Mid-Year Investment Outlook 2022

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Markets have struggled to find their footing so far in 2022, tumbling into bear territory under the weight of high inflation and ongoing supply chain struggles.

The lingering challenges have taken a toll on consumers, who show signs of spending fatigue and increased pessimism as they pay more for gas, groceries and other commodities.

After keeping rates at zero for the past two years, by March, the Federal Reserve realized high inflation was not "transitory" as they had previously asserted. They began a series of fed funds rate raises in March and plan more increases over the course of the year. Markets' lack of optimism that the Fed can push rates higher without incurring a recession contributed to their downward spiral in the second quarter.

For investors, big questions remain as we enter the third quarter. Will markets rebound? How high will interest rates go? Is the U.S. economy headed for a recession – and if so, how long will it last?

In the following pages, we examine the current situation and share our thoughts about what investors might expect in the second half of 2022.

Key Takeaways

- Consumers seem to be showing signs of spending fatigue amid high gas prices and the rising cost of goods.
- The Fed could potentially raise the fed funds rate to 3.25-3.5% by the end of the year. But will it be enough to combat inflationary pressures?
- After growing significantly last year, gross domestic product shrank in the first quarter, and the current forecast is for more of the same in the second quarter. However, the Fed says they are expecting GDP growth this year – a big task considering there is no relief in sight from ongoing challenges.

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A Turbulent First Half

Although markets ended 2021 at record levels, we were already seeing troubling signs of inflation accelerating and gas prices ticking up as we entered the new year.

The snarled supply chain became even more entangled following Russia's invasion of Ukraine in February, sending a further shock through world economies, especially in the energy sector.

By the end of the first quarter, the Federal Reserve changed its position on the "transitory" nature of inflation. Inflation rates hit 7.9% in March and continued their upward climb to hit a new 40-year high of 8.6% in May.[1] In an effort to combat inflation, the Fed enacted a series of interest rate raises in March, raising rates by 50 basis points (.50%) at its March and May meetings. The Fed took a more aggressive approach in June, raising rates 75 basis points (.75%), its largest bump since 1994.[2]

We also saw a reversal of GDP growth in the first quarter. After posting a strong 6.9% growth rate in the fourth quarter of 2021, first-quarter GDP shrank by 1.6%.[3] Forecasts are also calling for nominal GDP growth in the second quarter - a sure sign that the economy is struggling to find it's footing.[4]

In response to these challenges, equity markets sold off throughout the second quarter. Bond yields also rose, and the yield curve inverted late in the second quarter, signaling a potential recession could be lurking in the near future.

Despite the overwhelming challenges, there are a few bright spots as we enter the second half of the year. The unemployment rate was at 3.6% in May, matching pre-pandemic levels.[5] And while supply chain issues still exist, some industries are reporting increased access to raw materials, leading to positive earnings forecasts.

Still, these bright spots haven't improved markets' outlook. Markets have dropped around 20% since the first of the year, ushering in a bear market.[6] The ongoing challenges and lack of optimism have left investors to wonder: What will the second half of 2022 hold?

Looking Ahead to the

Second Half of 2022

There seems little room for optimism as we swing into the summer months. Oil has returned to over $100 per barrel,[7] and gas prices are averaging $5 per gallon just as Americans hit the road for summer vacations.[8] Travel was muted in 2020 and 2021 due to the pandemic, and people are eager to get out – but venturing out may come at a steep price as everything is much more expensive.

With current high prices, the U.S. consumer seems to be showing signs of fatigue. Consumer sentiment, which measures how people feel about their finances, dropped to 58.4 in May, down 24.5 points from just one year earlier.[9] Government stimulus payments have ended, and people are likely drawing down their savings faster as prices continue to climb.

After raising rates by 1.75-2.0% in the first half of the year, the Fed has said it will continue to raise rates into 2023. At the start of the year, markets seemed to feel the Fed might be able to engineer a soft landing, raising rates just enough to combat inflation without tipping us into a recession. It seems unlikely we will find that balance now.

The Fed currently has two options: 1) Raise rates to a level that will tame inflation, in turn causing a recession and causing markets to decline further; or 2) stand back and allow inflation to remain elevated. If they choose the second option, it might help the economy avoid an immediate recession and keep the markets afloat in the near term.

However, the second option could also lead to slow growth and inflation ("stagflation"), which could eventually tank the economy. Neither scenario is good. In our view, it could be more beneficial to put inflation in check, let markets reprice and find the bottom, and then rebuild. But right now, it seems the Fed will continue on its course and overcorrect, pushing the U.S. into a recession.

Although first-quarter earnings were decent overall, many companies signaled caution for earnings going forward. And while inflation may peak soon, it will likely remain elevated for some time. We may have some positive surprises to lighten the mood over the next few months – such as an end to the conflict in Ukraine – but investors should remain braced for ongoing volatility as we head towards the end of the year.

Final Thoughts

With so many lingering questions, how do we go forward? Focusing on the fundamentals is key in times of uncertainty and potential volatility. If you aren't concerned about your assets and are willing to ride through a season of volatility, stick with your current plan.

But if potential market turbulence creates anxiety or fear for the future, **this is the time to reassess your tolerance for risk and adjust your plan in a way that better aligns with your goals.**

Most importantly, **rely on your financial professional** for encouragement, advice and reminders about why you started on this journey in the first place. None of us knows what lies ahead in the next days, weeks or months, but we can all navigate the challenges – and take advantage of the opportunities – together.

Sources

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AE WEALTH
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AEWealthManagement.com
866.363.9595

2950 SW McClure Road, Suite B
Topeka, KS 66614

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