MARKET AND ECONOMIC REVIEW & OUTLOOK

AN UPDATE FROM THE ADVISORS AT GASKIN ASSET MANAGEMENT *CHARLOTTE, NORTH CAROLINA*

The following letter was written for you by the undersigned. The opinions expressed are those of your advisors at Gaskin Asset Management and do not necessarily reflect the opinions of Raymond James or its affiliates. We know this is a long letter, but we hope you will invest five minutes in reading it. Thank you.

THE ECONOMY - INFLATION

In our August 2021 newsletter, we warned of the likelihood of inflation and its risks to the economy and investment markets. Specifically, we commented on the risk of rising rates to long-term bond prices. We would like to take a moment to comment on inflation in general terms. With so much talk about inflation, we thought a little background might be worthwhile.

At the risk of oversimplification, please allow us to offer a very simple explanation of inflation. Let's assume, for a moment, that we live in an economy that is limited to 100 apples and 100 dollars. That's it. We only have 100 dollars to spend and 100 apples to purchase. Naturally, in that economy an apple would cost $1. But now, let's imagine locusts wipe out half of our apples. We still have $100 in the economy but now only 50 apples. In this scenario, the "supply" of apples would be reduced by half while the "demand" for apples as defined by the dollars available would remain stable. Thus, twice as many dollars would now be in our bank accounts to buy the reduced apple supply. Now, you might assume that buyers would simply save their extra dollars for the future. But that's not how this economic scenario plays out. Those with the apples would demand more for their limited supply. After all, they still want the $100 as their costs did not decline with the loss of the apples. So, those with the dollars would compete to be first to buy the reduced supply. Over time, the price of apples would rise to $2 per apple as supply and demand reached equilibrium. That's a simple explanation of what happened in the very early days following the pandemic shutdowns.

But it gets much more complicated. Now, let's assume that those who control the supply of dollars decide they need to produce more dollars to accommodate for the increased price of apples. So, they decide to increase the number of dollars available to purchase the limited supply of apples by 10, 20, or 40%. In other words, we now have roughly $140 to purchase the 50 apples. While the "demand" side of this equation increases exponentially, the "supply" side remains limited. Can you see where this is going? Oh, and by the way, let's assume in this imaginary economy, that the buyers can borrow additional dollars for their apple purchases at exceptionally low interest rates.

Sure, this is an oversimplification of the complex macroeconomic inner workings of our economy. Nevertheless, we believe that even the most complex problems can usually be reduced to simple terms. There are many issues weighing on the U.S. and global economies: the pandemic, war in Ukraine, continuing supply chain disruptions, and rising inflation. But to understand the correction, we need to fully grasp the problem. It is our belief that the solution to our current problem of rising inflation will require important economic adjustments such as reducing the dollars available in our economy, increasing interest rates significantly, reducing supply imbalances and reducing fiscal largesse. While these changes are necessary to contain inflation in our judgment, they could ultimately result in a recession. While we are not predicting a recession at this point, we think that it is entirely possible that the current inflationary cycle will end with a reversal of the rising gross domestic product (GDP) we have enjoyed for quite some time.

GASKIN ASSET MANAGEMENT

7615 Colony Road, Suite 100, Charlotte, NC 28226
(704) 544-7990 • (800) 407-2249 • (704) 544-7454 (fax)
www.GaskinAsset.com

Since we took the liberty to provide a simple explanation of inflation, we'll offer a quick definition of a recession. The technical definition of a recession is two consistent quarters of negative economic growth. In practical terms, a recession can be summed up as an inventory correction, which tends to follow periods of inflation. Here's why. While inflation is marked by a level of excess demand for limited supplies, recessions are basically the flip side of that same coin. A recession is marked by a period of excess supply accompanied by limited demand. You can see how this happens in your everyday life. Let's go back to our apple example. As apple prices rise from $1 each to $2 each, apple producers decide to plant more trees to harvest more apples. It takes a while for the supply of apples to catch up with demand but it happens eventually. This effort to increase profits eventually drives the price of apples back down toward $1 each as the market is flooded with apples. Unfortunately for the apple producers, they excitedly purchase more land and hire more staff to plant, nurture, pick, and market their apples. They could afford the additional expenses at $2 per apple. They could even make money at $1.50 an apple. But as prices begin to drop in response to the increased supply, the apple producers' profits eventually turn to losses. Consequently, the apple producers may be forced to initiate layoffs, land sales and ultimately much cheaper "bargain basement" apples. Prices eventually do stabilize. Producers and buyers adjust to the new price levels. Economic growth resumes. This economic back and forth has occurred repeatedly throughout our economic history.

MARKET & ECONOMIC SUMMARY

The war in Ukraine, lockdowns in China, rising inflation, and inflated tech stock prices all contributed to the worst month for the Nasdaq Composite since 2008[i]. As of April month end, the index is down 21% for 2022 with 13% of the loss coming in April alone. This marks the worst start for the Nasdaq Index in history. If you took profits in tech stocks last year, you may not feel this level of decline in your portfolio. By contrast, the blue-chip, Dow Jones Industrial Average is down less than half of the Nasdaq to a little more than 9% as of April 30, 2022. Furthermore, as we have mentioned in our last two letters, we expected "value" stocks to outperform "growth" stocks this year which they have done. Growth stocks, as measured by the Russell 1000 Growth Index are down -19.18% this year as of May 3, 2022 while value stocks in the Russell 1000 Value Index have suffered less than one-third that decline with a loss of only -6.12% for the same timeframe.

Bonds are generally considered a safe (or safer) haven for investment dollars when added to a diversified portfolio of stocks. This general consensus has been true for the most part for decades. However, rising interest rates have historically led to lower bond prices in most cases. There are several important exceptions to this rule such as ultra-short-term bonds and floating rate bonds. Generally speaking, however, investment grade intermediate to long-term bond prices tend to decline as interest rates rise. According to Matt Grossman in *The Wall Street Journal*, the yield of the 10-year U.S. Treasury Note experienced its biggest one-month increase in April since December of 2009 rising to 2.885%.[ii] According to Bankrate.com, the average 30-year fixed mortgage has climbed from 3.0% to 5.5% in the last year while the average money market yield has only climbed from 0.07% to 0.08%.[iii]

BOTTOM LINE

According to Randall Forsyth of *Barron's*, the Fed has become increasingly hawkish in the last few weeks with the futures markets now expecting the Fed funds rate to increase to a range of 2.75% to 3% by year end.[iv] There is a natural tendency to compare the current economic environment with past periods of inflation such as the 1970's and early '80's. There are clearly some similarities such as global instability and increasing fuel prices. However, this is not the late '70's. Pardon the pun, but OPEC does not have us over the barrel. Today, we have the capacity to produce excess energy to meet our needs, employment remains robust with unemployment near all-time lows at 3.6%, and corporate profits remain high.

In a recent article, Raymond James Chief Investment Officer Larry Adams offers five reasons to remain positive about the economy and investment markets going forward. We would like to briefly summarize three of his points here[v] …

- Overly Pessimistic Sentiment – The latest AAII Investor Intelligence survey found that the percentage of bullish investors has declined to the lowest level since 1992. This suggests that much of the bad news may already be priced into the market. In other words, this could be a buying opportunity.
- Healthy Corporate Earnings Growth – 1st quarter 2022 earnings have been very solid with strong revenue growth and favorable forward guidance. Forward S&P 500 earnings estimates for 2022 and 2023 have moved higher to $228 and $250 respectively. Bottom line – Corporate America is resilient in spite of international challenges.
- Strong Corporate Activity – With almost $2 trillion in cash on hand, U.S. corporations continue to enact shareholder-friendly actions such as buybacks and increased dividends. S&P 500 dividends are expected to rise 8% for 2022.

FINALLY

We are living through an odd yet fantastic but sometimes discouraging time. We worry about our health, political controversies, and the stock market to name just a few of our concerns. Yet, our worries can seem insignificant when we consider the war in Ukraine, the unimaginable suffering of innocents, and the possible use of nuclear weapons in our time. The questions are endless. How did we get here and where is this leading? Will Putin use nuclear weapons in Ukraine? Will the Russian troops go home? Will peace be restored? Will Ukrainian families be reunited to rebuild their country? Will the COVID-19 pandemic continue to recede? Will China invade Taiwan? Will supply chains be fully restored to pre-pandemic levels? Will the stock market stabilize this year? How high will interest rates go? Will grocery and gas prices climb higher? There are so many questions.

We cannot answer any of these questions with certainty. This much we do know. We should never bet against the home team. The United States remains a beacon of freedom and hope for the world. Our form of government can be exhausting and frustrating but there is no better form of self-governance on the earth in our judgment. Our economy is the envy of the world. Our dollar is the strongest and most sought-after currency in the world. Our corporations are some of the strongest companies in the world. Admittedly, we are struggling through a difficult time, but we've been through much worse. We will get through this.

Thank you for your continued confidence in our team. We seek to earn your trust every day.

Robert J. Gaskin, CIMA®
Managing Principal
Senior Financial Advisor, RJFS

Paul A. Gaskin
Senior Portfolio Manager
Senior Financial Advisor, RJFS

*Government bonds in this example are represented by the Ibbotson U.S. Long-Term (20-Year) Government Bond Index. Bond price is the capital appreciation (price return) of the index. Bond yield is the yield to maturity of the index. An investment cannot be made directly in an index.

**S&P 500 Index – [a registered trademark of the McGraw Hill Companies] is an unmanaged index of common stocks representing 500 industrial, utility, transportation and financial companies of the US markets (mostly NYSE issues).

---

[i] Gunjan Banerji & Caitline Ostroff, "Nasdaq Caps Worst Month Since 2008", The Wall Street Journal. April 30, 2022, p.A1
[ii] Matt Grossman, "Bond-Yield Rise Steepest Since '09", The Wall Street Journal. May 2, 2022, p. A1
[iii] "Consumer Rates and Returns to Investor", The Wall Street Journal. April 30, 2022, p. B7
[iv] Randall Forsyth, "A Tough Month Hits Stocks Hard but Spares Real Economy", Barron's, May 2, 2022, p. 4
[v] Larry Adam, "The Global Financial Market Ecosystem", Thoughts on the Market – Raymond James, April 25, 2022