Market Review and Outlook
June 30, 2022

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Market Environment

June 30, 2022

- Economy
  - The economic momentum still in place from excessive stimulus appears to be moderating from its heady pace, yet continues to provide solid nominal level of activity. Net of inflation however, growth is negative. (Q1 GDP -1.6%)
  - The incremental slowing has market sentiment handicapping the odds of a recession at an increasing probability.
  - Flushing out remaining supply chains, rebuilding inventory and return to travel, the office, and eating out continues to provide broad based activity and continued employment gains. There remains a significant labor shortage.
  - Consumer demand has shifted somewhat from goods to services, where labor is in short supply and wages are rising.
  - Demand for goods remains strong, but has moderated with some consumers backing off due to higher prices.
  - Inflation is reaching new highs and continues to accelerate in broad fashion. June CPI = 9.1%, core 5.9%, one month annualized June CPI 16.8%, core=8.7%. Inflation is currently the biggest threat to the economy and markets.
  - Supply chains have begun to normalize in some areas, albeit with delayed goods that have caused some mismatches in supply and demand for certain goods, but also with little progress in other areas.
  - Still high demand and low inventories have pushed median home prices to a new record at $400,000.
  - Higher home prices and mortgage rates (near 6%) have negatively impacted lower income and first time home buyers.
  - Policy induced inflation has begun to effect consumer behavior unevenly with lower income consumers shifting to reduced consumption and low cost brands, while upper income consumers spending habits are little changed.
  - Input costs including commodities and raw materials, manufacturing and operating, freight and transportation and employment costs remain high, and companies are passing those costs along to increased final prices.
  - Payrolls should continue to increase as government benefits continue to expire and there continue to be more jobs available than people looking for work. Jobs available however should begin to decline significantly but probably will not result in significant layoffs for some time.
  - The current unemployment rate sits at 3.6%, and there are about 1.9 jobs available for every unemployed person.
  - The Russian invasion of Ukraine pushed prices of crops and energy higher but has otherwise had little direct impact on the US economy. The war is having significant negative consequences in Europe.

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Market Environment

June 30, 2022

- Policy
  - Monetary policy is a disaster as the Fed tries to catch up by hiking rates aggressively and has vowed to continue to do so even at the risk of recession to fight inflation. But they also continue to buy bonds in the open market…(?)
  - The Fed tightened 75bp in June and has indicated to do so again in July. Fed, and market expectations are for the Fed Funds rate to end 2022 at just above 3%, a full percentage point above expectations at the end of Q1.
  - Markets are expecting Fed easing by mid 2023 as they have begun to price in the probability of recession.
  - Fiscal policy is on hold amid high inflation and as massive funds already approved are yet to be used.
  - Energy policy has been harmful for both fossil fuels and alternative energy.
- Markets
  - The stock market has reached bear market territory at down 20% from their highs as accelerating inflation and a significant rise in interest rates, together with downward earnings guidance has increased market volatility.
  - Periodic thoughts of the Fed backing off provides unlikely hope and brief rallies. The "Fed Put" is not an option.
  - The S&P 500 was down -16% in Q2, and down -20% YTD. "Growth" stocks were hit particularly hard.
  - Market and economic headwinds and tailwinds seem to be coming together sooner than expected as the Fed accelerates rate hikes well above previous market expectations and inflation seeps deeper into the economy.
  - To date, those companies that have increased prices, and have product to sell, have been rewarded.
  - Bond markets posted significant negative returns with the Aggregate Bond Index declining -4.7% in Q2 and -10.3% Year to Date in total return as interest rates rose above 3% across all maturities. The 10 year hit 3.5% in mid June.
  - Meanwhile corporate and mortgage yield spreads widened, furthering the overall bond market losses.
  - There has been nowhere to hide as even ultra short term maturities turned in negative performance. Short term Treasury Inflation Protected Securities (TIPS) continued to perform relatively well, in fact was positive in Q2.
  - This earnings season will be critical as the market will be watching if companies are able to continue to push costs through to consumers, and/or have the goods and services and workers to satisfy demand, all while interest rates move higher.
  - Interest rates are moving up and down between higher inflation and Fed policy, and a flight to quality from risk assets.

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Market Outlook

June 30, 2022

- We are in the midst of perhaps one of the greatest policy mistakes, simultaneously on fiscal, monetary, and energy policy in history.
- The Fed has acknowledged their policy mistake and are moving aggressively to catch up, which is causing increasing levels of uncertainty and volatility. They have stated they are willing to risk a recession to control inflation.
- We feel inflation will continue to be a key focus of markets in the near term as it continues to rise above expectations and forces the Fed to pull plans forward to remove excess stimulus more quickly, pushing rates higher and upsetting equity markets.
- Financial and risk assets have been the beneficiary of excess stimulus in the system for many years and are now faced with its removal. It is important to view markets and the economy in a 40 year window rather than a 3 year window.
- Volatility will surely continue amid rising rates with the 10-year Treasury reaching 3.5% and a real risk of S&P 500 reaching 3500, an additional 10% decline from the 20% correction already established.
- Strong enough economic momentum could provide support, however P/E ratios remain high and earnings growth is slowing.
- Employment growth should continue to accelerate with the removal of government stimulus, growing income needs and high numbers of jobs to fill, subject to inflationary pressures pushing back.
- We have begun to see significant declines and stress in unprofitable companies living off of free capital that is going away. We should begin to see the excess number of jobs available being reduced, however don't expect a significant rise in unemployment.
- Evidence continues to show businesses are having to raise wages to attract workers, while also cutting back on service hours and production as the cost and unavailability of labor prevents business growth. The employment void has begun to close.
- Rising costs of labor, raw materials, transportation, and other input costs are being passed through, with CPI printing 9.1% in Q2. An open question will be the ability to pass through higher costs and maintain volume through all phases of production and delivery.
- The inability to source materials or to produce finished goods, together with higher input costs being passed through to final prices, may both decrease sales and margins, curbing corporate cash flow and profit growth.
- As previously discussed, manufacturing will likely exhibit continued growth amid onshoring of supply chains and growth in logistics, new technology, including alternative energy, electric vehicles, efficient operations and transportation of goods and services.
- If job growth expands with people going back to work and supply chains begin to flow, economic growth could accelerate; however, if the current record number of open jobs don't get filled and inflation remains high, a recession is possible.
- There is a significant risk of a recession as defined by two quarters of negative GDP growth, where inflation is higher than nominal GDP. However, we feel the underlying nominal level of activity remains solid, and recession talk in a broader sense may be premature.

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Investment Strategy

June 30, 2022

- We remain defensive in both equity and fixed income markets amid growing earnings pressures and rising interest rates.
- Inflation pressures and inflation expectations are broad based and remain high as input costs such as wages continue to move higher, putting upward pressure on interest rates, while profit margins may contract as consumers begin to reject higher prices.
- The ability of businesses to pass higher costs through to consumers, and consumers willing to pay may be hitting a threshold. Early indications have shown this impact hitting lower income but not yet higher income consumers.
- Investment strategy has been reducing overall equity allocation by harvesting gains/trimming positions in growth sectors and rebalancing to high quality dividend paying value stocks and short-term fixed income.
- **During Q2, investment strategy moved to more significant underweight equities relative to neutral strategic asset allocation. Given the heretofore rise in interest rates and having avoided much of the damage, an explicit reallocation overweight in Fixed Income was made from equity and fixed income cash.**
- **The fixed income allocation is focused on short term US Treasuries at now over 3% yield while also adding GNMA mortgage backed securities (full faith and credit of US Government) at over 4%.**
- **We continue to underweight exposure to corporate credit given low incremental yield and risk of significant spread widening.**
- Within equities, Utilities, Banks and Energy are primary areas of focus with an "equal weight" strategy and minimal "FAANG+"
- Within fixed income risk has also been reduced in credit risk, including High Yield, and increasing quality into short term Treasuries and Treasury Inflation protected securities (TIPS). Some Treasuries have recently been extended into higher yields.
- Supply chain disruptions are likely to last longer than expected. The ultimate flushing out of supply chains could benefit transportation sector such as trucking and rails. Increased materials could boost production of low inventory products like homes.
- As we move into Q3 2022, higher interest rates, inflation, energy costs, and a growing debt burden, there is a risk of decelerating economic activity, and earnings. Rates have moved above 3%, and S&P 500 has realized a 20% correction.
- As we see progress unclogging the supply chains, jobs getting filled in critical sectors, and pricing pressures ease, we will feel more comfortable increasing risk exposures; however, significant progress is needed.
- Geopolitical risks have increased recently and may have consequences on the global economy, particularly in Europe.
- The yield curve is not "telling us" anything being flat/inverted as long as the Fed continues to sit on long rates.
- Significant economic energy remains in the system that should mitigate risk of deep recession, however will also maintain high inflation pressures, increasing uncertainty on corporate profits. Company specific management will be a differentiator.

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Market Review

S&P 500 – June 30th, 2022

- Equity markets remain volatile as the S&P 500 dropped into bear market territory at down -20% amid high inflation, aggressive Fed tightening, and significant rise in rates.
- Interest rates rose significantly in Q2 The bond market total return is down -10% YTD.
- Equity markets are being pushed around by individual company earnings, overall Fed tightening and higher interest rates, and increased talk of recession.
- Interest rates are vacillating between higher inflation and a flight to quality from risk assets.

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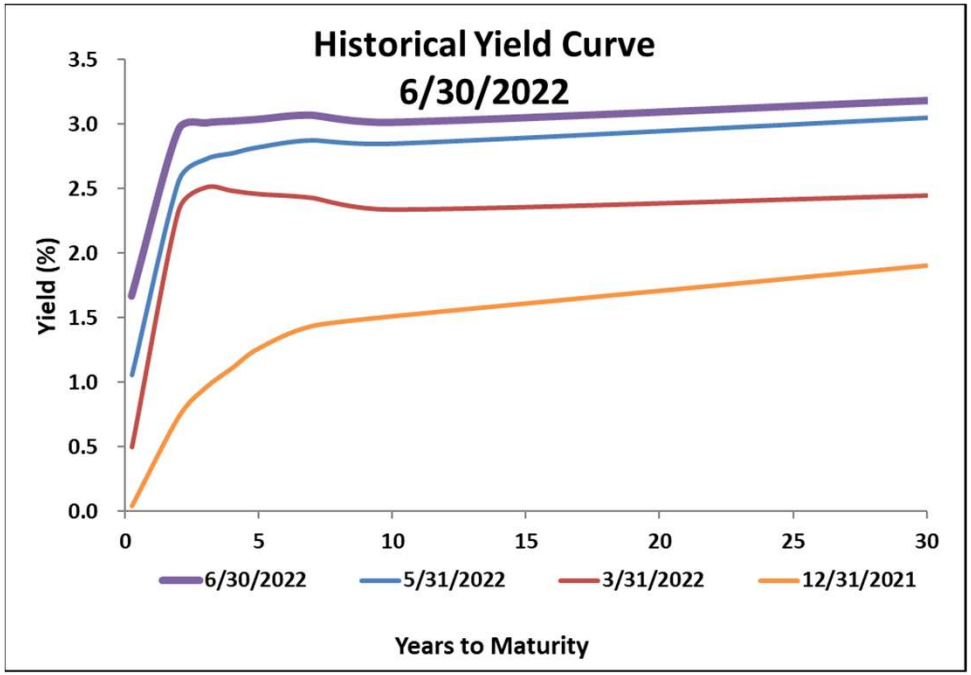
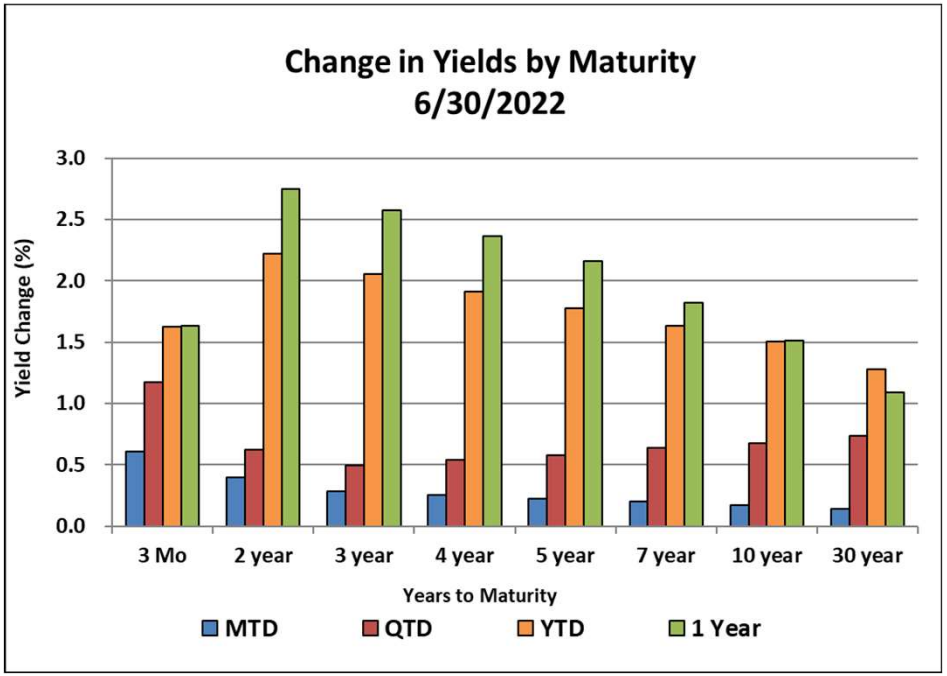
Market Review

Yield Curve – June 30th, 2022

- Q2 2022 saw rates rise significantly across the curve as the Fed accelerated rate hikes, trying to catch up.
- Long term rates led the rise in Q2 as inflation accelerated and the Fed began to unwind QE.
- As inflation and expectations of Fed policy ratcheted higher, rates rose to 3.5% across maturities until recession talk took hold, and rates fell back to around the 3% at quarter end.
- Interest rates remain volatile in a range as the Fed vows to tighten aggressively to fight inflation, while the risk of economic slowdown and the equity bear market generates a flight to quality into Treasuries.
- The range of 3% - 3.5% short term rates is correctly pricing in expectations of 3.25% Fed Funds rate at year end 2022, however longer term rates may have further to go to reflect reduced QE and persistent inflation.





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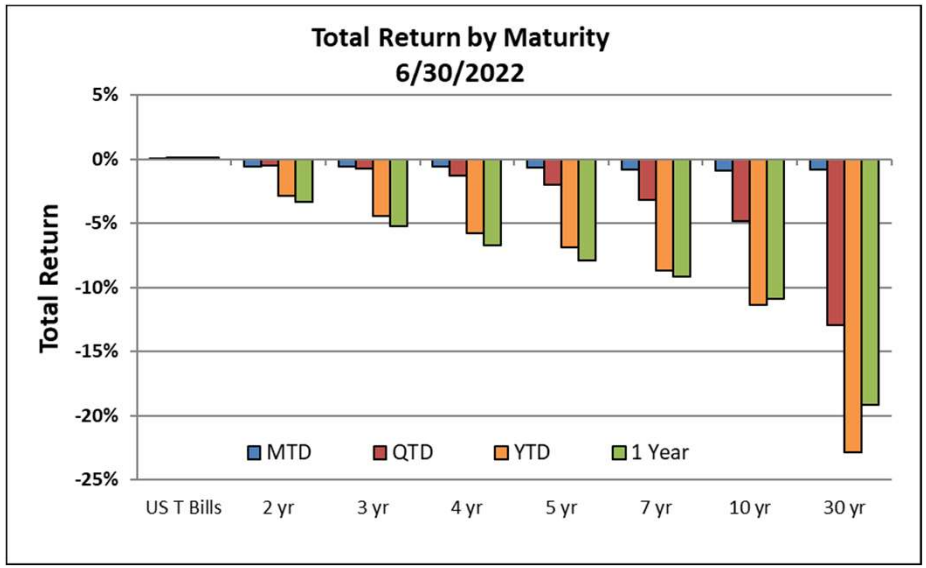
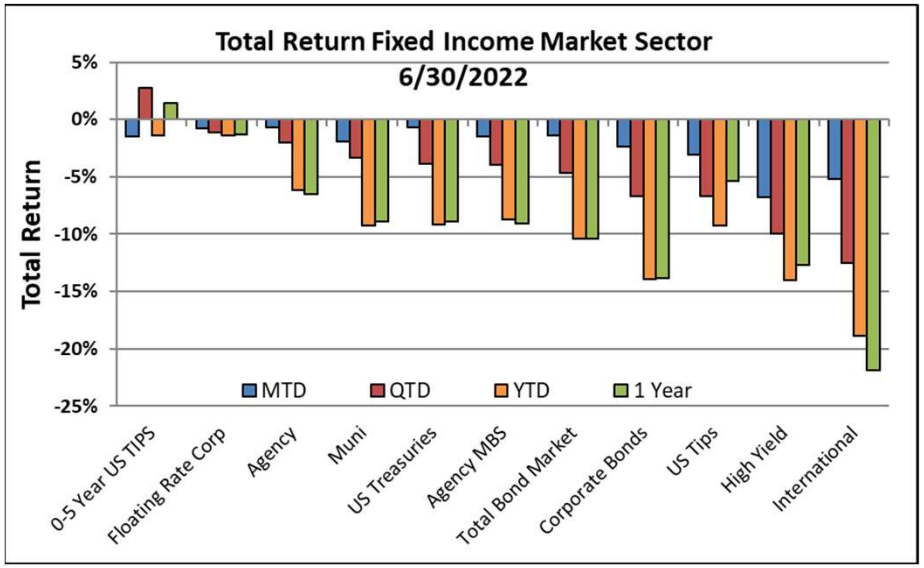
Market Review

Yield Curve and Sector Returns – June 30th, 2022

- The rise in rates in Q2 pushed total returns on Treasuries further negative, significantly so, particularly in longer term maturities (longer duration) with greater sensitivity to changes in interest rates.
- The losses across the bond market are some of the worst in history. The aggregate bond index is down more than 10% year to date. There was nowhere to hide. Even floating rate bonds were down.
- Corporate bonds, including High Yield, generated even worse returns than Treasuries as risk premiums widened. Mortgage backed securities also generated negative returns.
- Given actual inflation, **short term** TIPS have been the best performing bonds this year and positive in Q2.
- Longer term securities are still vulnerable with inflation high and the Fed still unwinding Quantitative easing. Short term rates may now have sufficient income to offset further price volatility.





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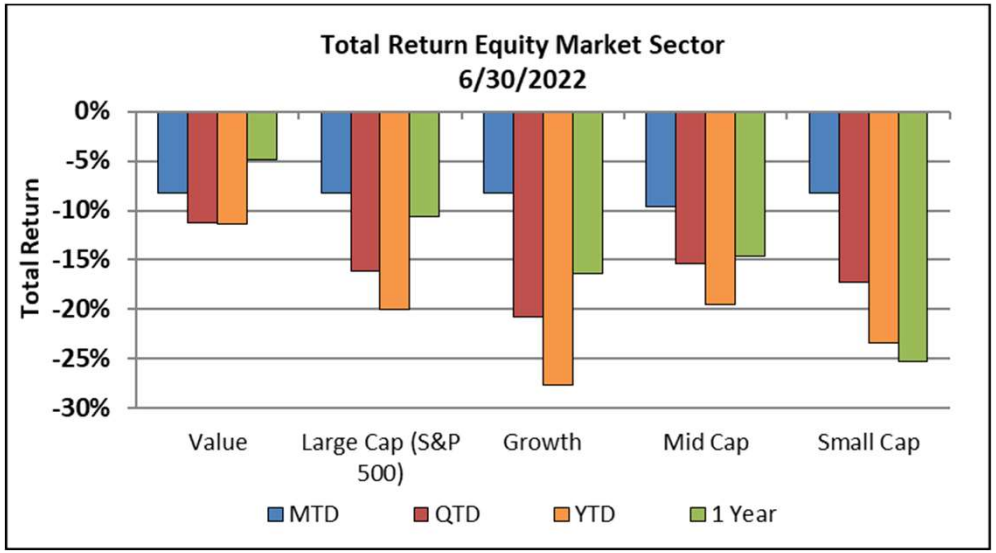
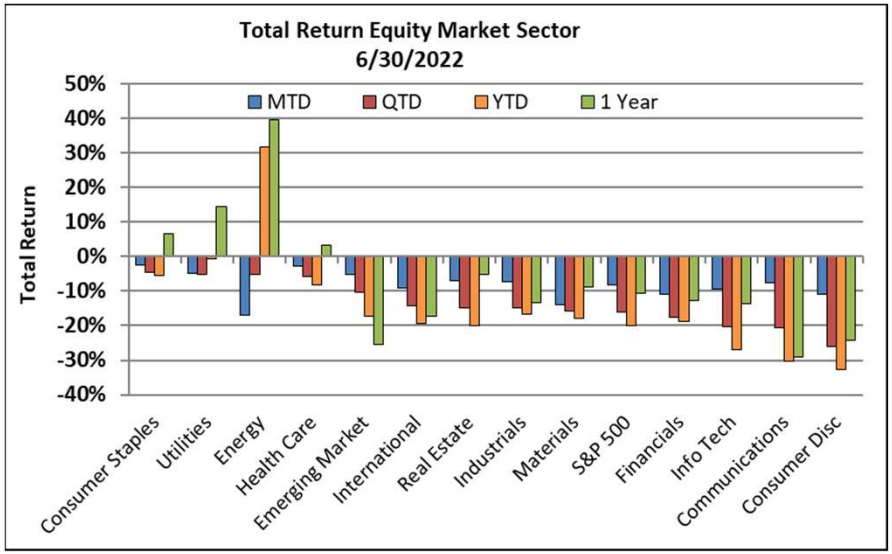
Market Review

Equity Market Returns – June 30th, 2022

- For the Quarter, Value stocks and sectors such as Energy & Utilities have minimized losses in Q2.
- Growth stocks were among the worst performers with sectors such as Information Technology and Communications being the most negative amid rising interest rates.
- In March, the market rebounded off the February lows, led by Utilities, Energy, Healthcare & Real Estate, while Banks and communications lagged.
- Over the past year, energy has dominated returns as the oil pushed above $100 a barrel.





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Market Scoreboard

June 30th, 2022

Market Summary - June 30th, 2022					
Bond Market	**MTD**	**QTD**	**YTD**	**1 Year**	**Yield**
Floating Rate Corp	-0.8%	-1.1%	-1.4%	-1.3%	1.2%
Merrill Muni Index	-1.9%	-3.3%	-9.3%	-8.9%	2.8%
US Treasuries	-0.7%	-3.8%	-9.2%	-8.9%	3.1%
US MBS Index	-1.5%	-3.9%	-8.8%	-9.1%	3.7%
Total Bond Market	-1.4%	-4.6%	-10.4%	-10.4%	3.6%
Corporate Bonds	-2.4%	-6.7%	-13.9%	-13.8%	4.7%
US TIPS (Inflation Prot.)	-3.1%	-6.7%	-9.2%	-5.3%	0.4%
High Yield Corporates	-6.8%	-10.0%	-14.0%	-12.7%	8.9%
International Bonds	-5.2%	-12.6%	-18.9%	-21.9%	1.4%
Commodities/Other	**MTD**	**QTD**	**YTD**	**1 Year**	**End Value**
Oil (WTI)	-5.5%	11.2%	46.5%	61.5%	106
Gold	-1.6%	-6.7%	-1.2%	2.1%	1,807
Dollar Index	2.9%	6.5%	9.4%	13.3%	105

Market Summary - June 30th, 2022					
Stock Market Indices	**MTD**	**QTD**	**YTD**	**1 Year**	**End Value**
DOW Jones Avg.	-6.6%	-10.8%	-14.4%	-9.1%	30,775
Large Cap Core (S&P 500)	-8.3%	-16.1%	-20.0%	-10.6%	3,785
NASDAQ Composite	-8.7%	-22.3%	-29.2%	-23.4%	11,029
Large Cap Growth	-8.3%	-20.8%	-27.6%	-16.4%	2,434
Large Cap Value	-8.2%	-11.3%	-11.4%	-4.9%	1,357
Mid Cap Core	-9.6%	-15.4%	-19.5%	-14.7%	2,269
Mid Cap Growth	-10.0%	-17.5%	-25.0%	-20.5%	1,035
Mid Cap Value	-9.3%	-13.5%	-14.0%	-8.7%	757
Small Cap Core	-8.2%	-17.2%	-23.4%	-25.2%	1,708
Small Cap Growth	-6.2%	-19.3%	-29.5%	-33.4%	7,563
Small Cap Value	-9.9%	-15.3%	-17.3%	-16.3%	13,714
Europe	-11.4%	-14.9%	-24.5%	-22.7%	383
England	-8.8%	-10.8%	-10.9%	-6.7%	7,169
Japan	-8.2%	-14.9%	-21.3%	-23.5%	28,792
Shanghi 300	10.0%	1.5%	-13.0%	-15.6%	4,485
International	-9.3%	-14.3%	-19.3%	-17.4%	1,846
Emerging Markets	-5.1%	-10.4%	-17.2%	-25.6%	40
MSCI China	6.6%	3.4%	-11.3%	-31.8%	544

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Market Review

Yield Curve Scenario Analysis – June 30th, 2022

- While it may feel like rates have risen significantly over the past year, past tightening cycles have seen 400 basis point increases in rates. Rates remain relatively low by long term historical norms.
- The rise in inflation currently dwarfs anything seen since 1984, so further upward rate moves are likely.

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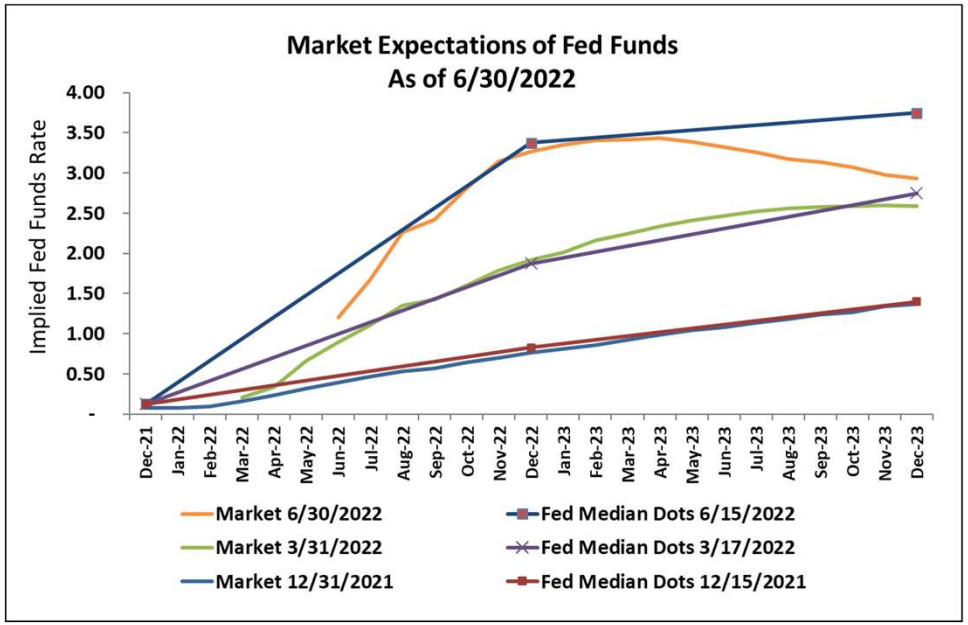
Market Review

Monetary/Fed Policy – June 2022

Federal Reserve Median Economic Projections As of 6/30/2022					
Change in GDP	**Actual**	**2022**	**2023**	**2024**	**Longer Run**
June 2022 Projection		1.7	1.7	1.9	1.8
Mar. 2022 Projection		2.8	2.2	2.0	1.8
Actual Q1 2022 yoy/qoq	**3.5%/-1.6%**				
Unemployment Rate					
June 2022 Projection		3.7	3.9	4.1	4.0
Mar. 2022 Projection		3.5	3.5	3.5	4.0
Actual June 2022	**3.6%**				
PCE Inflation					
June 2022 Projection		5.2	2.6	2.2	2.0
Mar. 2022 Projection		4.3	2.7	2.3	2.0
Actual May 2022	**6.3%**				
Core PCE Inflation					
June 2022 Projection		4.3	2.7	2.3	
Mar. 2022 Projection		4.1	2.6	2.3	
Actual May 2022	**4.7%**				
Projected Policy Path- Fed Funds					
June 2022 Projection	1.6	3.4	3.8	3.4	2.5
Mar. 2022 Projection	0.4	1.9	2.8	2.8	2.4

- The Fed hiked interest rates to a range of 1.5-1.75% in its March Meeting and ended New Bond Purchases in its Quantitative Easing Portfolio.
- Governors have pulled forward timing of the future rate Hikes, with the recent 75 bps in June, and likely again at the next meeting in July. Odds are increasing for 100bp
- The Fed is behind the curve and are playing catchup with both their outlook and policy.
- The market is expecting tightening to cause a recession, that would cause the Fed to turn around and ease after Q1 23.



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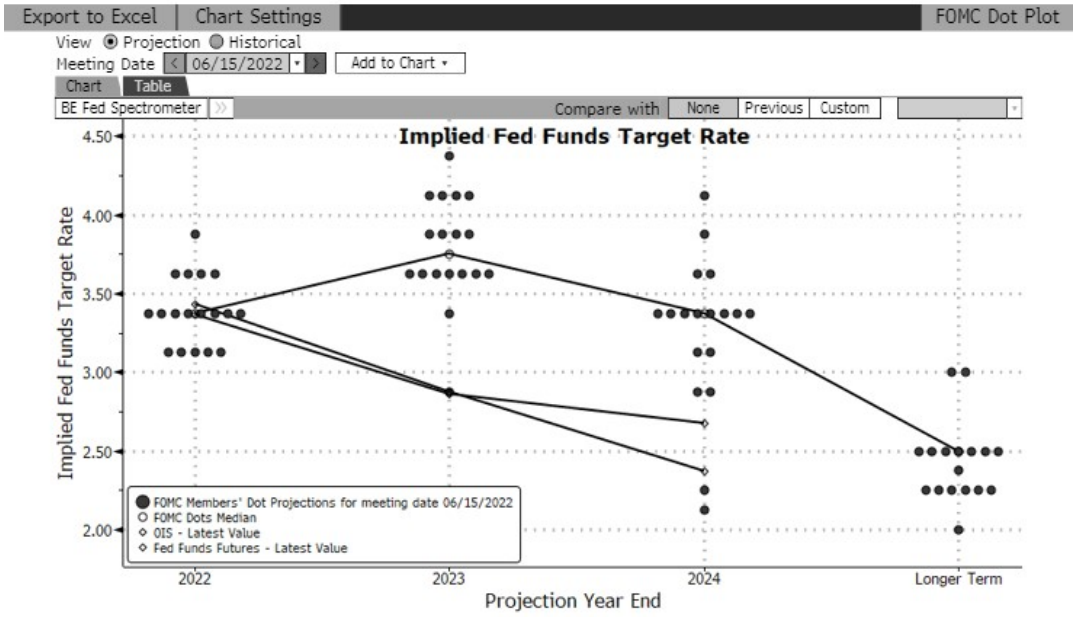
Market Review

Monetary Policy – June 2022

- All Governors agreed with the decision to raise interest rates 75bp, however 1 governor urged for a more moderate 50bp hike. The Feds Dot Plot shows all Fed Governors thoughts on where rates will be at each time period, with the median suggesting a rate just under 3.5 by year end 2022.
- Inflation expectations have risen but long-term inflation implied by TIPS remains well below actual inflation and our expectations.
- The strong economy, particularly the housing market, is leaving the Fed with little reason to continue the reinvestment of US Treasuries and MBS and needs to be addressed.



Current Fed Funds Rate
1.58

10 Year Tip	10 Year UST	Implied Inflation Premium
0.66	3.01	**2.35**

5 Year Tip	5 Year UST	Implied Inflation Premium
0.42	3.04	**2.62**

2 Year Tip	2 Year UST	Implied Inflation Premium
(0.36)	2.95	**3.31**

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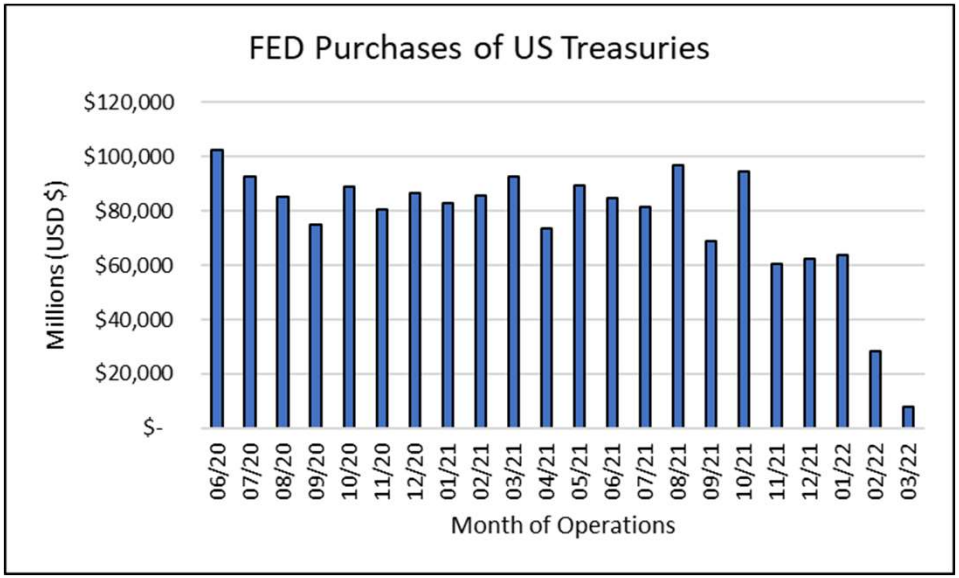
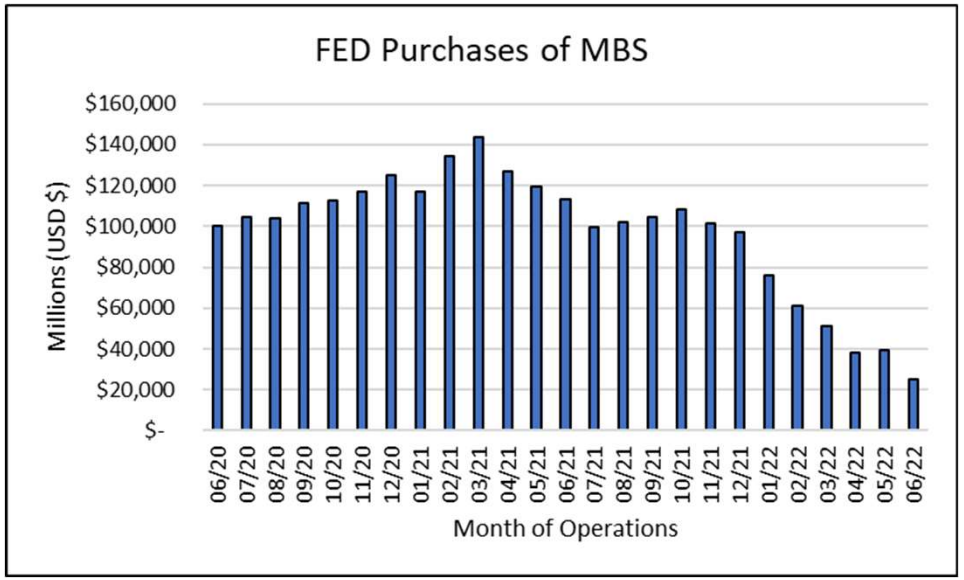
Fed Purchases

June 2022

- While the FED stopped purchasing US Treasuries in March of 2022, the Fed Bank of NY continues its open market operations through purchasing MBS.
- In the Final Week of Q2, the Fed Purchased $2.44 Billion in Mortgage-Backed Securities.
- In sum since 6/1/2020 the Fed has purchased: $1.684 Trillion in US Treasuries and $2.433 Trillion in Mortgage-Backed Securities to "maintain liquidity" and further stimulate the economy, which is currently running with inflation accelerating through 40-year highs.
- The Fed began to reduce purchases, but continues to reinvest in Mortgage Backed Securities.





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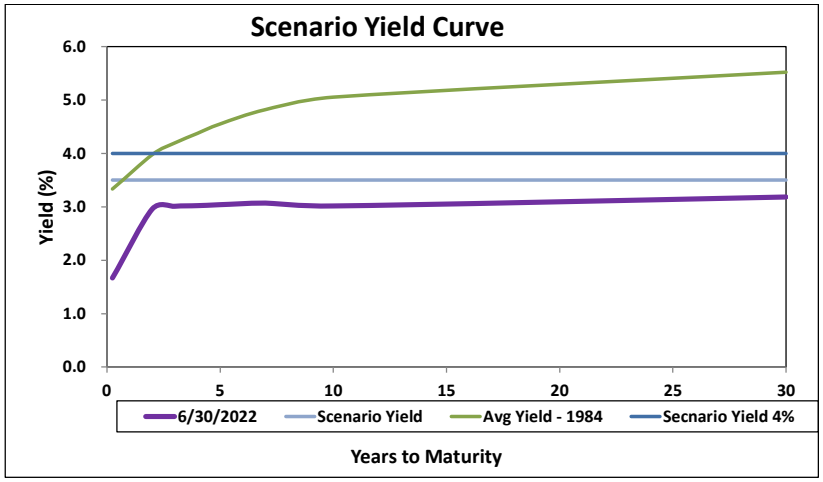
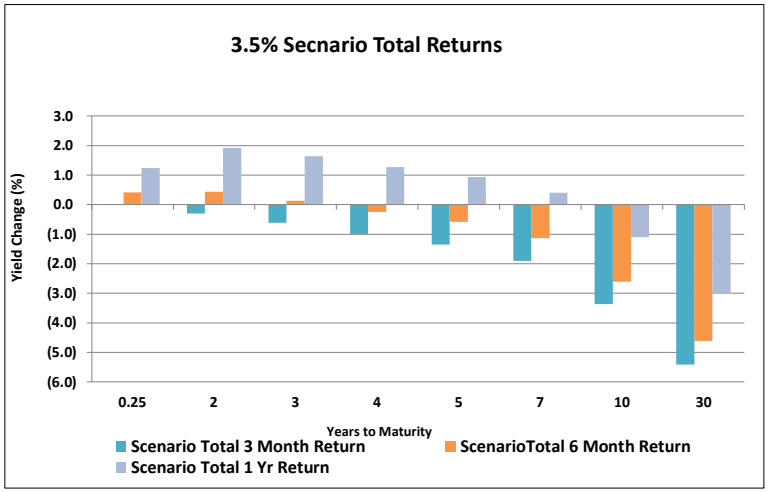
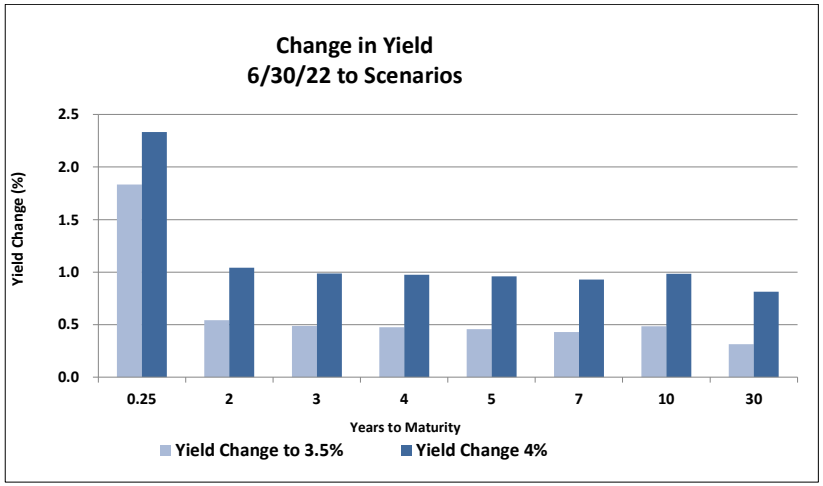
Market Review

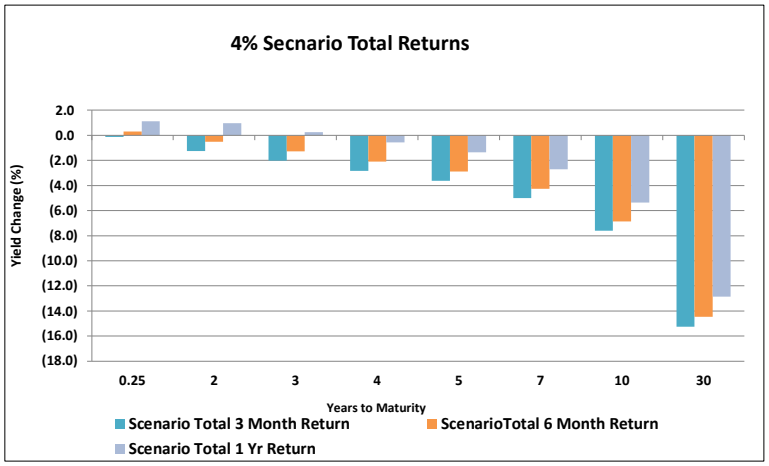
Yield Curve Scenario Analysis – June 30th, 2022

- Given the recent rise in rates above 3%, the higher current level of income in shorter term maturities is better able to offset a decline in price from further rate increases. In scenarios moving rates to 3.5% and to 4%, shorter term maturities still generate positive returns, where longer term maturities remain vulnerable.









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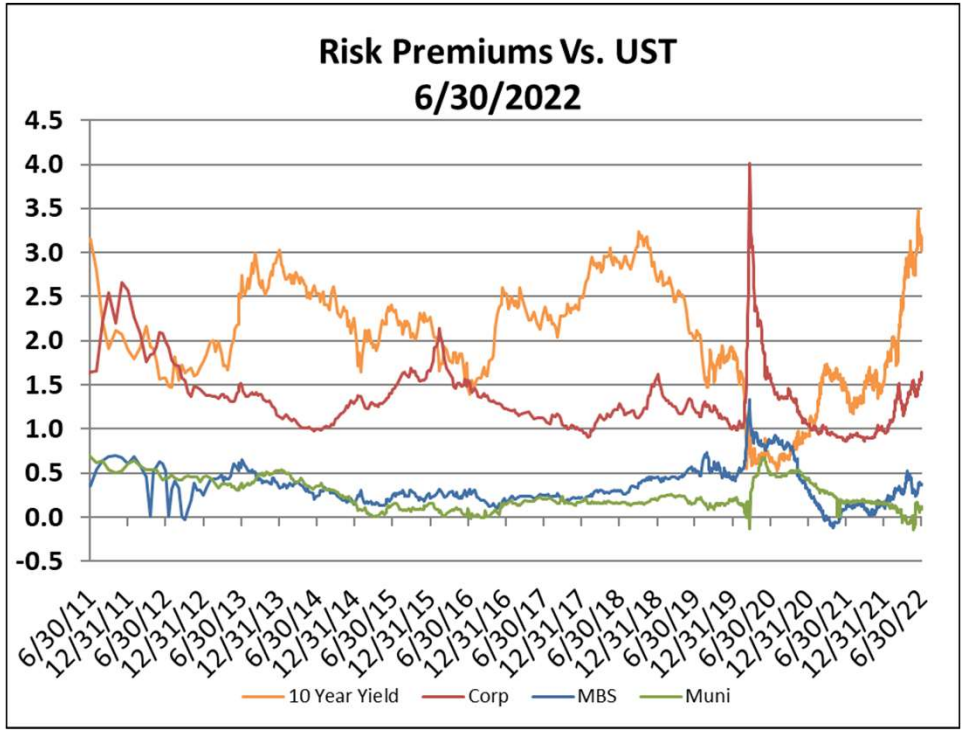
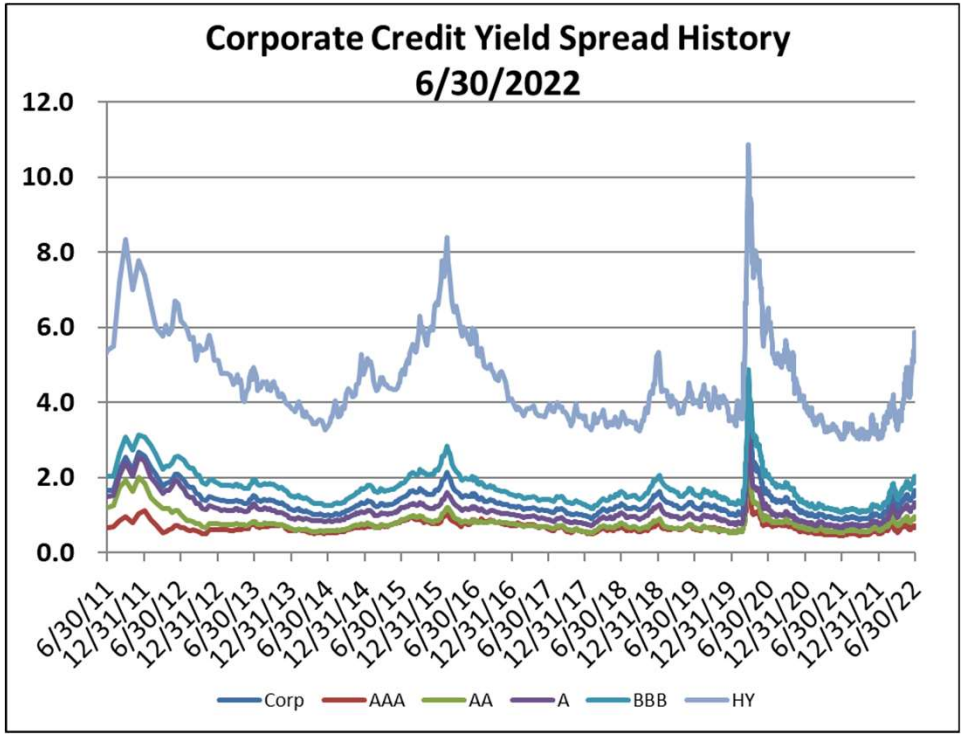
Market Review

Yield Spreads – June 2022

- Corporate, Muni & MBS spreads widened as all risk assets sold off in Q2, furthering the negative returns in the bond market. The deeper the credit the greater the widening.
- Corporate credit conditions have been strong; however, supply chain issues, increased costs (both financial/funding costs & operational costs), margin pressures, reduced operating ability, and/or lower cashflow may increase risk.





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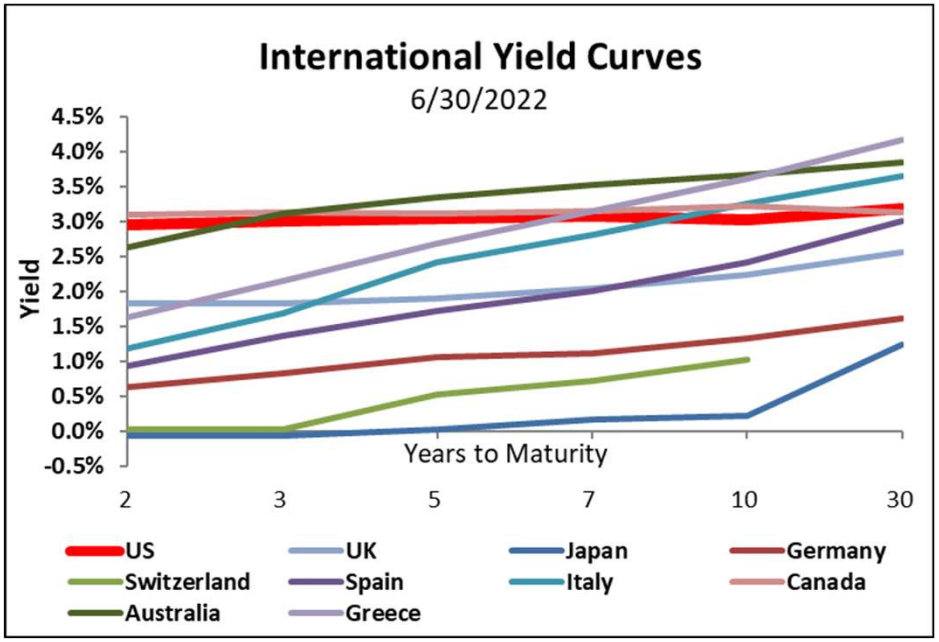
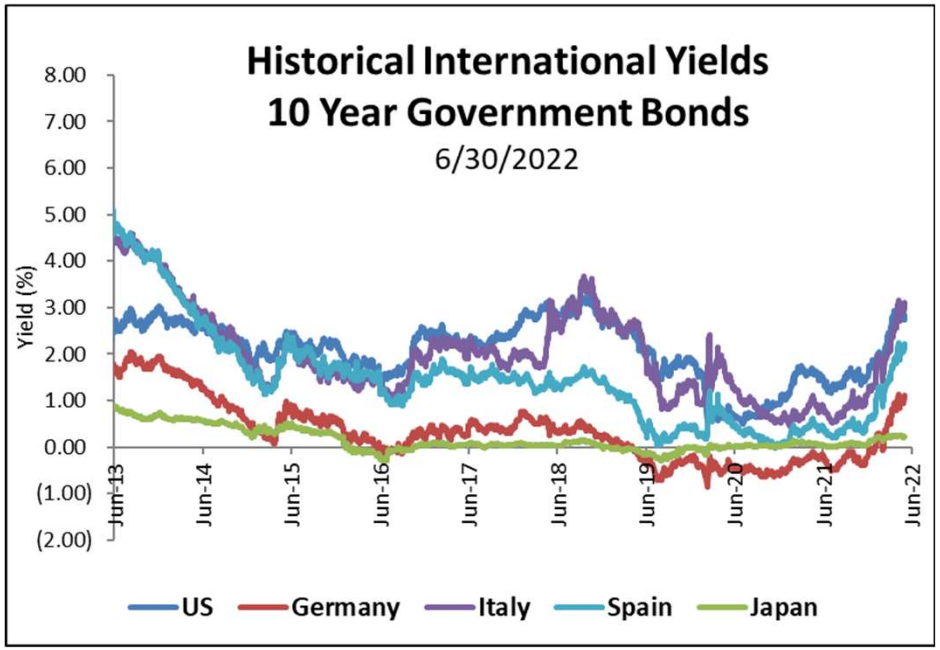
Market Review

International Yield Curves – June 2022

- Inflation has become a global phenomenon and interest rates are rising globally
- Central banks have differed on their response as some, such as Europe remain passive.
- The US continues as one of the highest yielding developed countries. These interest rate differentials also contribute to a strengthening dollar.
- Stress is becoming apparent in some areas such as peripheral Europe and emerging markets.





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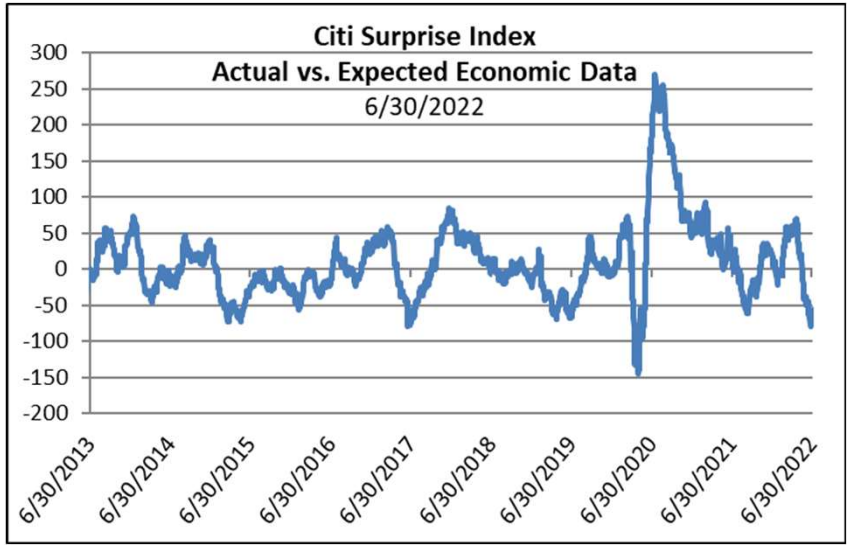
Economic Environment

June 2022

- Robust economic activity has moderated, and has been coming in well below expectations
- Economic activity remains strong in the US YOY, however has turned negative net of inflation in Q1.
- Global GDP has moved from strong growth across the globe to much more varied, with some countries being impacted more than others depending on impact of inflation and the Russian invasion of Ukraine.
- Inflation has moved higher around the globe with expectations of future inflation continuing to rise due to significant stimulus, the increased cost of doing business, and continued supply chain woes.



GDP YoY % Change

	Q2 2022	One Year Ago	Change
US	3.50	0.50	3.00
Eurozone	5.40	(0.90)	6.30
Germany	3.80	(2.70)	6.50
France	4.50	1.80	2.70
Italy	6.25	0.04	6.21
UK	8.70	(5.00)	13.70
Canada	5.00	17.90	(12.90)
Mexico	1.83	(3.85)	5.68
Australia	3.30	1.40	1.90
Japan	0.40	(1.70)	2.10
China	4.80	18.30	(13.50)
Russia	3.50	(0.30)	3.80
Brazil	1.69	1.29	0.40

**Canada GDP as of 4/30/2021*
**All other GDP as of 3/31/2022*

Inflation YoY % Change

	May-22	One Year Ago	Change
US	8.60	5.00	3.60
Eurozone	8.60	1.90	6.70
Germany	7.60	2.30	5.30
France	5.80	1.50	4.30
Italy	8.00	1.30	6.70
UK	9.10	2.10	7.00
Canada	7.70	3.60	4.10
Mexico	7.99	5.88	2.11
Australia	3.30	1.40	1.90
Japan	2.50	(0.80)	3.30
China	2.50	1.10	1.40
Russia	15.90	6.47	9.43
Brazil	11.89	8.35	3.54

**US, UK Canada, & Japan as of 5/31/2022*
**Australia CPI as of 3/31/2022*

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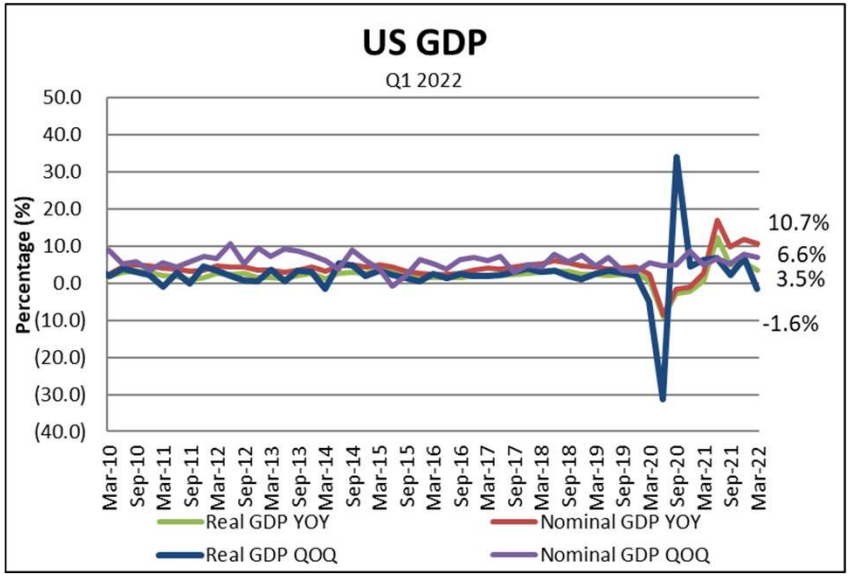
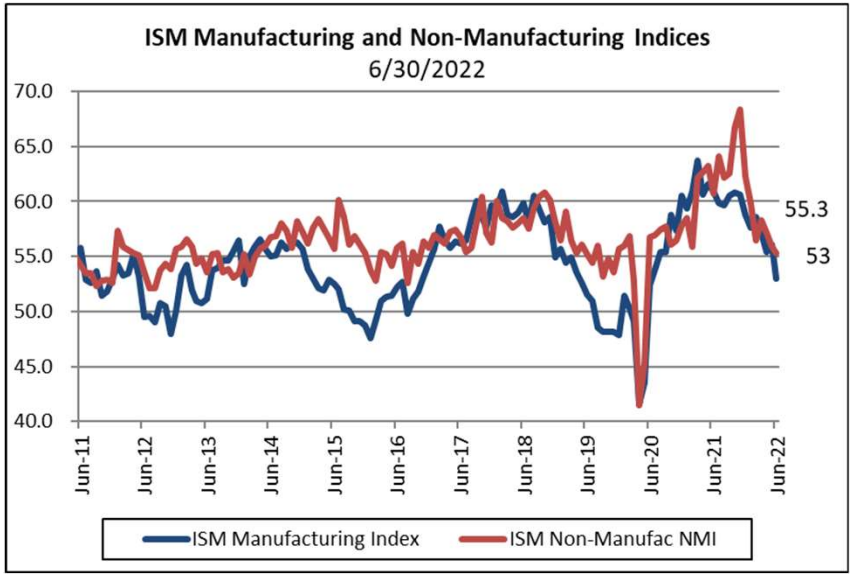
Economic Environment

June 2022

- US Economic activity remained robust in Q1 as the economy went back to work; the unemployment rate fell and demand for goods remained strong on the heels of significant government stimulus.
- Supply of goods, materials, workers, and services continues to be in short supply relative to demand, begun to moderate. High inflation has rendered net GDP negative.
- Production and Consumption has showed signs of slowing as high inflation has curbed demand on the one hand, while continued inability to produce goods and deliver services constrains supply on the other.
- Manufacturing and service indicators have moderated after a strong effort to rebuild inventory, but still shows growth as supply chains still need to be flushed out and outstanding demand satisfied.





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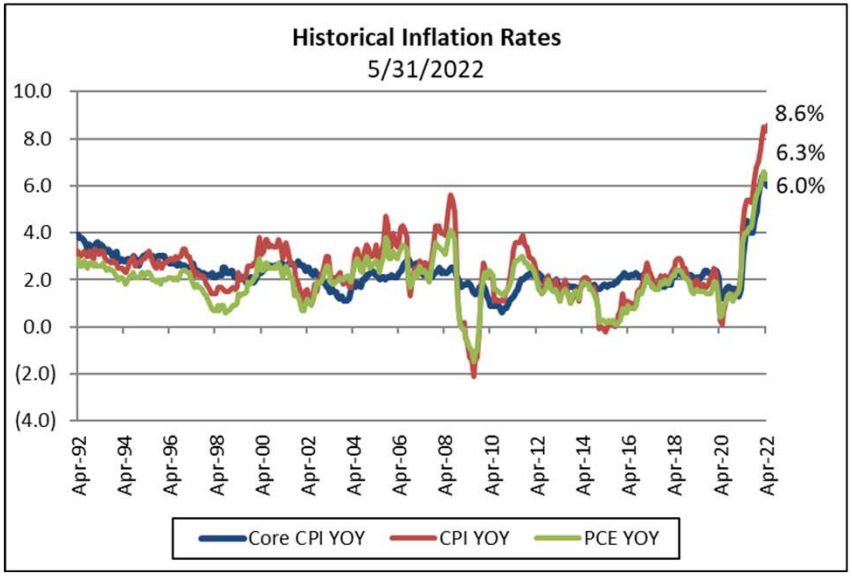
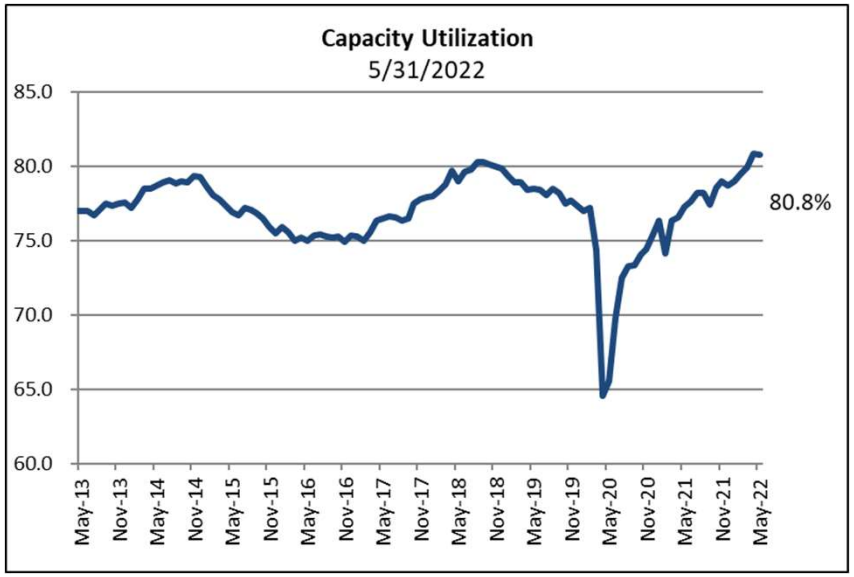
Economic Environment

Employment and Inflation – June 2022

- Inflation levels continue to rise amid continued strong demand and supply disruptions. Demand for higher wages by a tight labor force is contributing to higher costs, as are energy and other input costs.
- Expectations of inflation are increasing as input costs are being passed through at an increasing rate, resulting in demand for higher wages – potentially sparking a classic wage-price spiral.
- Capacity utilization has steadily increased as factories come back online; however, overall expansion of capacity is limited by worker and material shortages.





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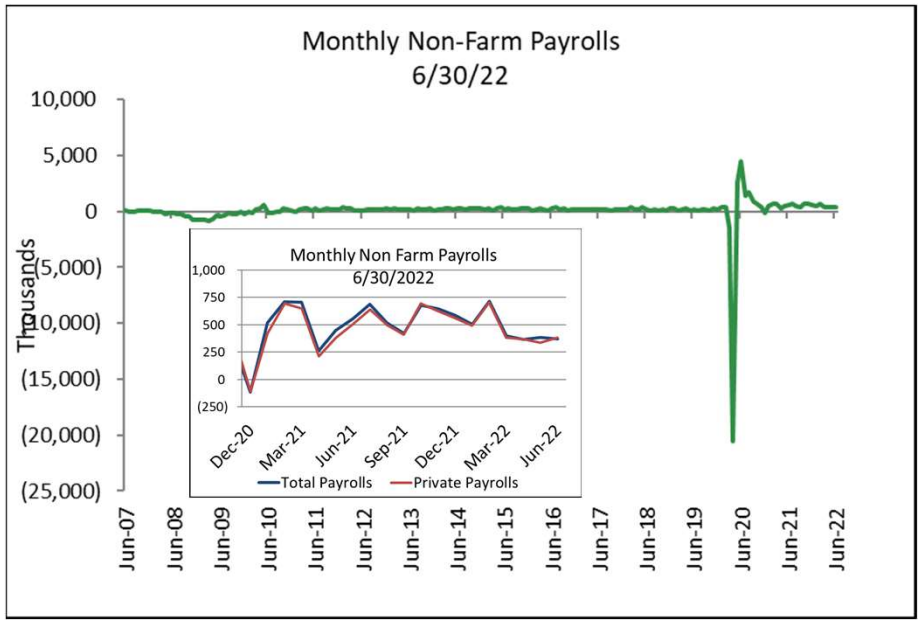
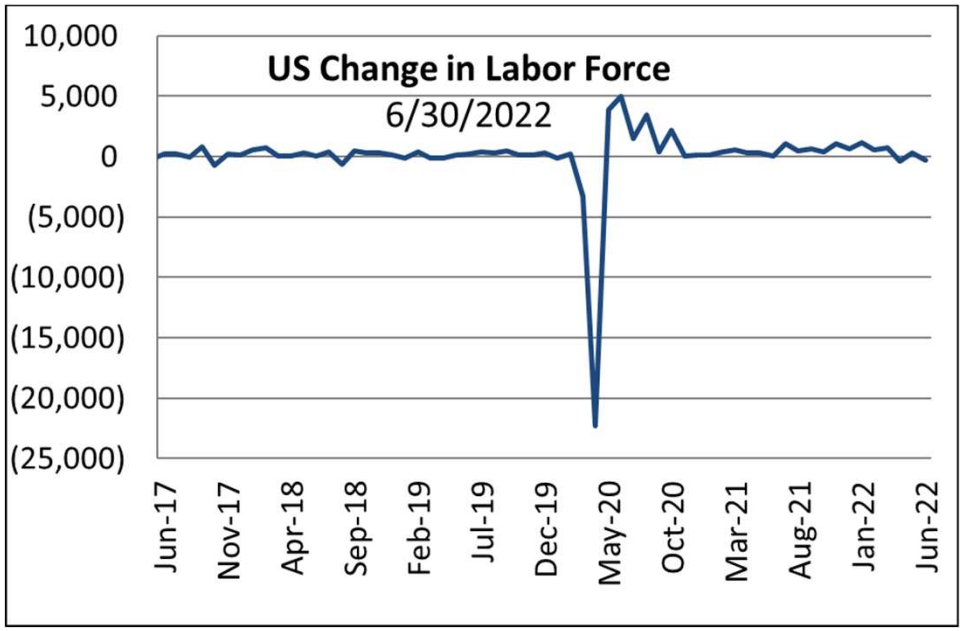
Economic Environment

Employment – Monthly Payrolls – June 2022

- Monthly payrolls continue to increase near 400,000 per month as workers get back to work and unemployment packages have rolled off.
- There are currently about 1.9 jobs available for every person unemployed, increasing employee turnover and pushing up wage pressures.
- The labor force continues to grow as people continue to return to work however has moderated. Much work is still needed to fill available jobs.





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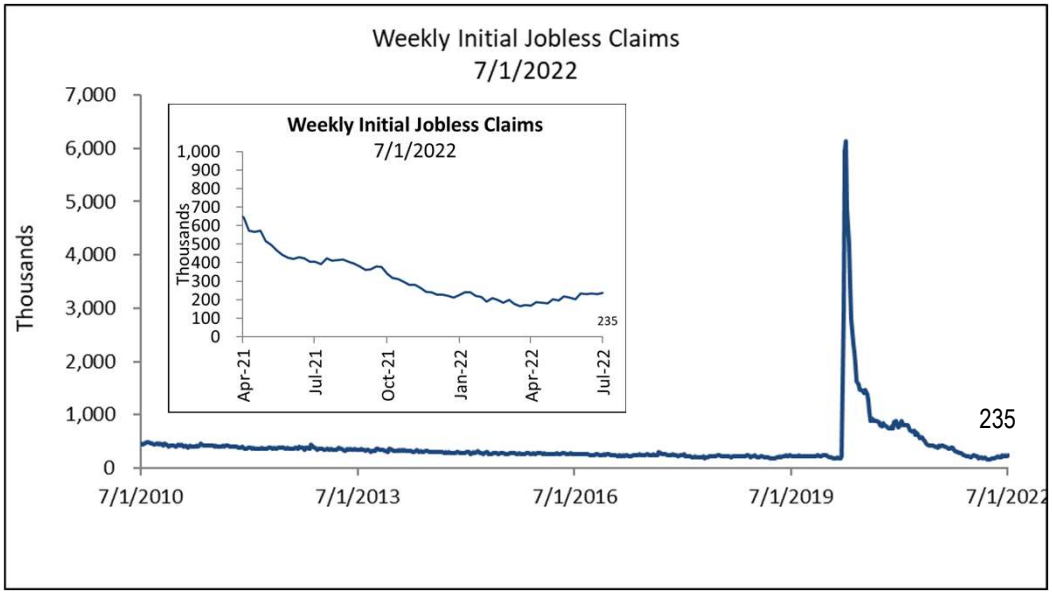
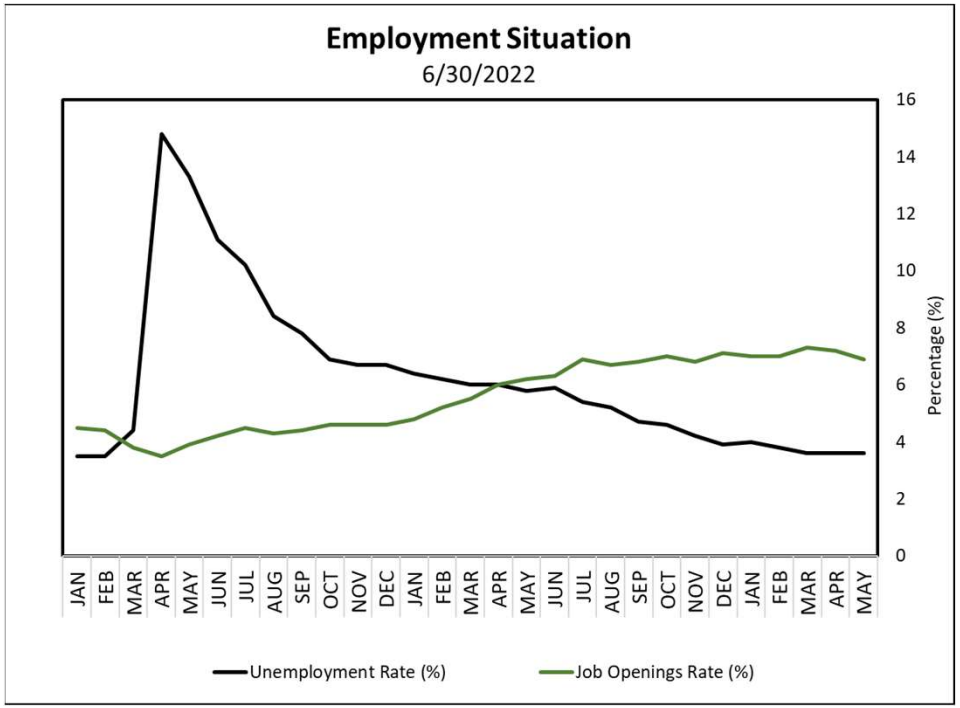
Economic Environment

Employment – Monthly Payrolls – June 2022

- Initial claims for unemployment remain as historically low levels as employers are hesitant to lay off workers amid the continued labor shortage.
- The unemployment rate has fallen to 3.6%, stabilizing under 4%, all while the US maintains a significant number of job openings; there were over 11 million job openings still in Q2.
- The unemployment rate was at 3.5% just before the pandemic.





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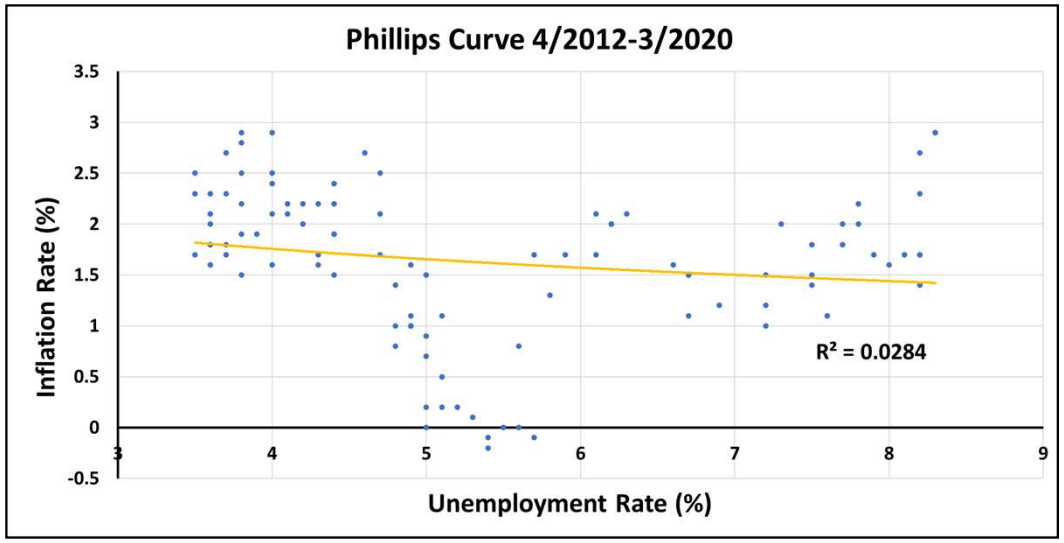
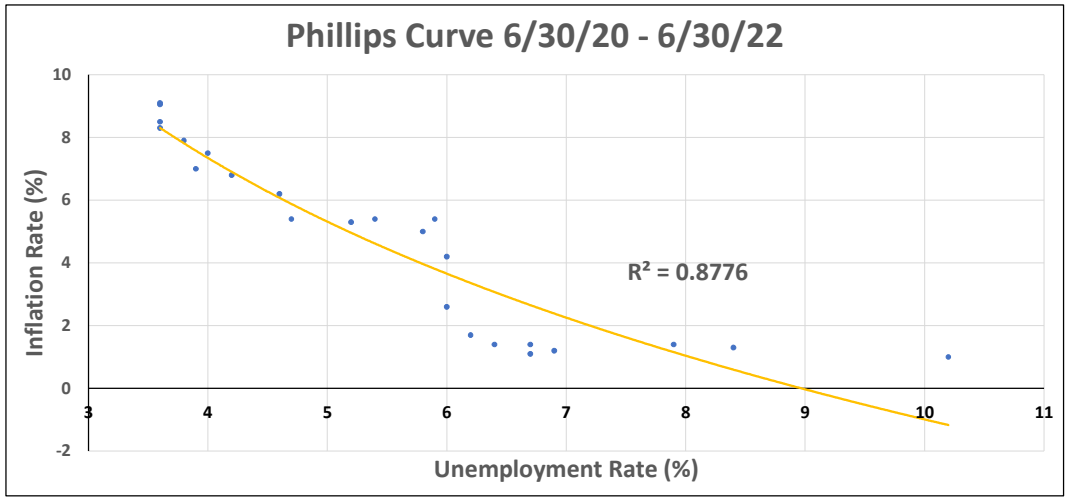
Economic Environment
Employment and Inflation – May 2022

- In the last two years, the Phillips Curve has re-emerged.
- Frustrated by higher prices, workers are bargaining for higher wages.
- The Fed has proved incapable of keeping inflation low, reducing trust in Powell's initiatives.
- Unemployment will continue to decrease as firms raise wages and hire employees to match robust consumer demand, a result of the Fed's easing policies during the pandemic.
- Real wages have fallen as inflation has risen, and as prices continue to rise due to supply chain shocks and high demand, expect further upward pressure on wages.





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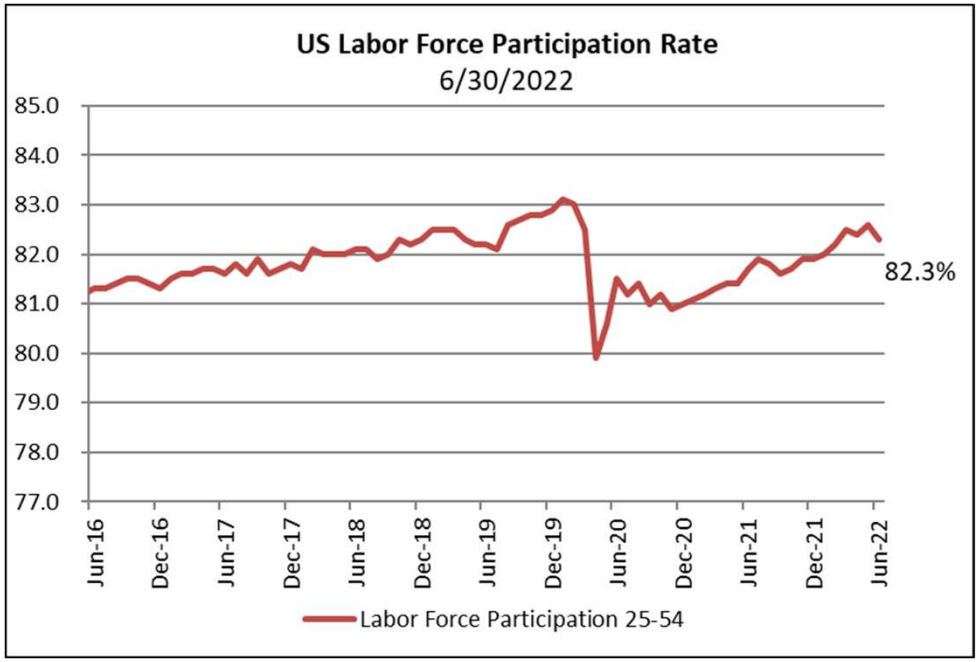
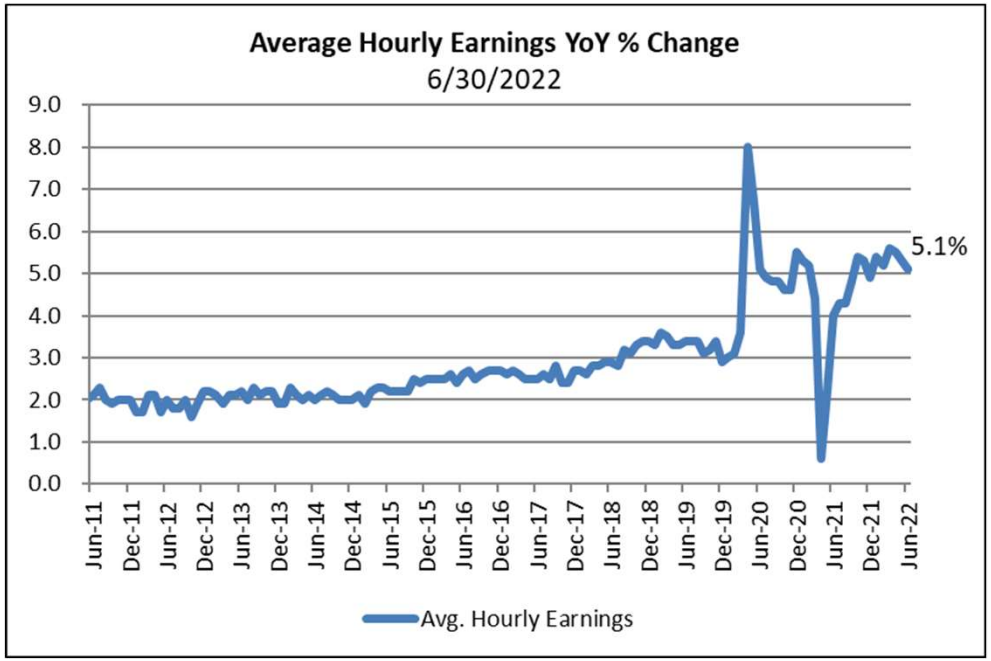
Economic Environment

Employment and Inflation – June 2022

- The prime working age participation rate has been increasing but has further to go.
- There are several pandemic related frictions in the labor market including remote work and required vaccination mandates that are impacting worker choices.
- Average hourly earnings have risen amid the need to provide incentive to bring people into the workforce; real hourly earnings are negative given a 2021 inflation rate of over 9%.





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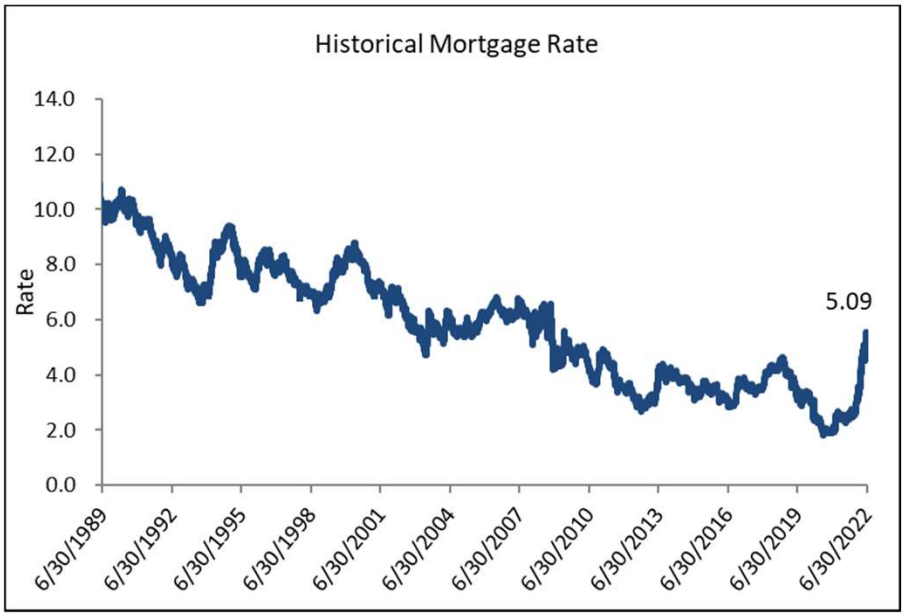
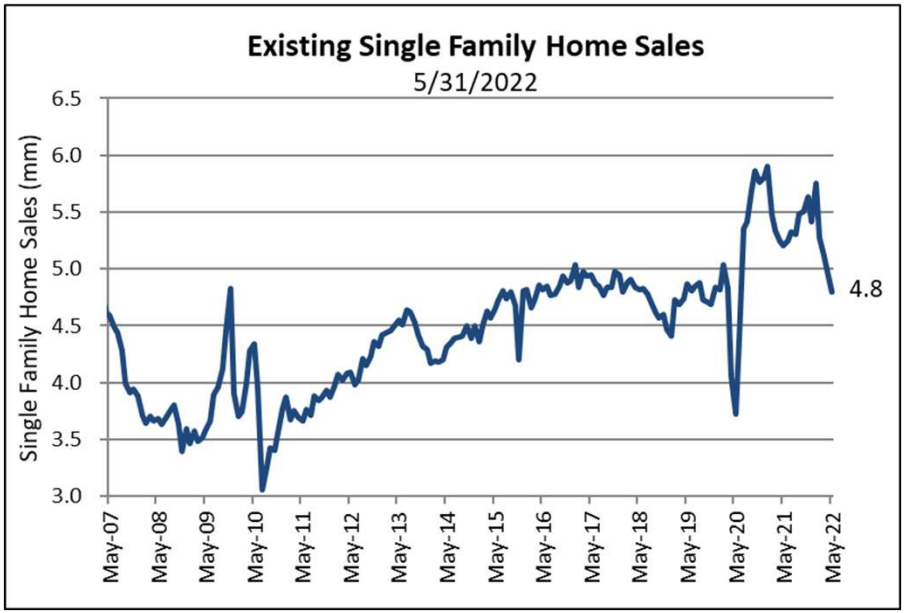
Economic Environment

Mortgage Rates and Housing – June 2022

- Mortgage rates have been rising but are still at historically low levels.
- The rise in mortgage rates along with record high home prices has reduced home affordability. While demand remains high, overall home sales have been significantly reduced.
- Continued demand and still low inventories have continued to push housing prices higher.
- Single family home sales have fallen but remain robust despite the surge in home prices. Home sales are being held back to the degree there are not enough homes for sale.





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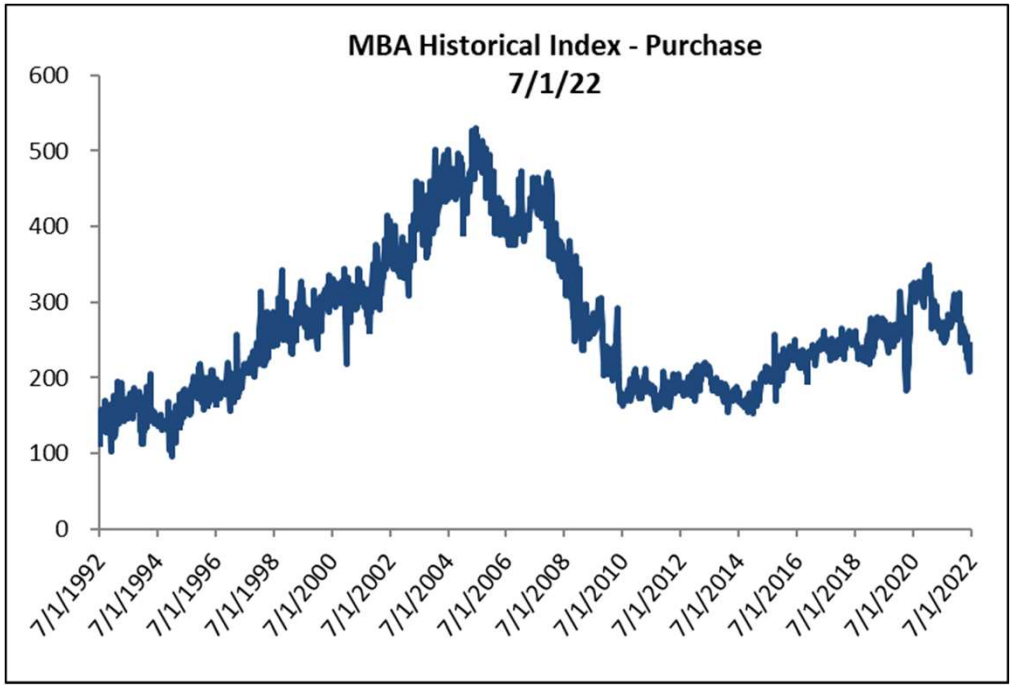
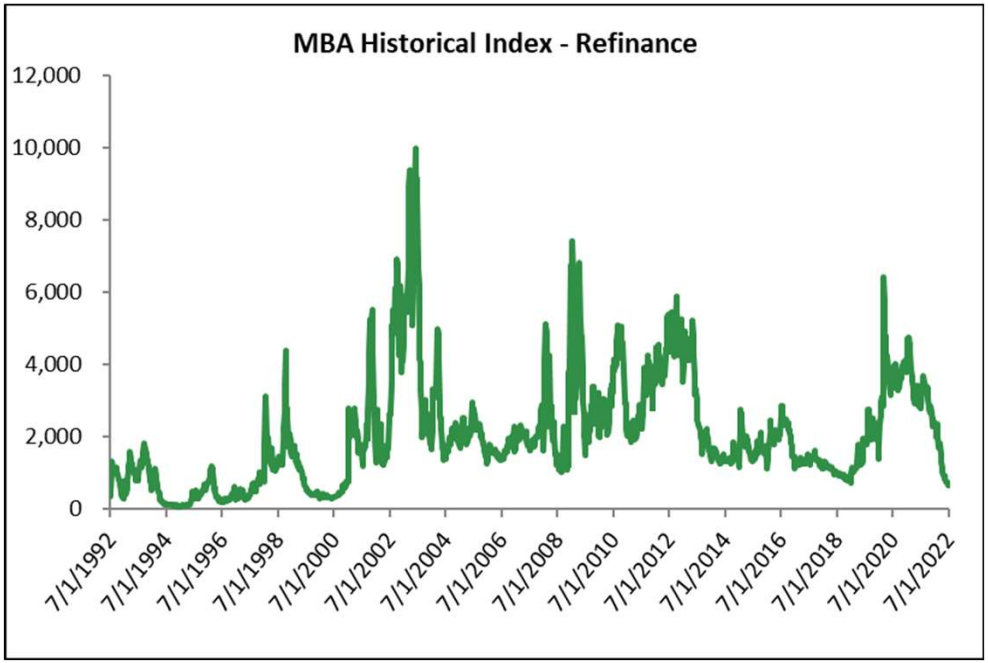
Economic Environment

Mortgage Rates and Housing – June 2022

- Mortgage Purchases have decelerated recently as a lack of inventory, rapid home price appreciation has reduced demand.
- Mortgage Refinances have slowed over the past year as rising interest rates make it less economic to refinance mortgages.





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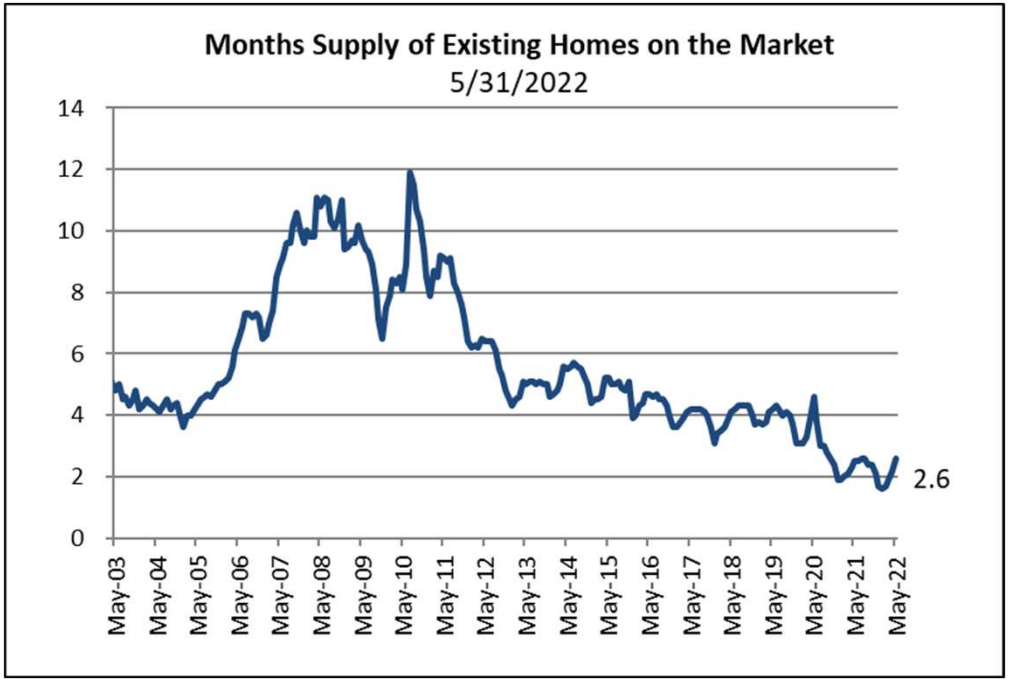
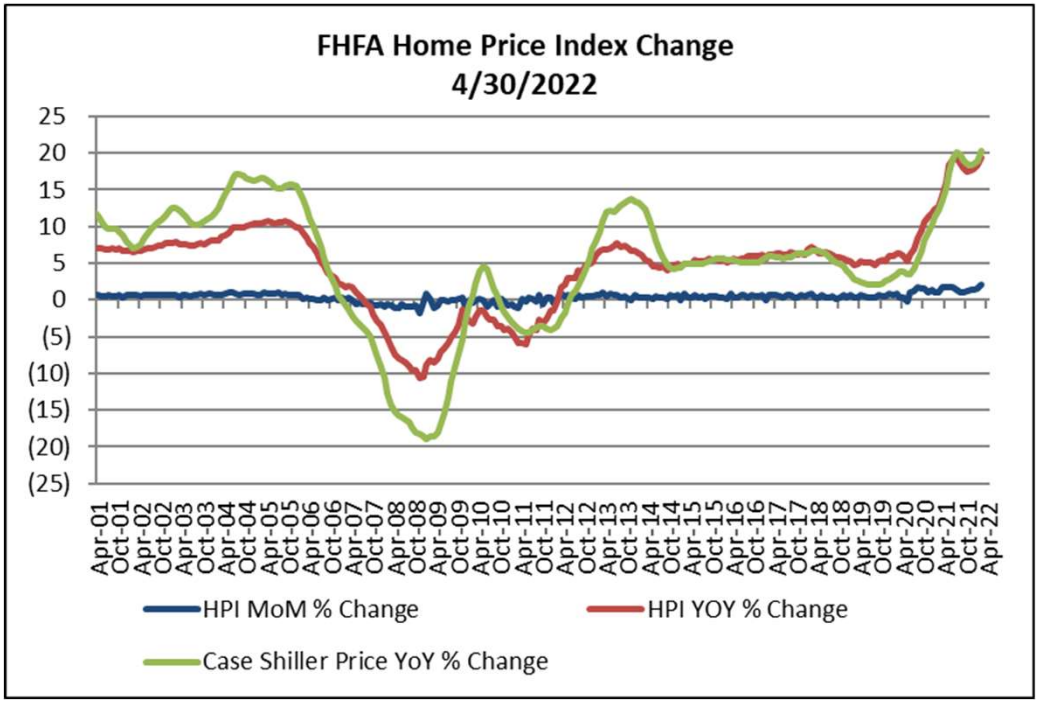
Economic Environment

Mortgage Rates and Housing – June 2022

- With the shortage of materials and labor, it has been difficult for existing home supply to increase; some supply chains are normalizing and sales slowing, causing an uptick in housing inventory.
- The high demand for housing has also pushed home prices up over 20% vs. year ago levels. The pace of home purchases and price gains has been broad based.





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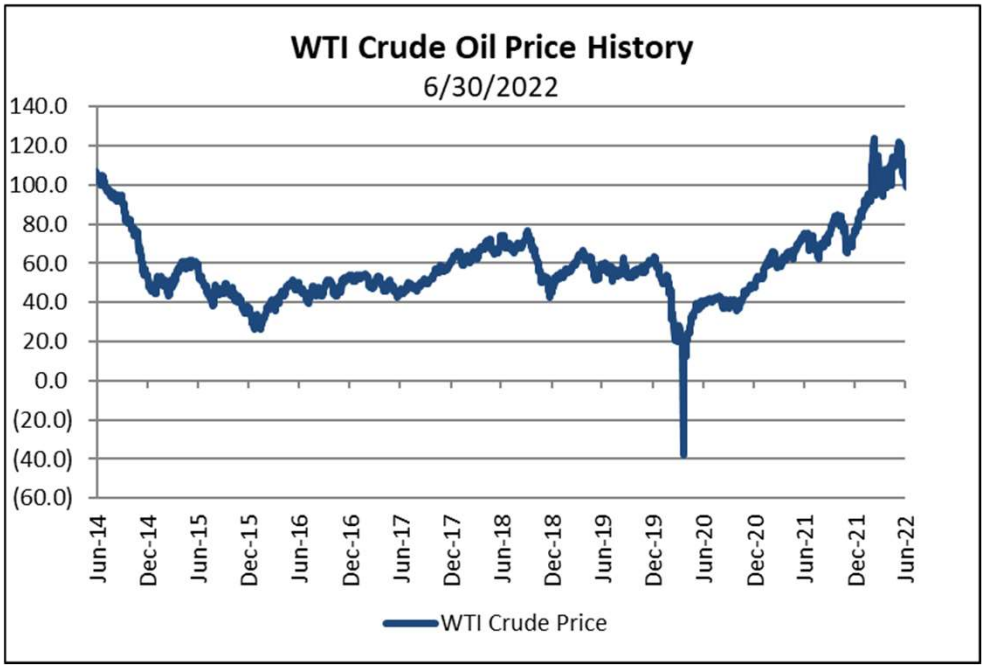
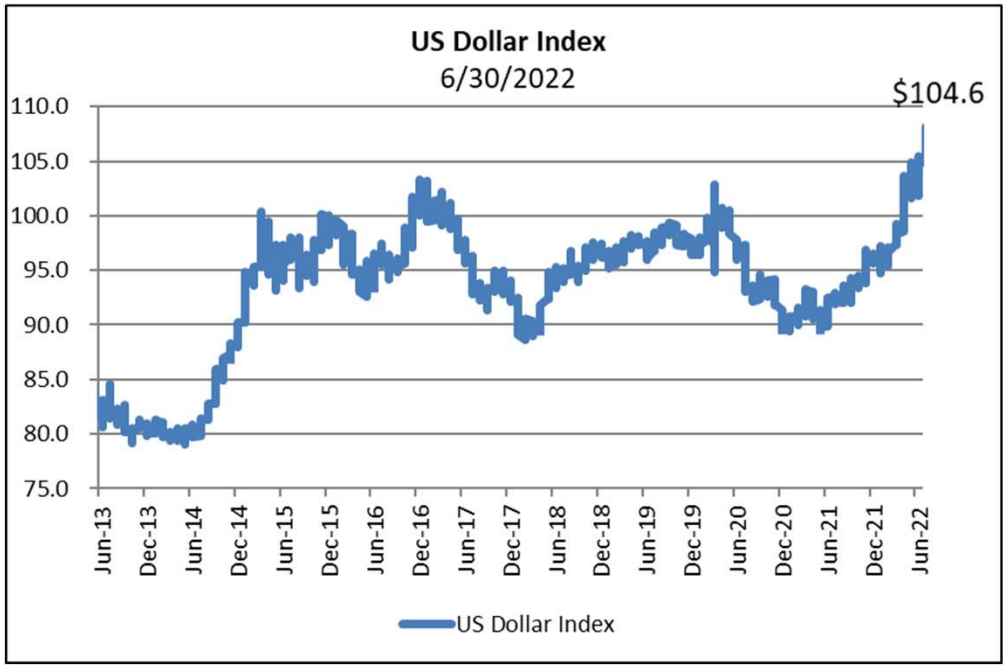
Economic Environment

June 2022

- The shift in policy to limit exploration, production, and distribution of oil and gas has led to a supply/demand imbalance and increasing energy prices, with oil above $100.
- The increase in energy prices has been exacerbated by the Russian invasion of Ukraine.
- The drive toward "green" energy is actually being hampered by supply chain disruptions and the accelerating costs for all energy, impairing investment and development.
- The Dollar continued to strengthen due to the relative strength of the US economy and higher interest rate differentials relative to global rates, as other central banks have been hesitant to raise rates.





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