Oak Tree "Short-term Economic Update"

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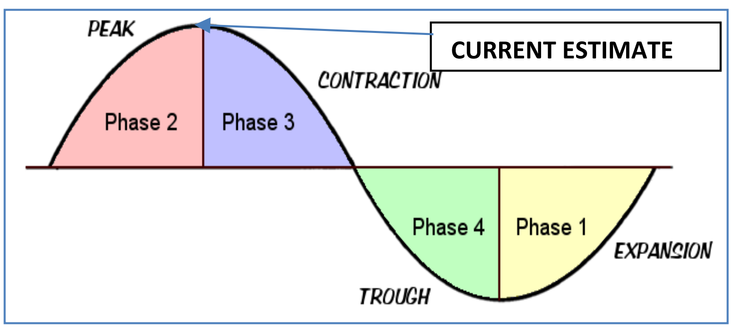
"*Your Money, OUR Economy:* They're Linked"

OVERVIEW: The business cycle seems to be closer to the end of Phase 2. In this phase the economy keeps strengthening. Commodities and interest rates rise. The inventory-to-sales ratio declines. Inflation rises. Credit conditions keep improving. Earnings expand. Stocks are in a bull market propelled by increased liquidity and higher earnings. Rising inflation and interest rates eventually hinder consumer optimism and become a headwind for earnings, the economy, and the stock market. This will be the time the business cycle typically soon moves to Phase 3.



Phase 1	***Expansion*** - When the economy starts growing again and GDP (Gross Domestic Product) is increasing at the fastest rate.
Phase 2	***Peak*** – the point when you see most growth of GDP, and the economy is its highest level. GDP increase constant
Phase 3	***Contraction*** (Recession) - When the economy starts slowing down and GDP decreasing at an increasing rate
Phase 4	***Trough*** - When the economy hits bottom and GDP decrease constant

The latest data seems to confirm what many have been anticipating. It is likely the economy cannot grow at the torrid pace of the last 12 months while it recovered from the pandemic. There are a few signs suggesting the economy is slowing down to a more realistic pace, which could be disappointing to those anticipating 5-10% growth rates to continue for an extended time. The rise in inflation is seems to be putting a break on our willingness to spend.

- **Purchasing managers – Strong**: Manufacturing purchasing managers report strong activity. The sector is still trying to replenish severely depleted inventories due to the business shutdown caused by the pandemic. The sharp increase in the index reflects the frenetic attempt to rebuild inventories. As in each former cycle, this rebuilding will eventually overshoot demand, forcing business to reduce production.
- **Employment - Weak.** Construction and manufacturing employment are two major sectors of the economy. Employment in construction has declined in four of the past five months. It confirms the weakness of the housing sector anticipated by the recent *decline* in lumber prices and worsened by the sharp 14.8% increase in home prices. Manufacturing employment increased a mere 0.1% m/m. Employment is slowing down, reflecting the overall adjustment of the economy to more sustainable growth rates of about 1.5%-2.0%.
- **Durable goods orders - Slowing down**. Durable goods orders and capital investments are showing strong growth rates but slowing down on a year-over-year basis.

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- **Income and spending - Down.** There has been a significant slowdown from February to May in income and spending for durable goods (big ticket items). These data do not make a trend, but they suggest the economy may be in the process of slowing down with the business cycle entering Phase 3.

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- **Commodities - Weak**. Commodities keep weakening in response to a weaker business cycle indicator. Weakening commodities have been correctly reflecting the economic downshift. Crude oil is still strong due to robust demand by the transportation and manufacturing sectors.
- **Inflation - Rising.** Inflation is rising. The price index of consumer spending rose +3.9% y/y. Consumer prices are up +4.9% y/y
- **Interest rates - Down**. Short-term interest rates. They are still anchored to 0%. The Fed may be concerned about the outlook. Bond yields seem to have many analysts confused. They may not recognize the changes that are occurring. Yields are declining because of the same reason; commodities are weak – reflecting a slower economy.
- **New home sales – Down.** New home sales are a leading indicator of the business cycle and of the stock market, and we have seen new single-family sales *slow*. Rising inflation and soaring home sale prices thwart consumer confidence and purchasing power. Eventually the weakness in consumer spending is reflected in slower economic growth, profits, and stock prices.
- **The Dollar - Strengthening**. The US Dollar strengthens when the business cycle declines.

Bottom line: The markets are sensitive to small changes in the growth of business activity, which may explain what is happening. It does not mean that we are headed for a major crisis. It may be more likely we are witnessing the gradual adjustment of the economy to a sustainable pace much slower than the current one as we regress to the averages.

The stock market. Year-over-year comparisons look bullish, but the comparisons are unfair given the lows of last year. It may be more logical to focus on the month-to-month trends, as they may be more informative. It is logical that we may have a slowdown once we have replaced the inventories that were low due to the pandemic. If that happens, we may see disappointing quarter-to-quarter earnings, which will have a bearing on equity prices. Equities will reflect these trends despite reliance on more stimulus and Fed easing. The good news is the month of July has seen stocks move higher in each of the past seven years, so it may still be a time to be optimistic. A properly allocated defensive portfolio is, however, justified in the current environment.

{Data source for information in update: https://www.bls.gov/ - Bureau of Labor Statistics}

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