

# MACRO & MARKET

PERSPECTIVES

INFLATION, GAS PRICES, RECESSION  
2ND QUARTER KEY TAKEAWAYS

STOCKS, BONDS  
& ASSET ALLOCATIONS  
OUTLOOK & OVERVIEW

3RD QUARTER 2022  
A FIRST LOOK

**PRESENTED BY**  
The Investment Committee  
of Oakworth Capital Bank

July 2022 | 2nd Quarter

2ND QUARTER 2022 ECONOMIC OUTLOOK & OVERVIEW

# 2Q

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A FIRST LOOK AT 3RD QUARTER 2022



JOHN NORRIS  
Chief Economist

*A letter from our*

INVESTMENT COMMITTEE

The specter of long-term inflation loomed over the markets during the 2nd Quarter of 2022. As the 12-month Consumer Price Index (CPI) hit a 40-year during the quarter, people wondered exactly what the Fed meant by saying inflation was transitory. It sure didn't seem like it.

As a result, investors felt they had two dreadful choices: 1) inflation would eventually drown out economic growth, or; 2) the Federal Reserve would kill economic growth by killing inflation with higher interest rates. In this sort of a gloomy scenario, investor psyche plummeted, and nothing seemed to work.

Stocks, as defined by the S&P 500, had their worst quarter in roughly 50 years. If you think that is bad, by some measures, the bond market has had its worst start to a calendar year since before the Civil War. Finally, while cash hasn't fallen like stocks and bonds, inflation has taken a big bite out of the US consumer's purchasing power.

In a lot of ways, every way actually, it was great to see the 2nd Quarter's taillights.

Interestingly, the economic data hasn't been as bad as the markets would suggest. To be sure, growth has been less than in was in 2021. However, outside of an explosion in our trade deficit, domestic output has been okay. Not great, but still not the worst case scenario so many had thought it was.

This takes us to the 3rd Quarter of 2022. The labor market remains tight. Banks are still flushed with liquidity. If you liked stocks at the start of the year, you should love the valuations now. Longer-term inflation

expectations are moderating, so bonds likely won't fall apart like they have thus far this year. This means stock prices should rebound from the 2nd Quarter's red ink.

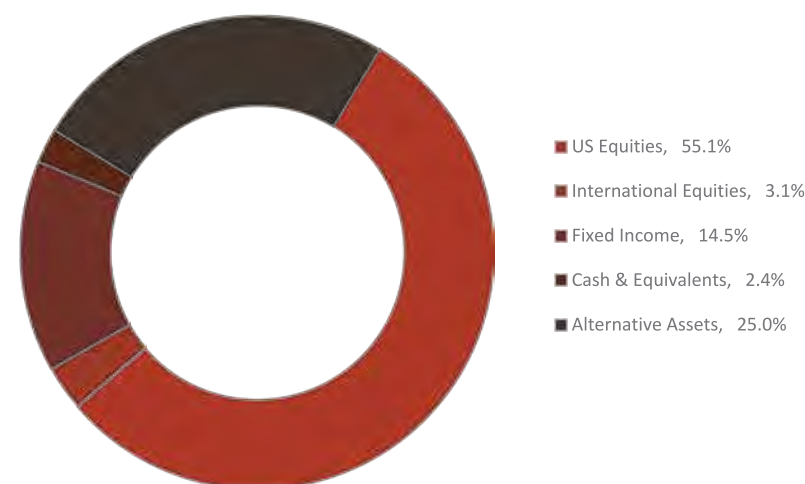
It hasn't been fun, but it appears as though there is some light at the end of the tunnel. Let's keep our fingers crossed the market funk is truly, to use the Fed's word, transitory.

Please enjoy our thoughts about what happened in the 2nd Quarter, if that is possible, and what might happen throughout the remainder of the year. Obviously, no one can look into the future with crystal clarity. However, by anticipating potential changes, we can capitalize on them for our clients' benefit.

Sincerely,

John Norris  
Chief Economist

*The Oakworth Capital Investment Committee distributes information on a regular basis to better inform our clients about pending investment decisions, the current state of the economy, and our forecasts for the economy and financial markets. Oakworth Capital currently advises on approximately \$2 billion in client assets.*



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2nd Quarter 2022

## KEY TAKEAWAYS



### 01. FEDERAL RESERVE

Thanks to stubbornly high consumer prices, the Federal Reserve increased the target overnight lending rate by 100 basis points (1.00%) during the 2nd Quarter. This was the most aggressive the Fed has been in any one calendar quarter in decades.

### 02. INVESTORS

Other than overnight cash, there was no place to hide during the quarter. Just about every mainstream broad index and asset class posted negative returns, prompting U.S. investors to wonder what they should do next.

### 03. CRYPTOCURRENCY

The markets found out how cryptocurrencies fare during a Fed tightening cycle: very poorly. The horrific quarter for the asset class left many investors wondering whether cryptocurrencies were ever going to live up to their promise. After all, if it doesn't maintain its value and you can't buy a gallon of milk with it (in most places), what good is it? We shall see.

### 04. GASOLINE

For a variety of reasons, gasoline prices soared throughout the quarter. Seasonal factors account for some of the increase, as does a decrease in domestic production and refining capacity. Fortunately, gasoline futures started to fall by the end of June. Unfortunately, Washington doesn't seem to have a workable plan to prevent this from happening in the future.

### 05. INFLATION

Consumer confidence fell sharply during the quarter, as the highest inflation in 40 years took a bite out of their purchasing power. Analysts started using the dreaded word recession with increased frequency. This despite a red-hot labor market with an estimated 11.2 million job openings.

### 06. MONETARY POLICY

Despite embarking on a tighter monetary policy in 2022, the Fed does not seem quite as intent on killing the economy to rein in inflation like Paul Volcker did in 1980. Time will tell whether that is good news or bad.

### 07. WASHINGTON

The Supreme Court had one of its most momentous sessions during the quarter. A common theme in its decisions was the curtailment of the federal government's power. Over the long term, limiting Washington's impact and influence on the economy should lead to increased economic activity. We just have to keep from tearing ourselves apart until then.

### 08. THE NEWS

The war in Ukraine and even COVID-19 fell from the front pages during the quarter. Unfortunately, inflation and a surge in mass shootings took their places. This extremely negative news cycle has undoubtedly had a negative impact on investor psyche, and the red ink in every asset class suggests that.

# ECONOMIC OVERVIEW

*John Norris*



If we had only one word to sum up the 2nd Quarter of 2022, it would be inflation. After all, the U.S. economy hasn't seen consumer prices increase this fast since the early 1980s. It was strong and persistent enough to largely push the war in Ukraine and COVID-19 off of the front page.

Investors could only question the Federal Reserve's previous use of the term "transitory" to describe inflation. Apparently, Jay Powell and the rest of his gang define transitory a little differently from the rest of us. Whatever the definition, it hasn't been fun for consumers.

While a huge surge in energy prices has been the source of pain at the pump and elsewhere, prices are up pretty much across the entire economy. This is especially true for inelastic goods. These

are items consumers must have, like food and energy, as opposed to want to have.

According to the U.S. Bureau of Labor Statistics (BLS), "food at home" increased by 11.90% for the 12 months ending in May 2022. Conversely, "food away from home" increased only 7.40%. While that is still much higher than the norm, eating out has gone up less in price than eating at home. Finally, as if consumers didn't already know it, motor fuel has risen an eye-watering 49.10% year over year.

Not surprisingly, this has taken a toll on consumer confidence. While confidence is still reasonably high by historical standards, the trajectory of its recent drop is one of the sharper in the series. This is evident in blue in the chart below. Further, the survey

RUNAWAY INFLATION  
12-Month Consumer Price Index



*Data points provided by Bloomberg*

suggests the U.S. consumer is increasingly concerned about prospects over the next six months. The orange line in the chart has fallen pretty significantly since the start of the year, and the current observation is as low as it has been in roughly a decade. This includes the worst of the economic lockdowns during 2020.

Suffice it to say, a concerned consumer is not the best news in a consumer-driven economy.

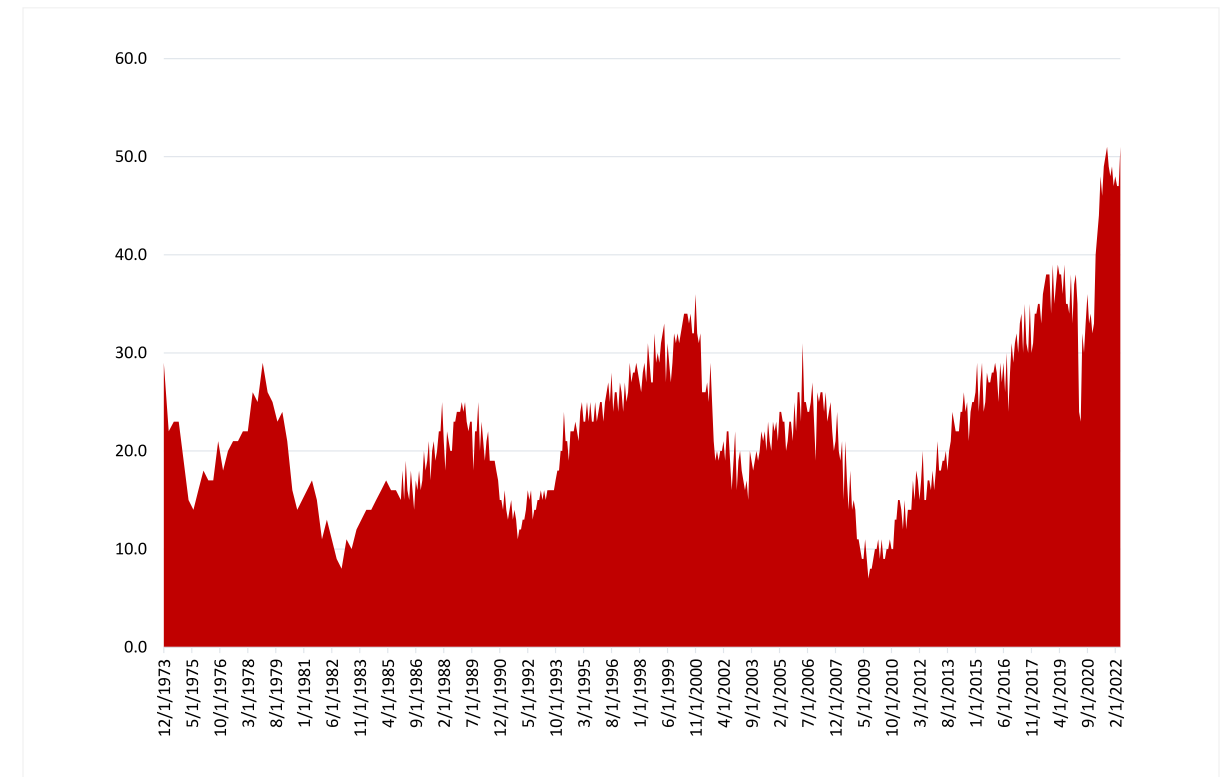
Interestingly, despite recent pessimism, the labor market continues to create a lot of jobs, and there is an enormous number of job openings. According to the BLS, there were roughly 11.4 million available jobs in the United States in April 2022. To put that

number into perspective, slightly less than the ENTIRE population of Belgium.

So, there seems to be a bit of divergence between employee and employer confidence. After all, if business were bad, companies wouldn't be hiring and looking to hire more. It is a very strange situation.

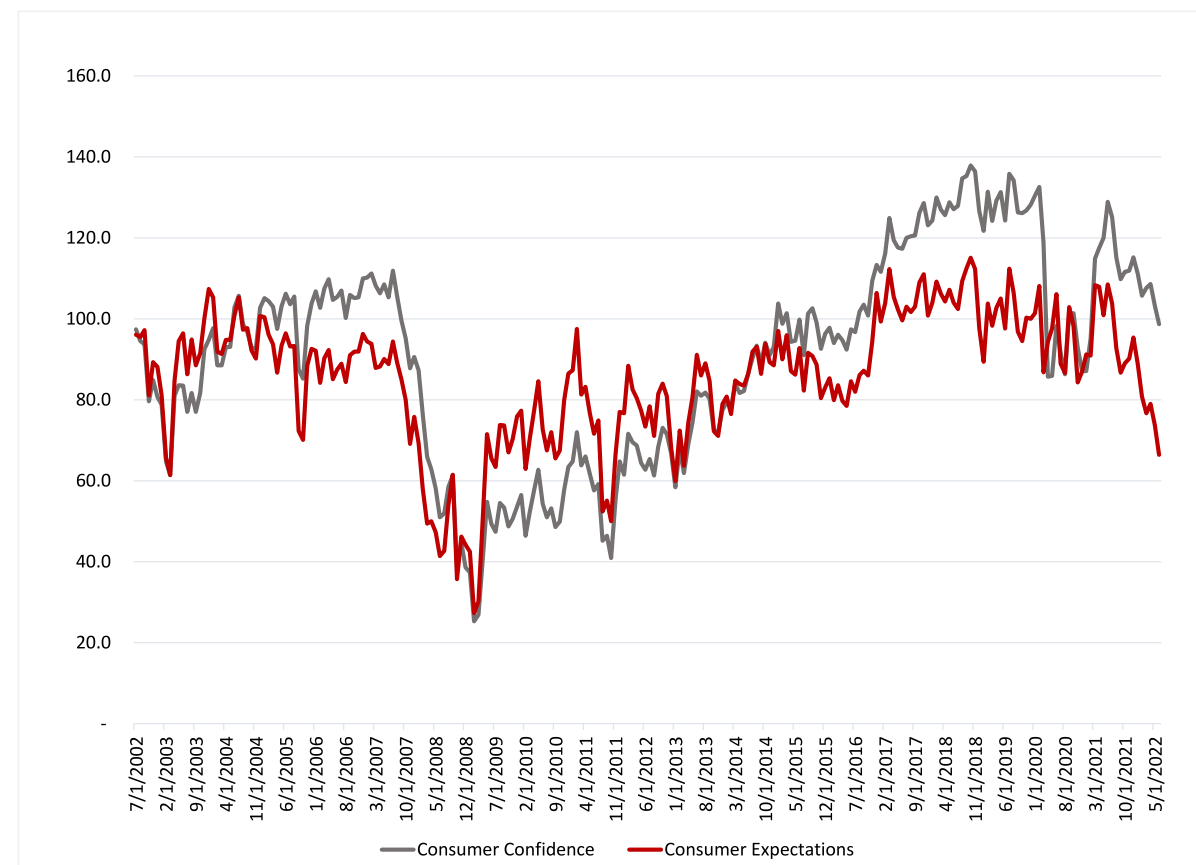
The chart below is a little obscure, but it drives home a very basic point: Employers are having an extremely difficult time finding workers. Not surprisingly, this has historically meant tight labor conditions and a booming economy. Recently, the NFIB (National Federation of Independent Business) Small Business Job Openings

SO ... ARE TIMES GOOD OR BAD? WE ARE GETTING MIXED MESSAGES HERE  
NFIB Job Openings Hard to Fill



Data points provided by Bloomberg

JUST HOW WORRIED IS THE CONSUMER  
Conference Board Consumer Confidence & Expectations



Data points provided by Bloomberg

Hard to Fill index hit an all-time high, almost 50 years.

This begs the question: How can the economy be falling apart and starved for workers at the same time? That is part of the head scratching of 2022. The data is weird and often contradicts, as this does.

So...Are Times Good or Bad? We Are Getting Mixed Messages Here

In truth, it was difficult to find too many silver linings in the dark clouds this past quarter. The news cycle was incredibly negative. Inflation and increased civil unrest largely kicked the war in Ukraine and COVID-19 off the front page. Basically, the West might be at the brink of war; this stupid virus is still floating about; higher

prices are hitting wallets and pocketbooks; and the U.S. seems to be tearing itself apart at the seams. This on top of buckets of red ink in the stock and bond markets, a collapse in cryptocurrencies during the quarter and scorching heat around the country.

What is not to like in that scenario? Is it any wonder investor and consumer confidence as fallen like it has? Where is the good news?

While still higher than anyone would like, commodity prices are beginning to turn over. This is especially true for metals and agricultural softs. For instance, prices for aluminum, copper, tin, zinc, hot-rolled coil and steel rebar were all lower at the end of the quarter than they were the start of the year. The same is true for lumber, cocoa, sugar, cotton and even live cattle. What's more,

prices for all metals (base, ferrous, and precious) have fallen sharply over the past three months. The same could be said for most agricultural commodities, including wheat, rubber, rapeseed meal and oil, as well as soybean oil.

In essence, input prices for many, if not most, of the products we buy were lower at the end of the quarter than they were at the start. That should be good news for U.S. consumers. If nothing else, it should slow the trajectory of inflation for finished goods.

In truth, there are a lot of signs pointing to lower inflation over the months ahead. First, the money supply (as defined by M2) is growing at a much slower pace in 2022. Through the end of May, the supply of money in the U.S. economy has grown at only slightly more than a 3% annualized rate. Second, as just mentioned, commodity prices are starting to fall. Third, the Fed is making money more expensive in the U.S. economy, and that has always helped retard higher

prices. Fourth, due to a fear of missing out, businesses overbought their inventories. This means firms will likely start to have to reduce prices in order to get rid of the excess.

Consider the following chart, which shows the absolute levels of inventories in the United States, both wholesale and retail. Clearly, they are at all-time highs, especially wholesale.

Finally, the U.S. dollar is amazingly strong given consumer angst in the country. This is important because there has traditionally been a pretty strong negative correlation between the strength of the dollar and inflation. While this hasn't held up very well over the past 12 months, there is no reason to believe the correlation is truly broken. After all, the past 24 months have been some of the weirdest and most challenging in my career.

The chart below shows just how strong our currency has been

recently. It tracks the past 30 years of the U.S. Dollar Index. This is a product of the Intercontinental Exchange, Inc. (ICE) and has the very rough weightings of: Euro (58%), Japanese yen (14%), Pound sterling (12%), Canadian dollar (9%), Swedish krona (4%), and Swiss franc (3-4%). To put it simply, the dollar hasn't been as strong as it is now since 2002.

In essence, the light IS finally at the end of the tunnel as it pertains to inflation. Absent something unforeseen, the worst of the price increases should be behind us. That is good news for our wallets, and it means the Fed likely won't have to kill the economy in order to crush inflation like Paul Volcker did in 1980.

That is the best news of all.

Truthfully, the 2nd Quarter of 2022 is best in the rearview mirror. The markets were absolutely brutal. Our society seemed fractured

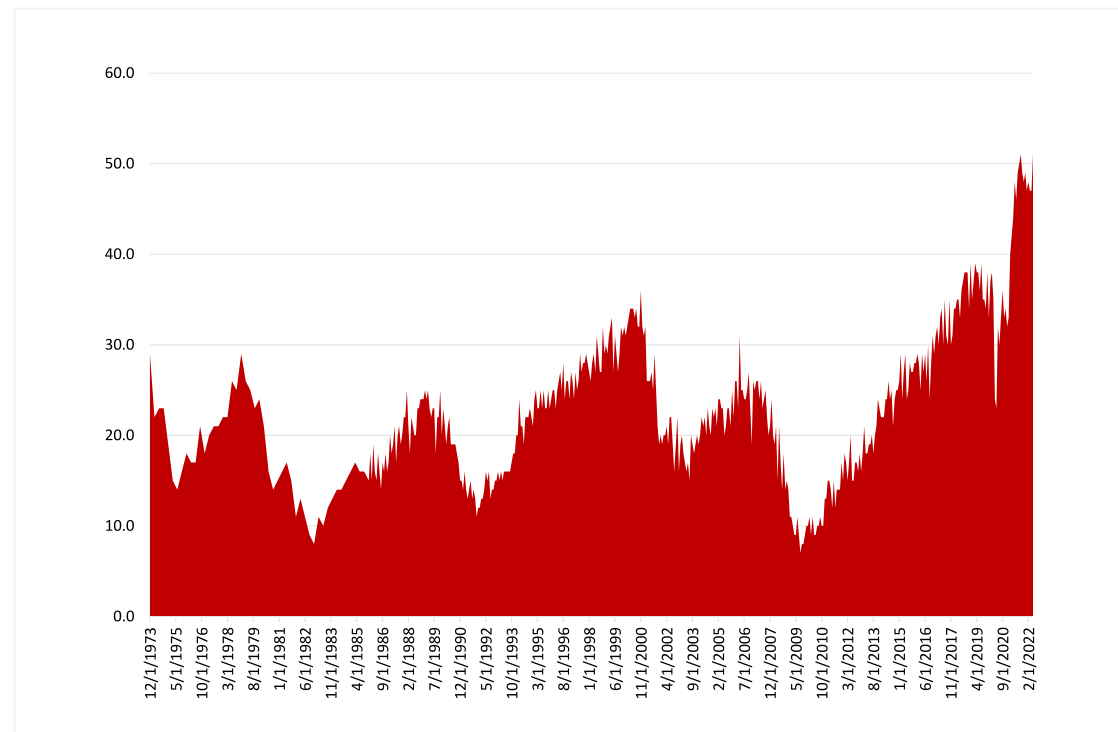
and amazingly ignorant on how economies actually operate. It became apparent Washington doesn't have a practical energy policy or even a firm grip on how the energy sector works. Heck, even the golden children of the past several years, cryptocurrencies, fell apart. At least now we know how they will perform in a tighter monetary policy.

In the end, the best we can say about the 2nd Quarter is it is finally over. For all the bad news, and there was plenty of it, the U.S. economy didn't collapse, nor is it likely to collapse in the near future. Better days are ahead. The sun will rise in the East in the morning, and that which doesn't kill us makes us stronger...and the 2nd Quarter didn't kill us, even if it tried.

Let's keep our fingers crossed that the remainder of the year is much improved. It should be.

### WHAT USUALLY HAPPENS WHEN SUPPLY GOES UP FASTER THAN DEMAND?

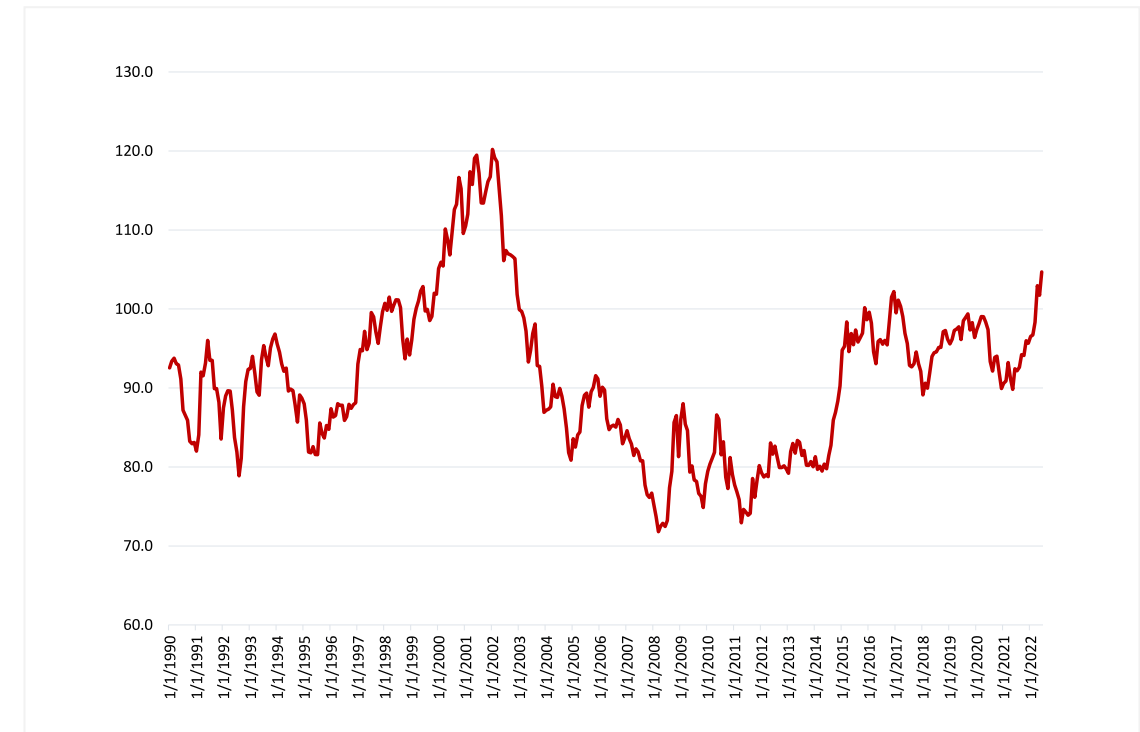
Wholesale & Retail Inventories



Data points provided by Bloomberg

### IF THINGS ARE SO BAD, WHY DOES EVERYONE WANT THE DOLLAR?

ICE US Dollar Index



Data points provided by Bloomberg

# ASSET ALLOCATION

*Sam Clement*

This quarter, the phrase that sticks out is undoubtedly “no place to hide.” There has been almost no place to hide, and that is what has made this market environment uniquely difficult.



A good way to get a sentiment gauge for the market is to note the most common phrases used by the pundits on television. This quarter, the phrase that sticks out is undoubtedly “no place to hide.” These phrases are often overused because they are true. There has been almost no place to hide, and that is what has made this market environment uniquely difficult. Not that stocks and bonds are moving in the same direction (down), but the durability of the drawdown in both. It has been outrageous, severe, painful and arduous.

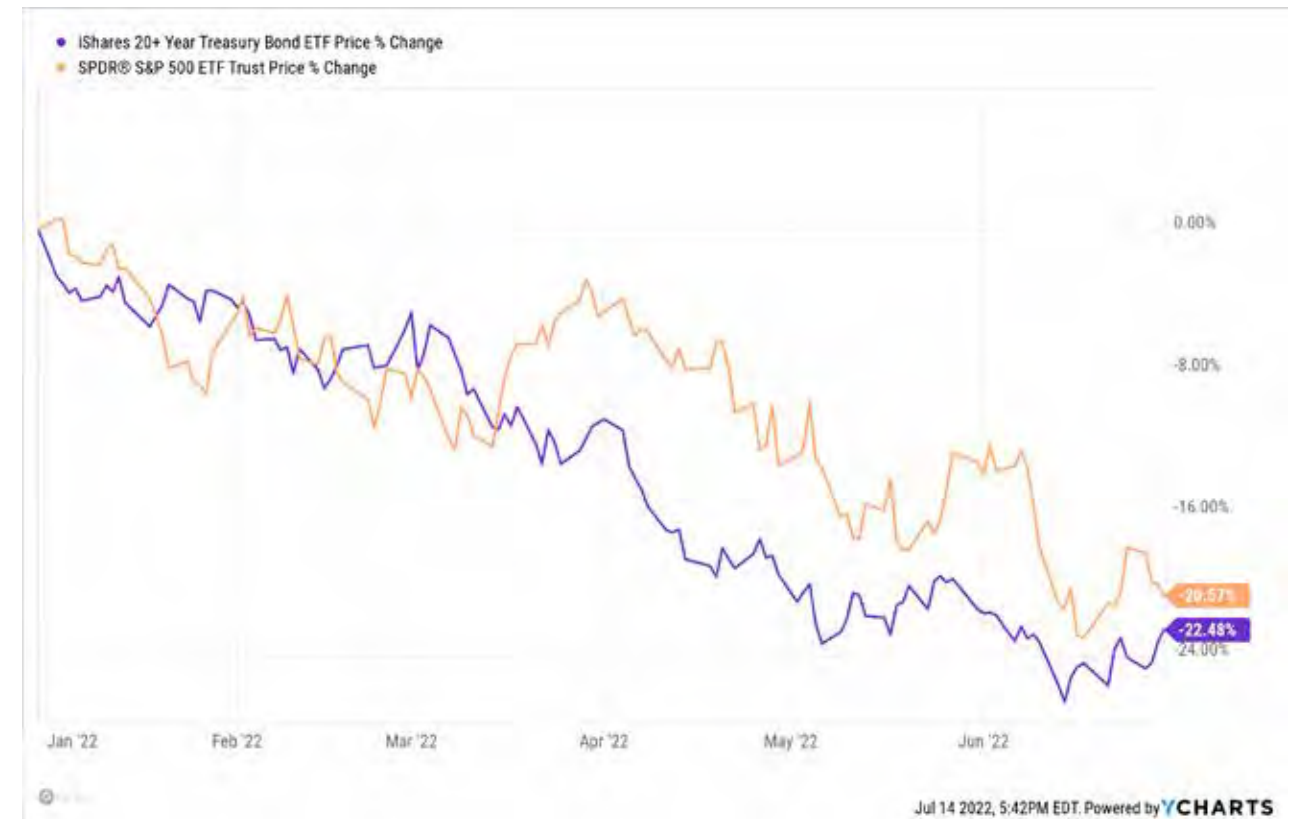
So bad a “Jackie Chiles-esque” pleonasm is the only sufficient way to get my point across.

While stocks and bonds historically move in opposite directions, there can be circumstances in the macro environment where it makes sense for them to move in the same direction, but normally not this much. Through two quarters, the S&P 500 is down over 20% and the 20+ year treasury, represented by the TLT exchange

traded TLT, is down over 22%. Have I mentioned how abnormal this is? In the 20 largest drawdowns for the S&P 500 since 1961, there hasn’t been a single period where the long bond lost even half of what the S&P 500 did. For the first half of the year, the long bond did worse than the S&P. Historic.

Where we are going is far and away the most important question to answer when investing money, as the markets are forward looking. However, to know where we are going, we have to know where we have been and where we are. The fact is that inflation is still too high! This has driven essentially everything that has gone on so far this year in the markets. Higher inflation has made bonds much less attractive, and the response from the Federal Reserve of aggressive rate hikes has made equities feel the pain, too.

Simply put, as long as inflation remains out of control, so will the market.





Oakworth's Investment Committee has been underweight fixed income for quite some time. Bonds are simply math, and the math has not added up. This call has worked well so far this year; however, fixed income is still a part of many portfolios' overall risk tolerance as a ballast to the volatility (although not lately). With the need for some exposure, the goal was to mitigate downside in a rising rate environment while not taking on substantial risk.

To us, the fixed income side of a portfolio is not where excess risk should be taken. That said, pairing some very short-term floating rate debt with some intermediate-term treasuries gets us in line with a "neutral" duration or neutral risk while allowing the portfolio to hold up better during this seismic move in rates.

We have often said we feel that equities are the most fairly valued of overvalued asset classes. That is no longer the case. Not the fairly valued part of that statement, but the overvalued part of it. By almost

any metric it is hard to argue that equities as a whole are overvalued. This should not be taken as a statement that the contraction in the market won't continue. However, it should be looked at through the lens of what is being bought.

Based on current expectations for earnings for the S&P 500 this year, the market is currently trading at less than both the 5- and 10-year multiples.

While the S&P 500 is often quoted as the "market," it is really the large cap portion of the market and excludes both small and mid cap stocks. These companies, especially small cap, tend to underperform as the yield curve flattens. With the Fed aggressively hiking rates, the writing was on the wall for a flatter yield curve; with this information, we exited small cap and trimmed our mid cap in the first half.

For sector allocations, in the second quarter of this year after a brief reprieve from the selloff, Oakworth exited both the Discretionary sector and Materials sector after adding to these in early fall 2020, when we were in the early innings of an increasingly apparent economic expansion. These types of sectors, with their more cyclical nature, tend to outperform during periods of expansion where the consumer is in a strong spot and the government is continuing to run massive deficits.

With the proceeds from the cyclical sectors, we rotated in to three areas of the market. Utilities and Consumer Staples, which are traditionally two of the three most defensive sectors of the market with strong inelastic demand in times of slowing growth like we have experienced so far this year. On top of these two, we saw a unique opportunity to add to the Biotech subsector.

Biotech is unique in that it is a cyclical part of the traditionally defensive healthcare sector. However, when I say it is cyclical, I mean it has its own cycle largely independent of some slowing in the broader economy. The Biotech sector cycle is largely driven by mergers, acquisitions, sentiment and the current drug pipeline, with the last two often correlated. Adding to biotech made sense as it was trading at levels first seen in 2017; has an attractive pipeline that is bound to produce substantial drugs; and had sentiment that had been so negative that the space seemed to be largely written off.

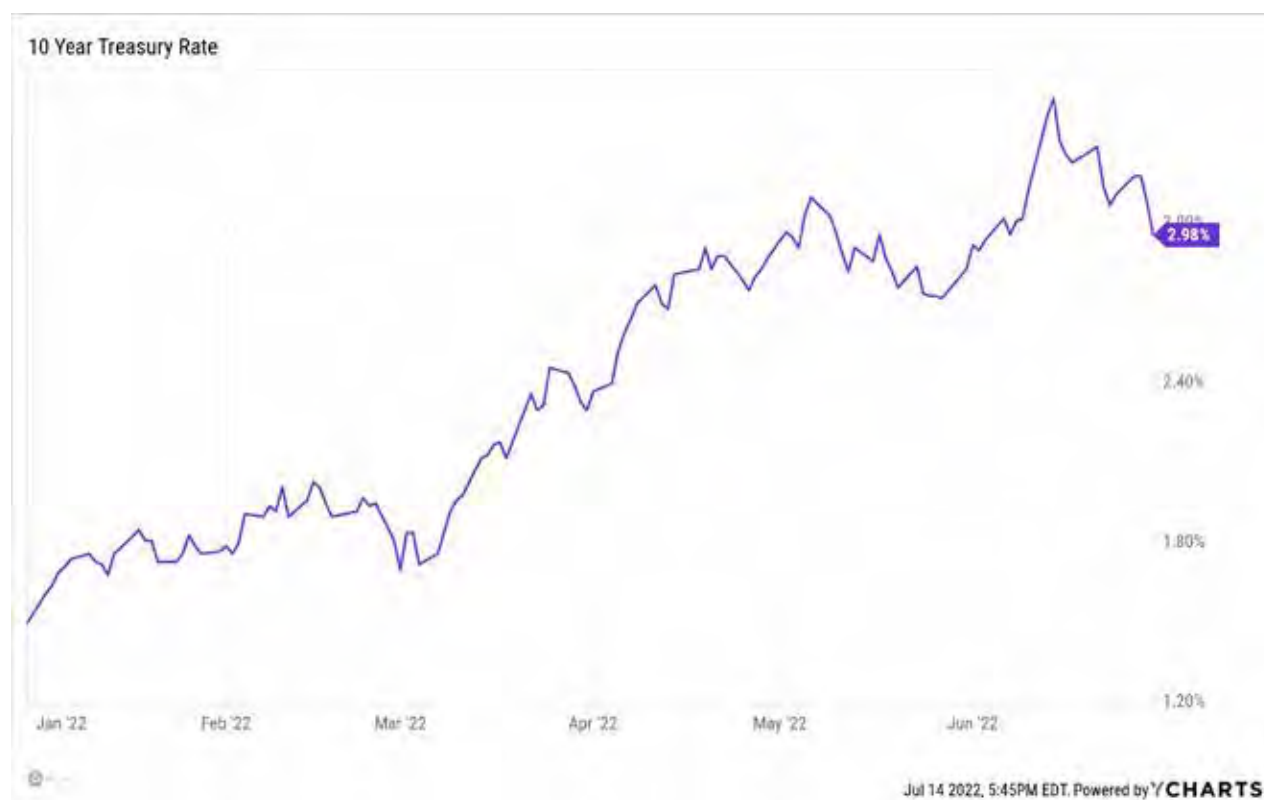
In addition to these moves, we also trimmed our position in emerging markets. With the dollar continuing to show strength even through an inflationary period, it made sense for us to trim that position. When there are fears of a global growth slowdown, we can see the U.S. dollar strengthen even during a period of high domestic inflation. Our emerging markets exposure continues to remain "ex China," as the clamping down on pro-business policies is not a short-term trend in our mind.

Looking forward to the second half of this year has generated a lot of optimism for our Investment Committee. We tend to get excited when we see opportunities to use our gray matter to generate good investments, and the opportunities we see are much more bountiful now than they were as little as six months ago.

Again, it is hard to argue the market as a whole is expensive. Last year it was hard to argue the opposite. High growth, highly profitable companies are now trading as if they have a short runway and a lack of profitability. These times are when opportunities are born. Questions we are asking ourselves in order to find appropriate opportunities include: When will the dollar's strength cool off? When do rates start to top? When will inflation top? And when do we dial up the risk?

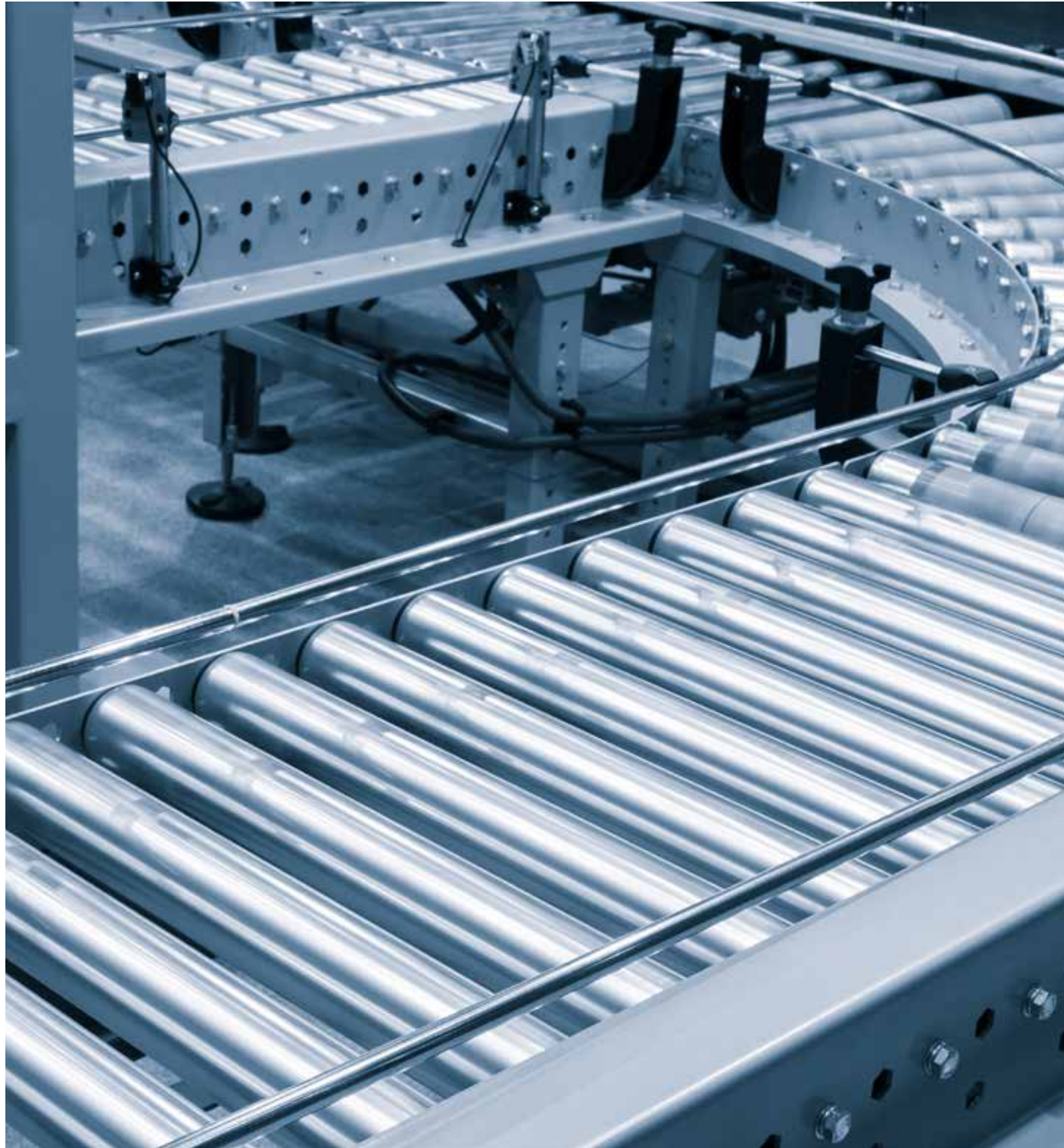
While the outlook is never crystal clear, it does seem to be getting a little less opaque. We continue to say we are going to have to work harder for our return this year than last. Our goal continues to be remaining nimble and taking in new information as it comes, making adjustments accordingly.

I continue to be a glass half full person, and with that I am looking forward to what the second half has in store.



# EQUITY

*David McGrath*



The first half of 2022 was nothing short of ugly for equity investors. As a matter of fact, this has been the worst start of a year for equity returns since 1970. Large cap, mid cap, small cap, domestic and international stocks were all down significantly in the second quarter of 2022.

INDEX	Q 2	YTD
S&P 500	-16.11%	-19.97%
Dow Jones Industrial Average	-10.78%	-14.44%
NASDAQ Composite	-22.27%	-29.22%
EAFE International Index	-14.32%	-19.23%
S&P Mid Cap 400	-15.44%	-19.57%
S&P Small Cap 600	-14.13%	-18.97%

The best index for large cap domestic stocks, S&P 500, has dropped 20% over the past six months. The growth side of the stock market, after a blistering hot two-year stretch, gave back a majority of those gains. The worst performing sectors year to date include technology (-27%), communication services (-30%) and consumer discretion (-33%).

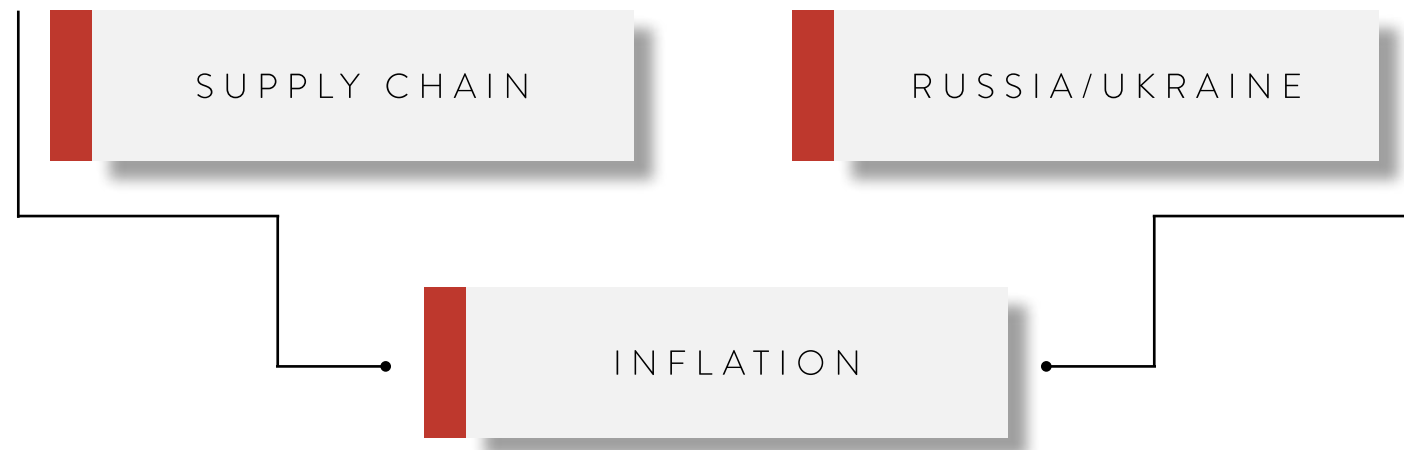
The lone economic sector that showed a positive return for the first six months of the year was energy. Surging oil prices have

allowed for stellar performance of the energy sector, up 31% year to date. Even that sector, however, could not produce a positive return in the second quarter (-5%). Like the energy sector, the defensive sectors of the market — utilities (-2%), consumer staples (-7%) and healthcare (-9%) — performed much better than the overall market, but all still showed a negative return for the quarter and year to date.

If we try to lay blame for this miserable performance, the culprit list would include supply chain issues, war in Ukraine, rising interest rates, inflation, slowing consumer spending, potential recession, etc. What makes this even more difficult to understand is each of these issues can interact with the others. To take it one step further, how can we organize these issues to understand the effect on each other, and eventually the effect on equity returns.

Right now, everything seems to start and end with inflation. With that in mind, what were the most impactful factors in allowing inflation to spike? There are many to pick from, but in our opinion the two most important factors with high inflation are the supply chain problems associated with the COVID pandemic and the war in Ukraine.

INDEX	Q 2	YTD
Energy	-5.29%	31.64%
Utilities	-5.09%	-0.56%
Consumer Staples	-4.62%	-5.58%
Healthcare	-5.91%	-8.33%
Industrials	-14.78%	-16.79%
Materials	-15.90%	-17.90%
Financials	-17.50%	-18.73%
Real Estate	-14.72%	-20.11%
Technology	-20.24%	-26.91%
Communication Services	-20.71%	-30.16%
Consumer Discretionary	-26.16%	-32.82%



There are other factors, including domestic energy policy and the push toward green energy, that have an impact on inflation. To us, however, the supply chain issues and the war in Ukraine have had, and will continue to have, the most significant impact on the level of inflation. Global supply chain problems are numerous and complicated. For example, China has a zero COVID policy, which has led to several significant shutdowns in some of their largest cities. Each outbreak, and subsequent shutdown, delays the recovery of the global supply chain.

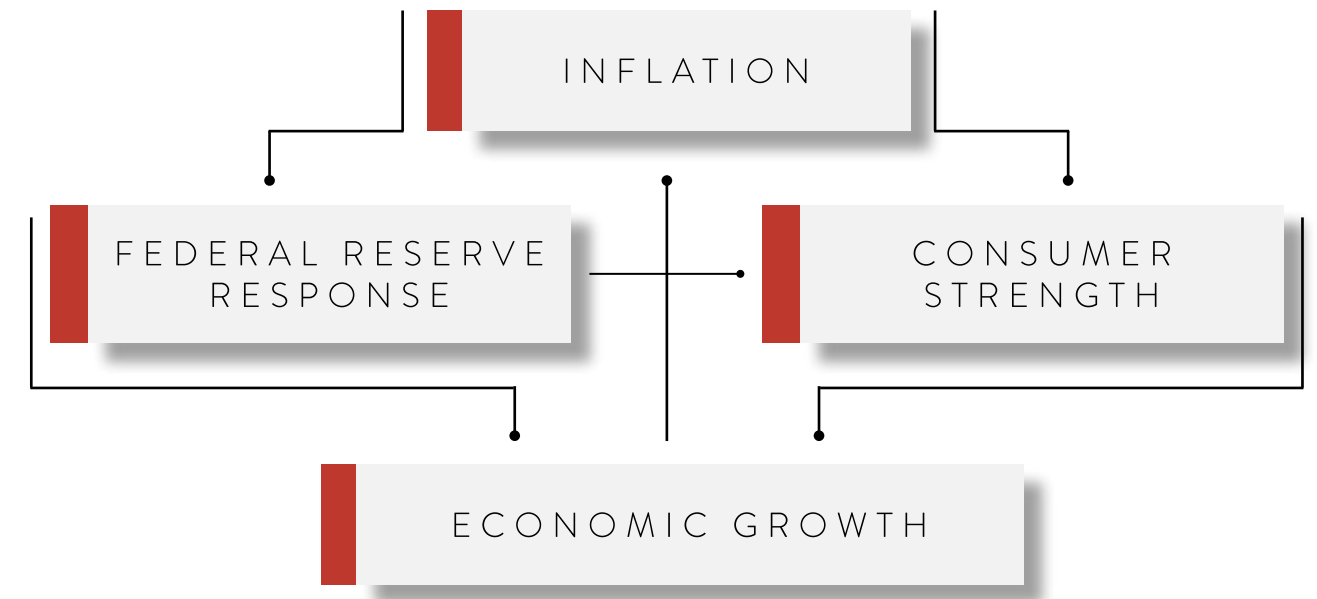
The war in Ukraine has also added a significant impact to prices on most commodities. Of all the unknowns impacting equity prices, this may be the most difficult to predict. Some resolution between Russia and Ukraine could have a dramatic downward effect on current inflation levels, but it is difficult to find an expert able to predict Russia's next move.

Since we now have an elevated inflation level, the next step is trying to understand what impact elevated inflation has on both the Federal Reserve (the Fed) and the U.S. consumer. The impact on equity markets from "the pivot" of the Fed has been dramatic.

In March 2020, the Fed cut the Fed Funds Rate to near 0%, and in June of 2020 began purchasing \$120 billion per month in Treasuries (\$80 billion) and residential and commercial mortgage-backed securities (\$40 billion). They did this to keep interest rates low and help stimulate economic activity.

This accounted for the most accommodative monetary policy in our lifetime, and in the first half of 2022 that all came to an end. The Fed Funds Rate has been increased 150 basis points year to date, with much more expected in the third quarter. All of the bond buying has also stopped, and the Fed is now shrinking its balance sheet.

Also, the consumer is directly impacted by both higher inflation and the actions from the Fed. Higher prices will reduce the direct purchasing power of the consumer. Higher interest rates from the Fed will affect things like mortgage rates (for new purchase, or if a floating rate mortgage is held) and rates charged with revolving credit lines (think credit cards). What the Fed is trying to do is to slow down the economy enough to bring inflation down.

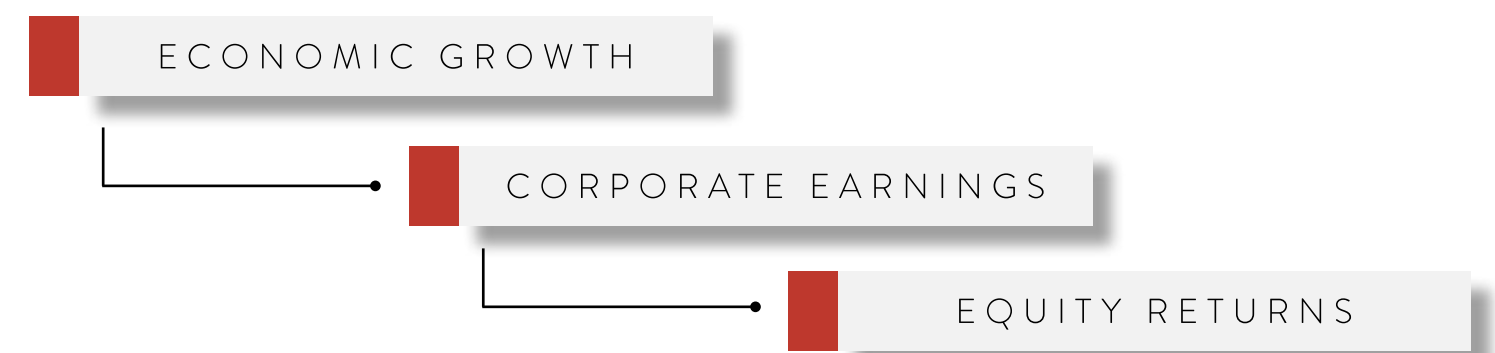


In a perfect world, slower economic growth will lead to lower inflation. Lower inflation will allow for more accommodative monetary policy from the Fed, and a stronger consumer. This is what we would call a "soft landing" from the Fed, slowing growth enough to bring inflation under control without causing a major recession.

Part of the problem the Fed is facing with this current economic condition is that all consumers are not created the same. From the start of the pandemic to the end of 2021, the U.S. consumer had amassed roughly \$2.7 trillion in "extra" savings. So far in 2022, the consumer has spent down \$114 billion of that extra savings.

Unfortunately, that \$2.7 trillion was not spread evenly among all consumers. The bottom 20% of consumers had little to none of that savings, and inflation is hitting them very hard. This difficult reality is starting to show up in some very low consumer confidence numbers.

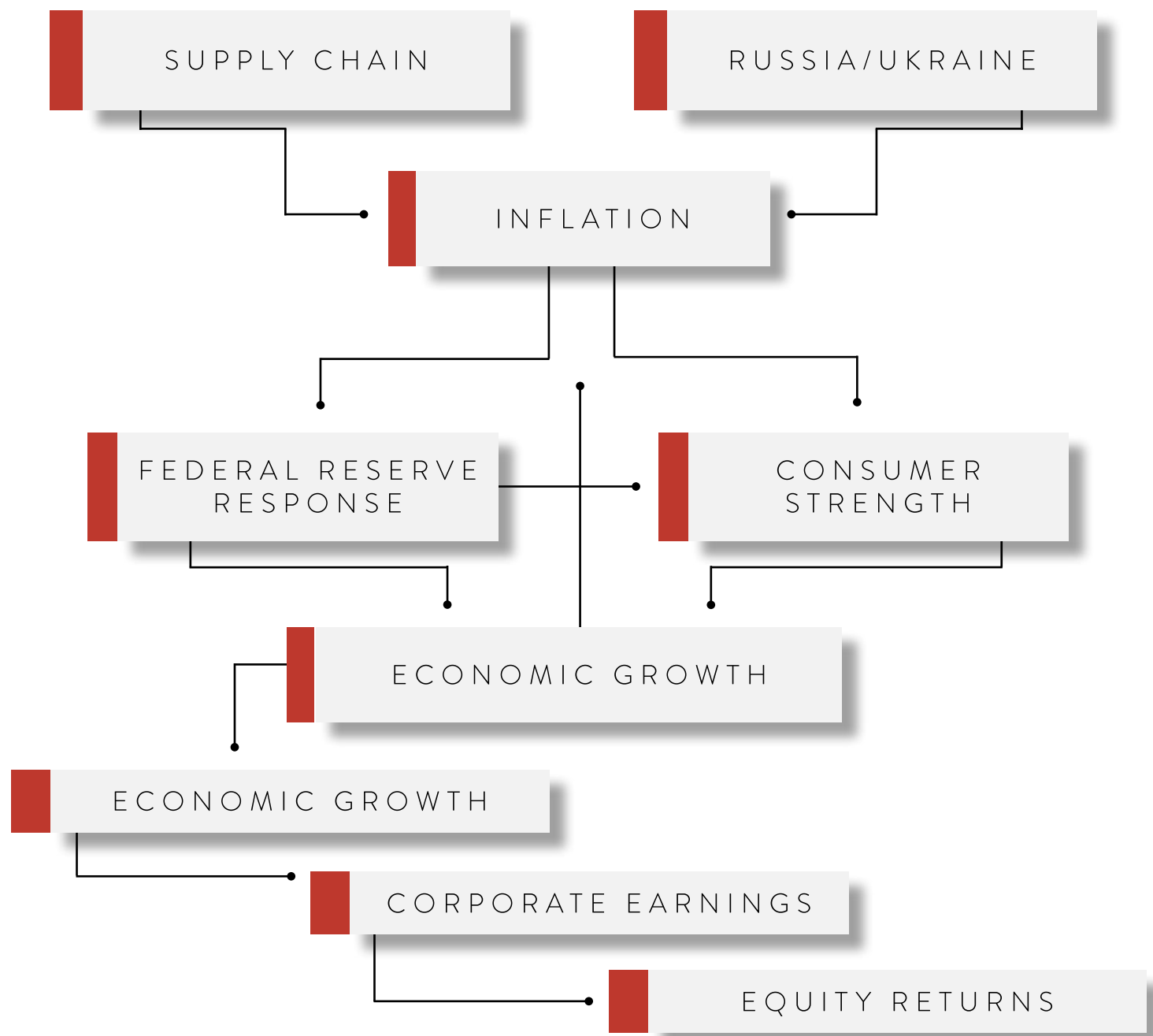
The top half of consumers have a significant financial cushion and are starting to tap into that reserve right now. So how does all of this tie into the performance of the stock market? This is where it gets very interesting. Strong economic growth translates directly into strong corporate earnings, and strong corporate earnings will typically yield strong equity returns.



The economy is slowing, without question. To what extent has elevated inflation and the Fed's changes to monetary policy made the consumer change their behavior? It is clear that the weaker consumer segment has already changed, but what is not clear is how the financially stronger consumer has changed. This is why the current earnings season is very important. If earnings for the second quarter come in at or above current expectations, it is a clear sign that the top half of the consumer is carrying the economy, and

corporate earnings, through this period of high inflation. If on the other hand we see earnings come in well below expectations, the strong balance sheet of the consumer did not protect corporate earnings. Due the bear market in stocks during the quarter, we believe investors were pricing in lower corporate earnings.

So many moving pieces at the moment. If we put all of those flow charts together, it looks something like this.



One way to think about what happened to stock prices the first six months of 2022 is a domino effect of bad news. Both supply chain issues from COVID and the war in Ukraine helped push inflation to extreme levels. The Fed then had to step in and dramatically change monetary policy from accommodative to restrictive. High inflation and the changes from the Fed have had a mixed impact on the consumer, with the weakest of the consumers taking the brunt of the pain. All of this slowing economic growth at some point will drag down corporate earnings. Whew, that is a lot!

- At current levels, the stock market is pricing in some pretty bleak news for the rest of the year. Is it possible to see some clarity to the issues that have caused the most concern to the stock market? Here is a small list of potential market-moving events over the last half of 2022:
- Supply chain problems: Fewer COVID-related shutdowns in Asia, and the potential for easing global shipping costs, could make the supply chain picture start to look much better by the end of the year. We have very little chance to “fix” the supply chain in the next few quarters, but we may start to see the light at the end of the tunnel.
- Resolution between Russia and Ukraine: This may be the most difficult event to predict. A resolution could have a substantial downward impact on commodity prices, and downward pressure on inflation. Continued tensions that leave the extra layer of costs across a broad selection of commodities will keep inflation higher for longer.
- Overall inflation: Will the spike in prices across the board over the past 12 months show signs of slowing? We are starting to see many commodity prices start to decline, and if the market starts to smell that we are past peak inflation, it could have some positive ramifications to equity prices.

- Federal Reserve: The market has priced in some very aggressive moves by the Fed to combat rising inflation. If the Fed starts to sense that inflation is starting to come down, it may be able to move a bit less aggressively to raise interest rates, and slow down the consumer.
- The consumer: How strong can the consumer remain in the face of spiking prices? This quarter's earnings season will give us a good answer to that question. Even if earnings are strong, the longer inflation remains elevated, the more consumer strength will erode.
- The economy: Are we in a recession right now? If so, it is a very mild one. With a very robust job market and strong business and consumer balance sheets, this could be unlike any recession we have seen in 40+ years.
- The election: The markets typically react well to an election. We have some political certainty for two years. If history is any indication, and the party out of power (Republicans) has a strong midterm election, the result would be shared power in Washington. This is the most preferred power structure for equity markets.

We are not predicting that all of these market-concerning events are going to happen favorably in the next few months. What we are saying is that none of these events occurs in a vacuum. For example, improvements in the global supply chain could help lower inflation levels, which could cause the Fed to be less aggressive in raising interest rates and also take some pressure off the consumer. A good domino effect, if you will. The exact opposite of the negative domino effect that hit equity owners over the past six months.

BONDS

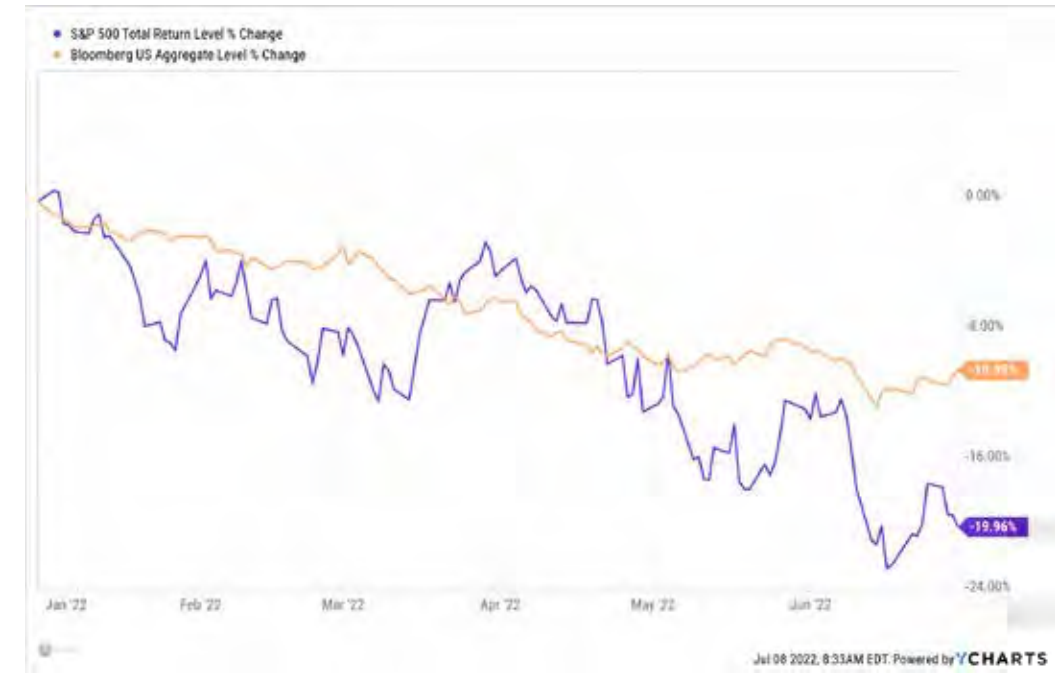
*Sam Harris*



As echoed elsewhere in this rendition of our quarterly outlook and review, there truly was nowhere to hide during the 2nd Quarter of 2022 — aside from overnight cash, if you're into that kind of thing. While the stock market struggled (and struggled immensely at that), the bond market was little different.

Why did this happen? The answer is quite simple — and something discussed in the past — interest rates did not keep up with the

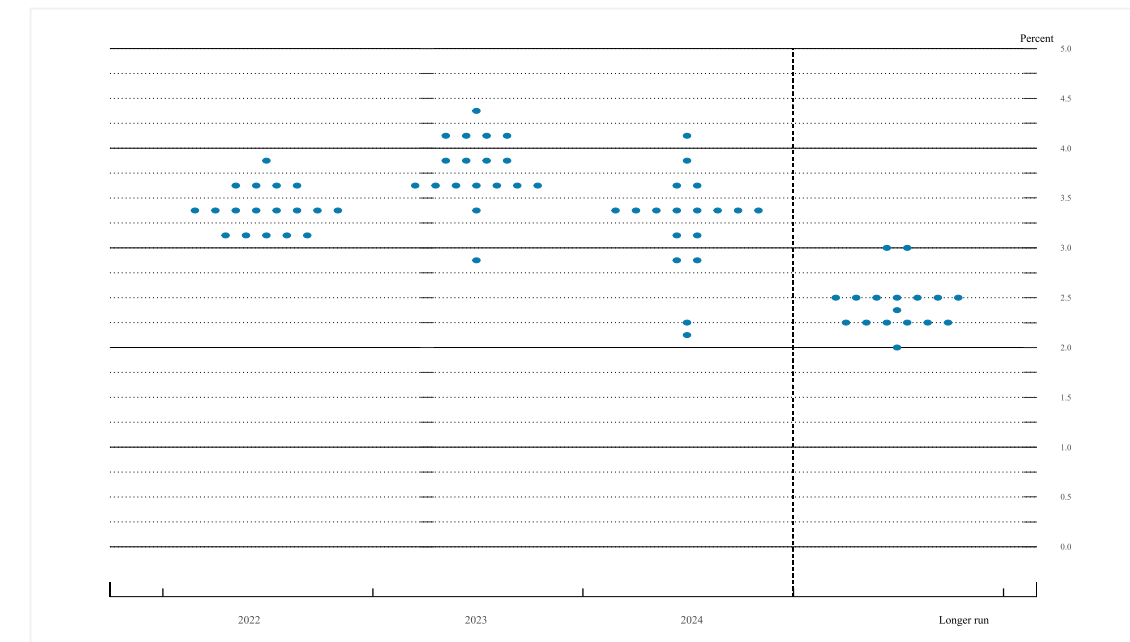
hottest inflation seen in 40 years, so something had to give. This is and was evidenced by May's +8.6% Consumer Price Index. As such, the Central Bank raised its overnight lending target in both May and June — with the latter seeing its most aggressive upward hike since 1994. Yet still, as we sit here in early July, longer-term yields still pale in comparison to the current inflationary environment — suggesting Jerome Powell and his crew of cronies still have work to do.



To this end, the Federal Reserve essentially remains the author behind the bond market's novel — so the Fed goes, so the bond market should follow. While we do not see Jerome Powell “hiking to oblivion,” as former Fed Chairman Paul Volcker did when he raised the benchmark lending rate in the early 1980s from 14.0% to 20.0%, we do see the Fed retaining the necessary level of aggression in order

to appropriately combat the persistent inflationary environment. And this was only further telegraphed in more layman's terms via the June FOMC Meeting Minutes, as well as the Fed's June Dot Plot (seen below). After all, price stability remains one-half of the Fed's dual mandate.

**FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate**



Data points provided by the Federal Reserve

We have said, and keep saying, fixed income is an unattractive place to park cash in a rising rate environment — as interest rates go up, bond prices go down — so there will be an element of principal erosion. This is no different as we enter the 3rd Quarter.

A stoic Fed chairman and Reserve board appear poised to raise an additional 75 basis points in July, a likely 50 basis points in September and an either 50 or 25 thereafter (this remains a bit murky, as only time will tell). Currently, the Fed Futures are pricing a year-end lending rate of somewhere between 325-375 basis points, which would put Prime at 625-675 for all those curmudgeonly bankers out there. Interestingly enough, the Fed Futures appear to be pricing a rate cut roughly around March 2023. This would suggest big, bad recessionary fears have crept into the market, begging the question — are we currently in one? Perhaps so.

Alright, the Fed's Overnight Lending Rate is one thing, but let's take a look at a bit longer-dated debt — specifically the treasury market, where some funky things are unfolding. As mentioned earlier, the bond market is pricing in at least an additional 150 basis points in upward movement on the Overnight Lending Target Rate. So, because of this, the Treasury yield curve has seen a few instances of inversion.

First, though, let's address what an inverted yield curve really means. This only occurs when shorter-term debt "yields" greater than longer-term debt. Historically, an inverted yield curve has indicated a looming (or currently present) recession; however, the timing of such has never been quite as black-and-white. Inevitably, market sentiment shows long(er)-term outlook is poorer relative to that of short-term, and that long-term yields may continue to fall. This is a long-winded way of saying an inverted yield curve

allows for fixed income investors to see greater returns with short-term investments. As corporate credit spreads continue to widen (especially in the high-yield space), investors largely do and will prefer lower-risk instruments — and Oakworth is no different. To that end, we added IEF, BlackRock's iShares 7-10 Treasury Bond Exchange-Traded Fund back earlier this year.

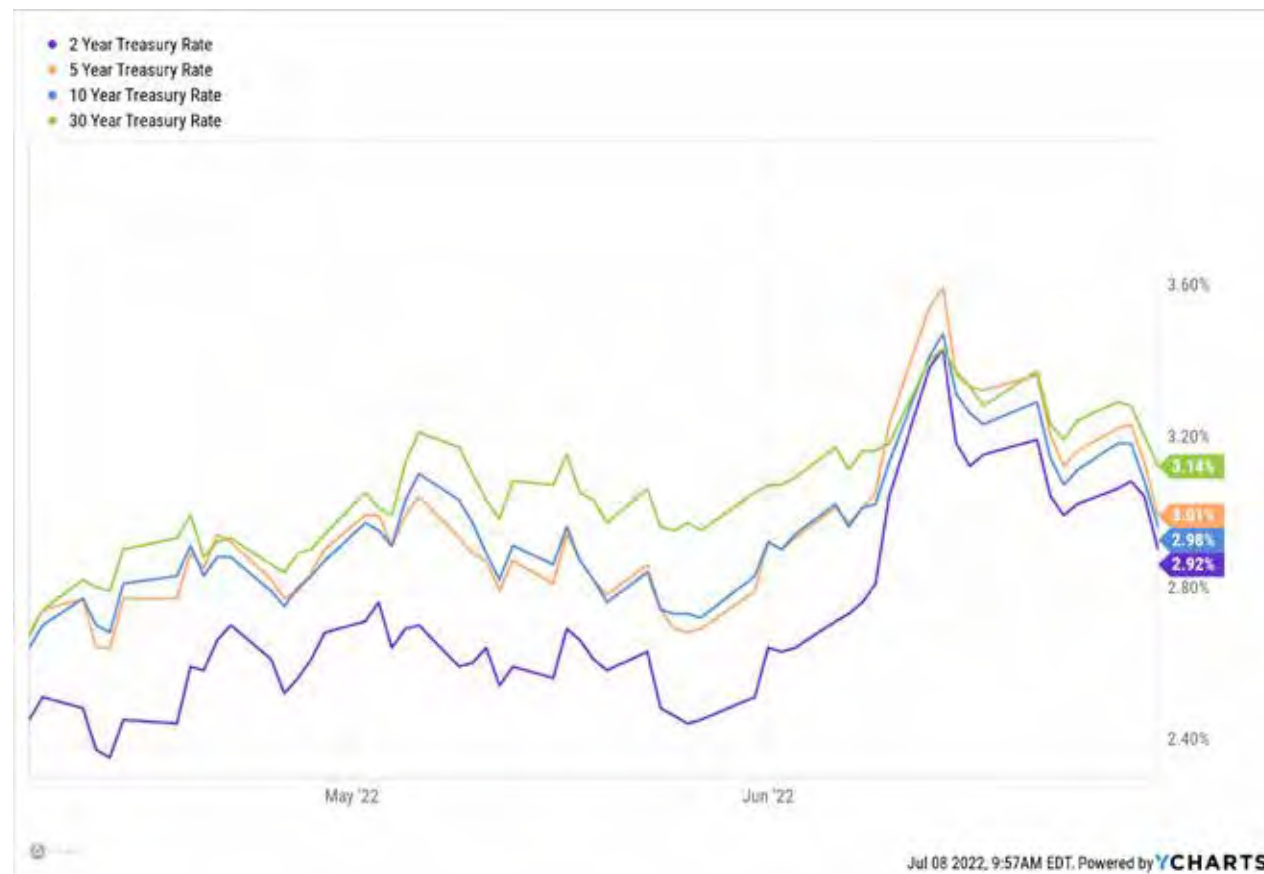
Digging into how bonds actually performed for the quarter, the 10-Year U.S. Treasury yield skimmed 3.47% in June, a level not seen since April 2011, before falling to close the quarter out at just over 3.00%. As such, given the aforementioned correlation between bond yields and bond prices, indices (and Exchange-Traded Fund proxies) fell (as seen below).

Clearly, High Yield took it on the chin in the quarter (as spreads widened with both defaults and default fears rising); however, Corporate Debt was not too terribly far behind so far as underperformance. Taking a look under the proverbial hood here, though, does not warrant significant heartburn. Corporate balance sheets remain robust despite persistent supply chain headaches, labor shortages and elevated input costs. Within the corporate space, higher interest rates will be preferred, and bond yields should

exceed most duration exposure on this part of the yield curve. This is, however, assuming spreads remain stable or even improve.

The best performing class was those tax-advantaged municipal bonds. While these do not excite the average investor, current macro factors such as low unemployment, improved/improving revenues on an annual basis and continued liquidity driven from pandemic-era facilities should support and boost the sector in both the short and intermediate term. Again, muni bond rates are much higher on the shorter end of the curve, where valuations currently appear a bit more attractive, with pesky inflation and uncertain legislative leadership headwinds for the longer end.

So, what does all this mean? The Fed remains boxed in a very uncomfortable corner, and its only way out is to kill inflation. Should, rather when, the Fed accomplishes this, the bond market should stabilize, the yield curve should positively slope and investors should expect their nominal returns to near-mirror that of business cycle pasts. Appropriate asset allocation remains pertinent for any investor attempting to navigate these challenging times. But hey, after all, that's what we're here for, right?



TICKER	SECTOR	2Q PRICE RETURN	2Q TOTAL RETURN
AGG	Broad US Market	(5.06)	(4.58)
GOVT	U.S. Treasury Debt	(4.05)	(3.74)
LQD	Corporate Debt	(9.02)	(8.40)
VTEB	Municipal Debt	(3.16)	(2.75)
MBB	Mortgage Debt	(4.30)	(3.87)
HYG	High Yield	(10.55)	(9.48)

*3rd Quarter 2022*

A FIRST LOOK

While we still don't know the actual extent and timing of the next U.S. recession, one thing is certain: it should not be as severe as the ones in 2020 and 2007-2009.



- The Federal Reserve will continue to increase the target overnight lending rate, despite signs of a cooling economy.
- Because of these rate increases, the U.S. dollar will continue to show strength relative to other major trading currencies. If the past is prologue, this should help drive down prices for imported goods.
- Outside the auto industry, businesses will struggle with the large inventories they have built up. This should also help to moderate inflation.
- Despite all of the turmoil in the world, the prospect for more expensive money and a cooling in overall economic activity, corporate America should still be able to increase profits this year.
- Higher mortgage rates will take some steam out of the housing market. While some overheated markets could feel some pain, this should not come anywhere close to being a repeat of 2008. As a result, home prices should start to cool, and construction materials will come down in price.
- Thanks in large part to the massive sell-off in the markets during the first part of the year, U.S. stock valuations should start to entice investors during the 3rd Quarter.
- Although the 1st and 2nd Quarters of 2022 made a strong argument for the need for U.S. energy independence, Washington won't enact a coherent and/or realistic energy policy.
- The lack of an understanding of basic economics in the leadership positions of the G-7 will continue to skew the global economy from the West to the East.
- The first photo drop from the James Webb Space Telescope will amaze the world and create a new interest in the universe around us.
- Thanks to the West's continued assistance of material and money to Kyiv, the conflict in Ukraine will continue to limp along with no real, acceptable conclusion. As a result, Europe will stagger into winter with a very uncertain supply of energy.
- Thanks to a stronger U.S. dollar, tighter monetary policy and a decrease in the price of most commodities, the Core CPI should start to turn over during the quarter.
- Unless something unforeseen happens, the Federal Reserve will likely increase the overnight rate by 125 basis points during the 3rd Quarter.



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Mr. Norris oversees Investments and Thought Leadership for Oakworth Capital Bank. Prior to helping to start Oakworth, Mr. Norris was also Chief Economist, Chairman of the Investment Strategy Committee, and a Senior Fund Manager for Regions Financial Corporation's Morgan Asset Management (MAM) subsidiary. Before joining Regions, he served as the Chief Investment Officer for The Trust Company of Sterne, Agee & Leach, Inc. and started his professional career with Mercantile-Safe Deposit & Trust Company in Baltimore, Maryland, as an Institutional Fixed Income Portfolio Manager.

As part of his role at Oakworth, Mr. Norris hosts a podcast, writes a weekly blog, and speaks publicly on the economy and the markets to a wide variety of audiences. Outside of Oakworth, he currently serves on the Board of Directors for the IPC Foundation, serving as the finance chair, and was recently appointed to Board of Directors of the Alabama Trust Fund by Governor Ivey. Mr. Norris also serves on the advisory board for Gabriella White LLC (Summer Classics), as well as the advisory board for the economics/finance department at Samford's Brock School of Business. Finally, he is a member of the Birmingham Rotary Club. He received his Bachelor of Arts from Wake Forest University and his Master of Business Administration from the University of Baltimore.

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# THOUGHT LEADERSHIP

We believe communication is the key to successful client relationships. While sharing useful information is beneficial, regardless of source, Oakworth believes in the value proposition of developing and having its own experts and ideas. By generating our own market commentaries, economic newsletters, topical subject analysis and serials, and even conversational podcasts and videos, our clients know we are using our knowledge, creativity and expertise to help them succeed.



## Our Podcast

### *Trading Perspectives*

In this weekly podcast, Chief Economist John Norris, Portfolio Manager Sam Clement and Director of Wealth Business Services Courtney

Truss exchange perspectives on the driving factors influencing our economy. Trading Perspectives can be found on Apple Podcasts, Spotify, Google Play, YouTube, and all other major podcast outlets.



## Our Blog

### *Common Cents*

Started over 20 years ago, Common Cents is a weekly blog written by Chief Economist John Norris detailing and explaining the events that

impact our economy. John distills the latest information, making it easy to understand how these events affect daily life.







## ABOUT OAKWORTH

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After the largest capital raise in the state of Alabama, we opened our doors to the public on March 31, 2008. Over the years, we have developed a reputation as one of the safest banks in the United States. In 2016 we expanded our markets in Alabama, adding a South Alabama office in Mobile. In 2020 we expanded to the state of Tennessee, opening a Middle Tennessee office in Brentwood.

We are a privately owned company with fewer than 400 shareholders. All managing directors and the majority of our associates directly own shares of the company. We believe this instills a strong business-owner mentality throughout the company.

In addition to your client team, our bank's leadership team consists of experienced and well-versed individuals, allowing us to offer a wide range of Private and Commercial Banking, Wealth Management and Advisory Services. Our core values and overall mission are building blocks for the long-term success of our clients, associates, shareholders, and communities.

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*The opinions expressed within this report are those of the investment committee of Oakworth Capital Bank as of the date of publication. They are subject to change without notice, and do not necessarily reflect the views of Oakworth Capital Bank, its directors, shareholders, and employees.*





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