Vestor Capital
INVESTMENT & WEALTH MANAGEMENT

Economic and Investment Outlook — July 8, 2022

Equity Market Update

Major broad-based U.S. equity indexes pulled back between 15% and 20% in the first half of 2022. The technology heavy NASDAQ index fell almost 30% as investors fled high growth companies. The market is facing a two-headed monster of higher interest rates and inflation, resulting in continued weakness. Until inflation tapers and the Federal Reserve stops raising interest rates, we believe markets will continue to struggle. The old saw to "Not Fight the Fed" refers to the fact that markets generally face headwinds during interest rate hiking periods, and this time, unfortunately, is no different.

Developed International indexes recorded losses in line with U.S. markets as they are facing many of the same issues that the U.S. is dealing with. Emerging market (EM) indexes continue to be weak due to slowing growth in China. While much has been said about the effects of the COVID induced shutdown, we believe that China's growth is on a long-term slowing path as we begin to see the cracks in the government directed economy model.

It is important to remember that equities have performed very well over the past decade. This is the first major market correction in many years and while unpleasant, it is a normal part of the investment cycle. We believe that when we begin to see inflation slow and interest rate hikes cease, markets will strengthen. Unfortunately, we remain in the waiting room.

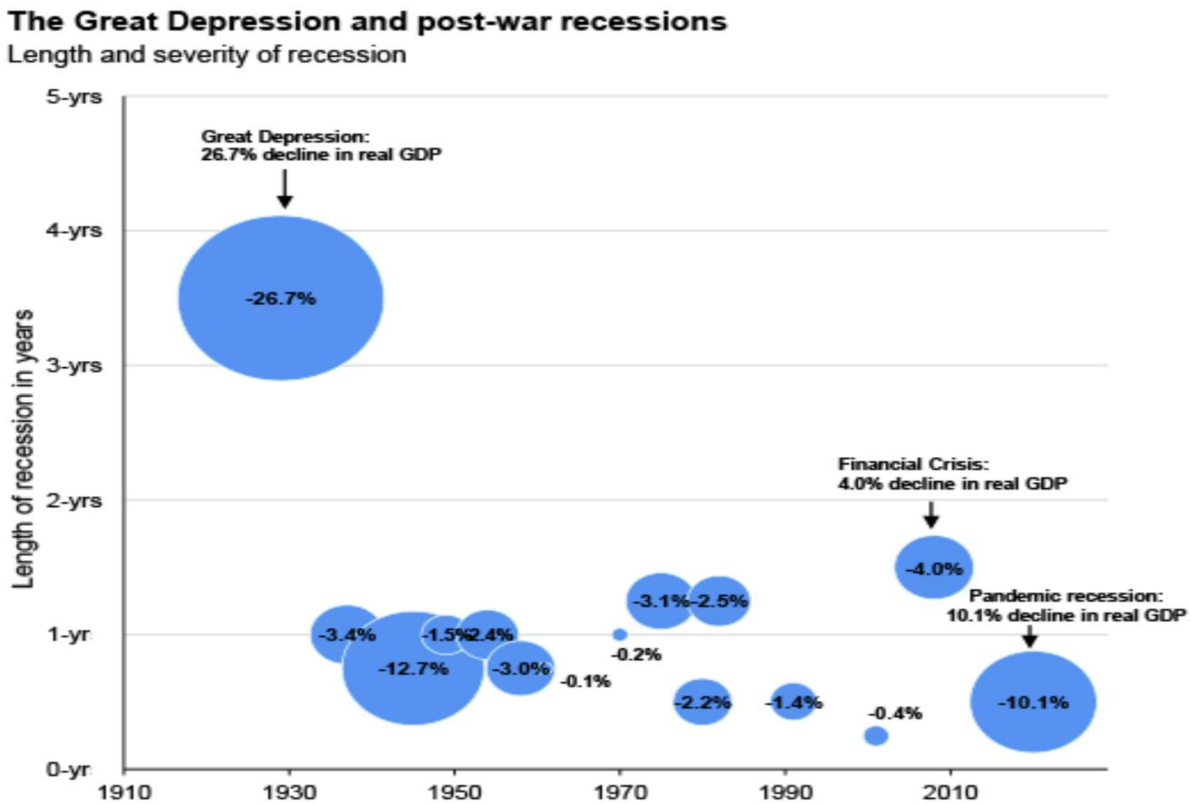
Total Return Performance for the Major U.S. and International Stock Market Indexes

Equity Index	*YTD June 30, 2022*
United States	
Dow Jones Industrial Avg.: 30 Stock Composite	**-14.44 %**
S&P 500 Composite: U.S. Large Cap	**-19.97 %**
NASDAQ Composite: Technology Heavy	**-29.92 %**
S&P 600 Small Cap: U.S. Small Cap	**-18.97 %**
International	
MSCI EAFE Large Cap: Europe, Asia & Far East Large Cap	**-19.23 %**
MSCI EAFE Small Cap: Europe, Asia & Far East Small Cap	**-24.47 %**
MSCI EM Emerging Market: Emerging Market Countries	**-17.57 %**

Source: Bloomberg, L.P.

Economy

The media drumbeat that we may be entering a recession necessitates a look into what a recession might actually look like. The graph below highlights that most recessions last one year or less and Gross Domestic Product (GDP) falls by 3% or less. The only major economic contractions that we have experienced over the past 40 years have been the Financial Crisis and the government induced pandemic recessions. As the U.S. economy has transitioned to a more service-based economy, swings in the business cycle have become more muted.



Source: JPMorgan Guide to the Markets 6/30/2022

Employment/Inflation

The June employment report was strong with 372,000 jobs created vs. estimates for 265,000. The unemployment rate held at 3.6%. On the negative side, wage gains of 5% were below inflation resulting in less purchasing power.

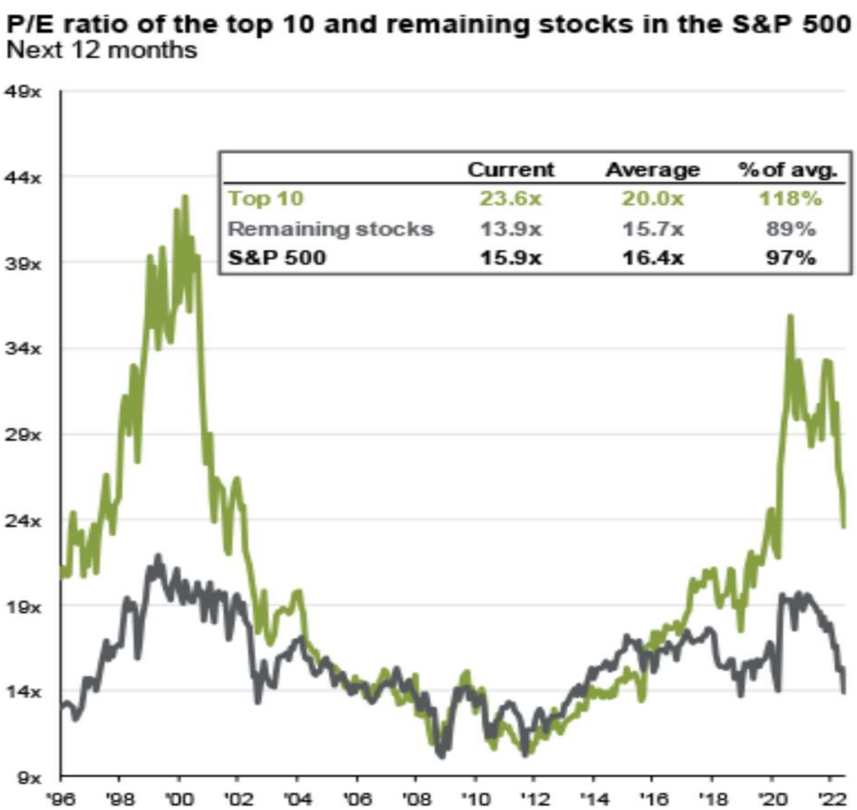
Inflation is the elephant in the room currently. The May inflation reading of 8.6% is the third straight month of readings above 8% which is concerning. Due to elevated inflation reports, the Fed is accelerating interest rate hikes in an attempt to slow the economy which presumably will cause inflation to slow. No one knows, including the Fed, how many interest rate hikes will be required to slow inflation and that has investors nervous.

It is important to remember that the best cure for high prices is high prices. By this, we mean that higher prices generally result in less consumption which in turn causes inflation to ebb, regardless of what monetary authorities do with interest rates. We expect inflation will naturally begin to slow as consumers begin to consume less. Lower consumption will likely result in slowing economic growth which will result in the Fed slowing or stopping interest rate hikes. This is the “soft landing” scenario that monetary officials are hoping for. In the meantime, all eyes will remain on monthly inflation reports.

U.S. Equity Market Outlook

As a result of the market correction that we have experienced this year, price-to-earnings (PE) ratios have fallen as corporate earnings have generally been strong. The graph below highlights that if you exclude the top 10 stocks in the S&P 500, the average PE of 13.9 is almost 2 points lower than the long-term average, signaling that the stock market is not expensive on a valuation basis. A number of stocks are trading at very low valuation levels. Of course, what is important is the direction of future earnings. If future earnings decline, then the current low PE ratios are not as attractive as they first appear.

The key determinant of equity returns going forward will be corporate earnings. If inflation slows and interest rate hikes taper off, we believe corporate earnings will be resilient, providing a solid foundation for equities. We believe this is the most likely case. In the event that inflation remains elevated, and the Fed continues to raise interest rates, then earnings are likely to be pressured. Recent equity market volatility has been elevated as investors attempt to grapple with all these possibilities. We believe that the picture will begin to clear over the coming months, providing a better investing backdrop.



	Current	Average	% of avg.
Top 10	23.6x	20.0x	118%
Remaining stocks	13.9x	15.7x	89%
S&P 500	15.9x	16.4x	97%

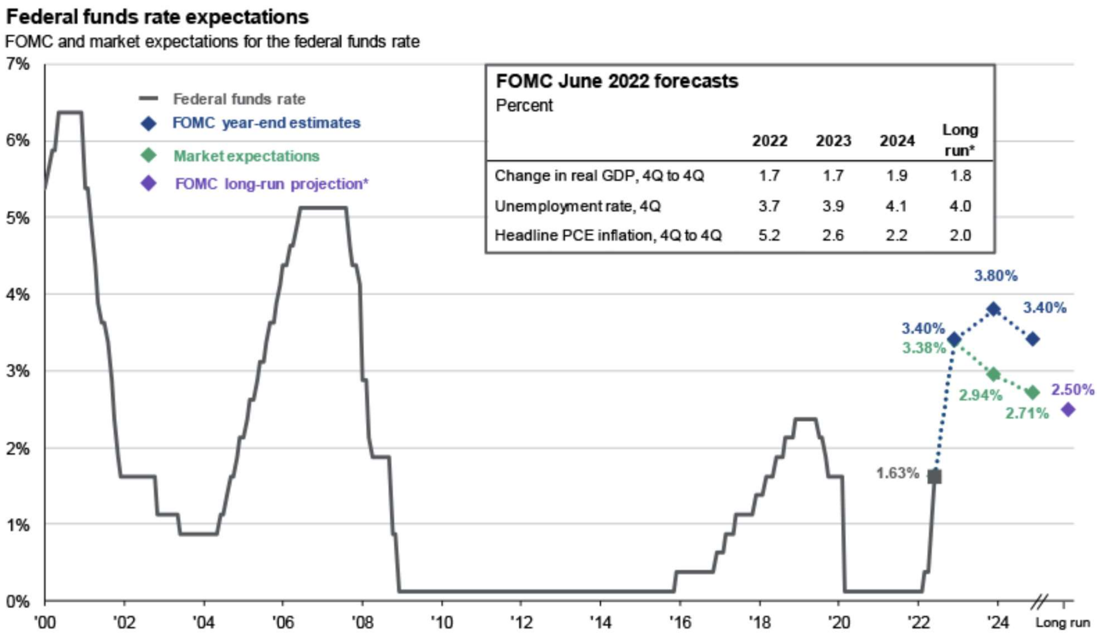
Source: JPMorgan Guide to the Markets 6/30/2022

International Equity Market Outlook

International equities have performed in line with their U.S. counterparts this year as many of the issues facing U.S. companies are also impacting international firms. We expect international equities to strengthen when the issues we highlighted above resolve themselves. The one wild card will be how Europe deals with their energy security concerns related to supply issues with Russia. In addition, China is likely on pace for slower growth in the coming years which impacts not only Chinese equities, but also many companies which depend on China for exports.

Fixed Income

The bar chart below highlights that the market expects fewer rate hikes than the Federal Open Market Committee (FOMC), and that rates may actually start to fall by 2023 or 2024. None of the estimates project rates rising to levels seen in prior tightening cycles which is encouraging. With long-term treasury rates currently at about 3.0%, it appears that the market has largely discounted the expected interest rate hikes over the coming months.



Source: JPMorgan Guide to the Markets 6/30/2022

Summary

It is important to remember that equity performance in 2020 and 2021 far surpassed anyone's expectations, and negative returns in 2022, while painful, are a healthy resetting. Negative fixed income returns are frustrating for investors. Interest rates were at generational lows in 2021, and the only direction they could go was up. This eroded the value of existing bonds, resulting in negative returns. Even commodities which had performed well for much of 2022 have fallen recently, highlighting that no asset class is being spared in the current environment.

In the event of an economic slowdown, companies in the U.S. are in an excellent position to weather the storm as debt levels are low and margins are at historically high levels. Our view is that the U.S. economy will either have a "soft landing" or at worst a shallow recession over the coming year. We expect corporate earnings to remain resilient which should help ease investor concerns. We believe that the market has largely priced in this scenario, setting the stage to advance once we get clarity on the economy's direction over the coming months.