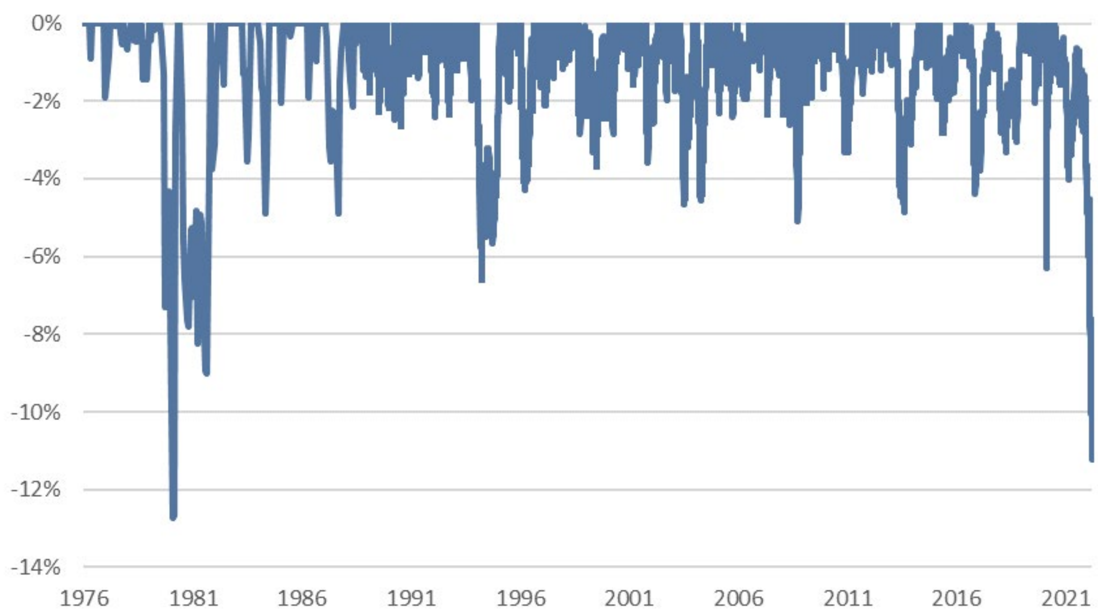
MARKET COMMENTARY

Fig. 1: Peak-to-trough drawdown, Bloomberg Aggregate Bond Index



Source: Bloomberg, Mill Creek.

US Gross Domestic Product (GDP) contracted -1.4% in Q1 2022. Coupled with a higher-than-expected 8% inflation print, this data appears troubling. *Is it stagflation or the start of a recession?* In our opinion, no, at least not yet. The underlying fundamentals remain far stronger than the headline number implies.

Net exports and inventories subtracted -3.2% and -0.8% from the overall GDP number, whereas the more important *private final domestic demand* number, which includes personal consumption, business fixed investment, and residential investment, was up 3.7%. These numbers imply that we're still in an overheating economy where supply can't keep up with demand. Inflation remains far too high, and the Federal Reserve won't find any reasons in the GDP report to change their current tightening plans. They will likely begin the first in a series of at least four 50bps hikes at their meeting this week.

Economic Geopolitical Review

- Despite the negative Q1 advance print for GDP, the US economy remains overheated. The NY Fed Weekly Economic Index indicates current real growth of about 4.5%.
- Inflation remains well above the Fed's target, but market-based pricing indicates the Fed has not lost credibility and will successfully tame inflation. Market participants expect inflation to average 2.5% between May 2027 and May 2032.
- Financial conditions have started to tighten. For example, average 30-year mortgage rates are now 5.42%, compared to 3.2% at the beginning of the year.

- The US dollar has strengthened 8% this year and 14% over the last 12 months.
- China continues to tighten COVID restrictions. Many forecasters believe China's economy contracted in Q1 and will do so again in Q2, and repeated lockdowns have exasperated global supply chain backups.
- The war in Ukraine continues to weigh on Europe. Year-over-year real GDP forecasts have declined from 4% to 2.8%, and inflation remains problematic.

Market Review

- Global equity markets generally declined in April and have once again fallen near correction territory.
- Earnings season is about 50% complete in the US. So far, 79% of companies have reported positive earnings surprises.
- US equity valuations have declined as earnings continue to grow. The implied equity risk premium (the expected return above Treasury bonds) is now higher than it's been since 2019.
- Interest rates continued to increase in April. Ten-year Treasury Bond Yields ended the month at 2.9%.
- Fixed income portfolios have suffered substantial drawdowns. The Bloomberg Aggregate Bond Index has declined 11.2% since 2020, its worst drawdown in 40 years (Fig. 1).

Our Perspective

- Sentiment has become too negative as investor and consumer sentiment measures have fallen to levels not seen since the depths of the financial crisis. The probability of a US recession continues to increase, but it is still not the most likely outcome over the next 12 months.
- Real economic growth in the US is gradually slowing — as it needs to — but remains above trend. We are watching housing and aggregate household income as leading indicators of growth and inflation, respectively.
- Prudent asset allocation remains the best way to address geopolitical risk. Investors with cash on the sidelines should consider using the sell-off as an opportunity to accelerate dollar-cost-averaging plans.
- Against the backdrop of elevated inflation and above-trend growth, we continue to overweight US equities within global equities and allocate to private debt and absolute return hedge funds out of high-quality bonds.

*Authored by **Michael Crook, CAIA***