MCD CAPITAL

Macro Overview Report

May 2022

- **Growth-Inflation Trade-off**: Central Banks face uncertainty given the risk of a recession with interest rate hiking but the underlying pressure of rampant inflation if interest rates are not increased. The Federal Reserve has clearly stated its intent to dampen growth, prioritizing taming inflation.

- **Optimistic GDP Forecasts:** Q1 2022 GDP growth came in lower than expected (-1.4%) due to elevated import growth and lower inventory restocking. However, GDP growth is expected to rebound in Q2 2022 (~2.1%), but then slow as we enter Q3/4. This is due to inflation continuing to erode consumer purchasing power and higher interest rates making borrowing more expensive. Nevertheless, government spending should help offset these headwinds as federal infrastructure investment begins to roll out toward the end of the year.

- **Sturdy Spending**: In April 2022, personal expenditure in the US grew 0.9%, continuing March's upward mobility, indicating that consumption remains strong despite rising prices. However, there have been drastic discrepancies in spending habits: with the largest increases coming within groceries, cleaning supplies and supplements; while the largest decreases have come within electricals, garden outdoors and clothing.

- **Descending Market Outlook:** Stocks and Bonds are both down YTD as a result of an inability to overcome doubt looming within the market. COVID-19 continues to plague supply capabilities at a global level, particularly within China's manufacturing areas where lockdowns have been imposed, while the war in Ukraine continues to wreak havoc within the energy sector.

- **Poor Bond Returns:** Major central banks, including the Fed, have defied expectations regarding efforts to normalize rates. Rates are beginning to touch pre-Covid levels as economic stimulus is no longer required. It is likely that investors will begin to challenge perceived safety premiums on bonds and seek additional compensation for the risk of holding in such an inflationary setting.

- **Stumbling Equity Returns**: Investor confidence in the success of intervention by the Fed is falling and interest rate hikes are breeding concerns of a recession. This is leading to a dumping of equities, which have had negative returns amid the worsening macro picture.

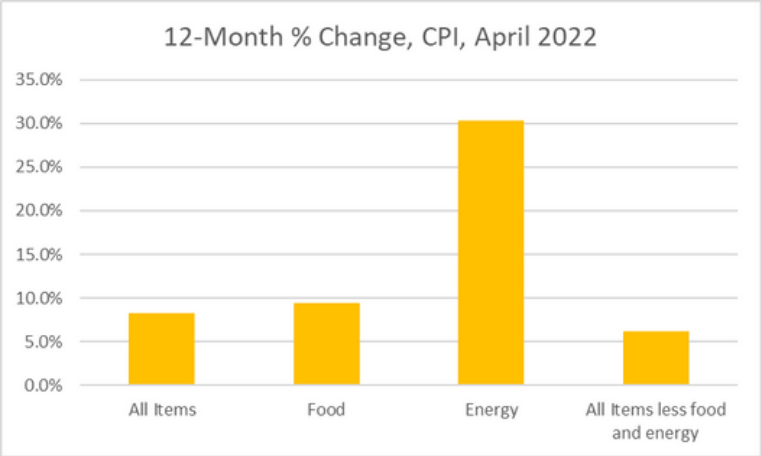
- **Central-made Volatility**: It appears that significant uncertainty exists within the Fed, which in May 2022 emphasized that they would continue to hike interest rates until inflation had been taken under control. However, analysts believe that the Fed may be coerced into another pivot this year to avoid a recession. Such a pivot is indicative of previous reversals by the Fed, which attempted to convince investors that inflationary pressure was a 'transitory' symptom last year before having to backtrack given the persistence of this inflation. Analysts believe these sharp pivots are a driver of market volatility.

AUTHORS :

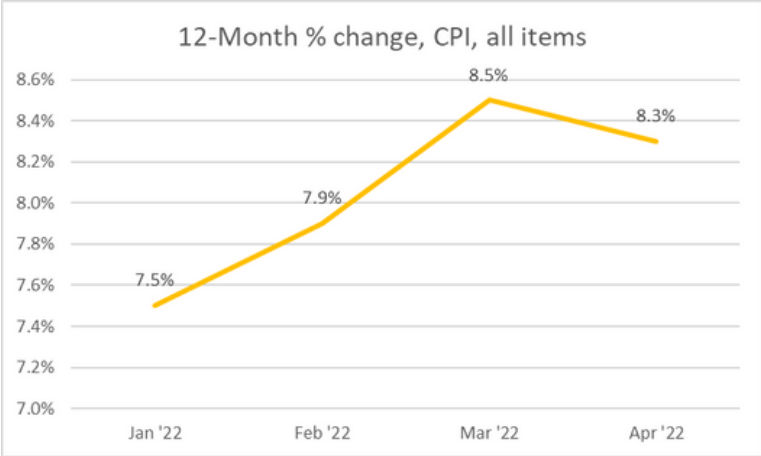
Jasmyn Leong - Head of HR & Communications, MCD
Aaradhya Gupta - Senior Analyst, MCD News Team
Laurynas Ivanauskas - Senior Analyst, MCD News Team
Habibullah Abdulrazak - Senior Analyst, MCD News Team

Stagflation: A Cause for Concern

Following the double shock of COVID-19 and the Russian Invasion of Ukraine, inflation rates have continued to exceed expectations, straddling 40-year highs and dominating US headlines. In April alone, the consumer price index accelerated 0.3%, bringing the 12-month total to 8.3% (not seasonally adjusted). Core CPI (which excludes volatile food and energy prices) however has only risen 6.2% in the last 12 months. This is indicative of the rapidly rising energy prices that bear the majority of the responsibility for rising inflation.



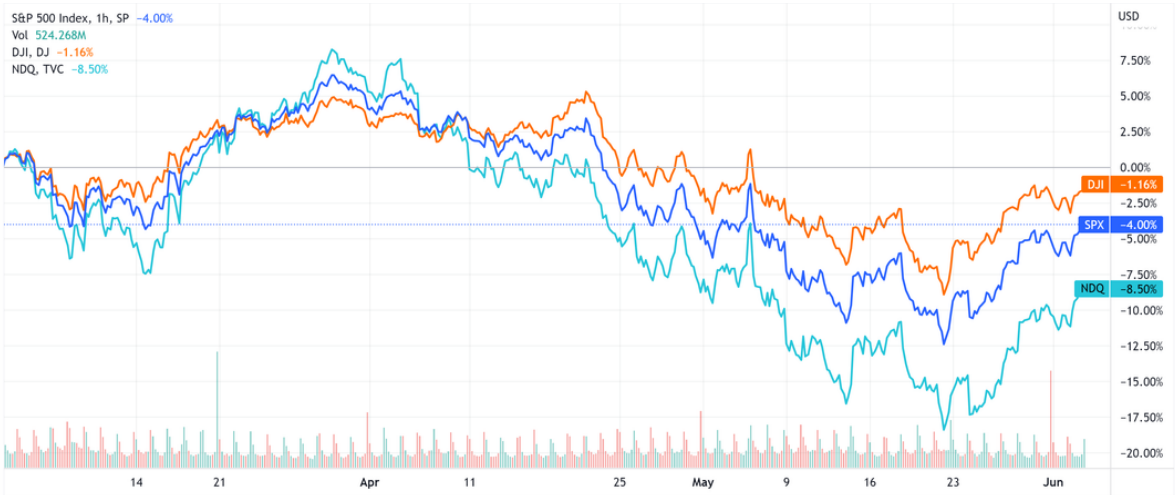
Source: US Borough of Labour Statistics



Source: US Borough of Labour Statistics

Consequently, purchasing power of consumers has taken a steep downturn, with a 0.1% drop in real wages in the month of April, furthering the 2.6% decrease over the last 12 months. In response, the Federal Reserve has announced the biggest interest rate hike since 2000 (0.5 percentage points), a response that inverses the previous COVID-based policy that pulled rates to near zero in March 2020. The tandem acceleration of interest rates and prices is draining confidence from the US economy, which hit a three-month low in May. Previously, Jerome Powell, Chair of the Federal Reserve, dismissed concerns that the Fed's rate hiking cycle would send the economy into a recession. However, many analysts are predicting a retractment of this assertion given the intensifying presence of recession talks following continued supply chain and energy sector issues that are fuelling inflationary pressure.

The Impact on Stocks



Source: Tradingview.com

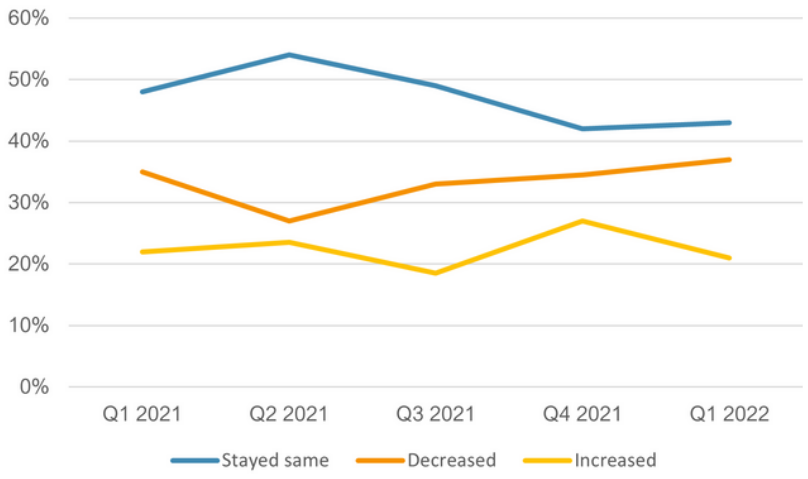
Markets continue to look for signs that CPI readings will mark the peak in pandemic-era inflation, pushing indices towards bear markets, with the S&P 500 exceeding the benchmark 20% plunge from its high. Investors are dumping equities given fears Federal Reserve rate hikes to fight inflation will tip the economy into a recession. This has meant exceptional volatility, an aspect that is expected to be characteristic of the investor narrative for the balance of Q2, and even the balance of 2022. The Dow Jones Industrial Average has certainly shown this, experiencing its biggest one-day drop since 2020 in May. Analysts believe that these sharp declines reflect the beginning of the impacts of inflationary pressure on earnings, the resilience of which has finally been broken. The prospect of downward revisions to earnings estimates is the latest headwind to face stock investors, already shaken by rampant inflation and the impacts of central-bank tightening aimed at controlling it.

"STAYING IN, SPENDING OUT"

The new and famous Covid-19 era has surely established new habits in the minds of the people. While January and February perceived a decline in expenditure and sales, March showed pretty strong numbers. According to McKinsey surveys, *"US citizens had $2.8 trillion more in savings for 2022 than they had in 2019, and many didn't hesitate to dip into those savings as pandemic restrictions eased across the country."*

In April 2022, personal expenditure in the United States grew **0.9** percent month over month and the index stood at **108.6**, but it dipped slightly in May. The index now stands at **106.4**, the decline was smaller than the analysts expected, indicating that consumption continues strong despite rising prices, yet the consumer's confidence has declined. Motor vehicles and parts, food services and lodgings, as well as housing and utilities, all saw increased spending, although spending on gasoline and other energy commodities fell. **Looking into the future, if consumer spending stays robust, it will prevent the overall economy from slipping into recession.**

For the middle and low income group, things have become more difficult to afford. The given graph shows how a large part of the U.S. consumers have experienced a reduction in their expenses (quarterly) as the FED continued to hike the inflation rate, focusing on buying more of essentials and less on discretionary purchases.



Quarterly changes in consumer spending since January 2021
Source : Jungle Scout Consumer Trends

Housing prices rose **20%** in March as compared to the previous year, which is making housing highly unaffordable. And since the U.S. is importing most of its consumption, this leads to a supply chain issues, not to mention the high oil prices, which in turn affects the **Groceries and Transportation**. And each of the above factors, which are the most important ones in the daily lives of an American Citizen has experienced a significant price increases over the past year.

Two-thirds of the economy is represented by Consumer Spending and we have now online consumers as well as offline consumers. In a nutshell, although the officials anticipated a low spending environment, most people are not hesitating to open up their wallets and follow their basic expenditure trends.

Lynn Franco, senior director of economic indicators at The Conference Board said "***We still have headwinds from the war in Ukraine, rising prices, interest rate hikes, but consumers have been weathering it pretty well -- even though we did have a slight decline, it's relatively a strong reading,". "And a lot of that comes from the fact that confidence has been supported by strong job growth, so that's helping to offset some of these challenges that consumers have been facing over the last couple of months.***"

Compared to the last quarter, Consumers are buying more :

- **29%** *Groceries*
- **23%** *Cleaning & Supplies*
- **21%** *Vitamins & Dietary Supplements*

Compared to the last quarter, Consumers are buying less :

- **27%** *Electricals*
- **26%** *Garden & Outdoor*
- **25%** *Clothing*

Source: Jungle Scout Consumer trends

Date	Time (GMT)	Flag	Event	Previous	Forecast
02/06/2022	13:15		ADP Employment Change MAY	202K	300K
03/06/2022	13:30		Unemployment Rate MAY	3.6%	3.5%
03/06/2022	13:30		Non Farm Payrolls MAY	428K	325K
03/06/2022	15:00		ISM Non-Manufacturing PMI MAY	57.1	0.55
07/06/2022	13:30		Balance of Trade APR	$-109.8B	$-90.3B
08/06/2022	10:00		GDP Growth Rate YoY 3rd Est Q1	4.70%	5.10%
09/06/2022	12:45		ECB Interest Rate Decision	0%	0%
10/06/2022	13:30		Inflation Rate, Core Inflation Rate YoY MAY	8.3%,6.2%	8.3%,6.2%
10/06/2022	15:00		Michigan Consumer Sentiment JUN	58.4	59
13/06/2022	07:00		GDP MoM APR	-0.1%	0.1%
14/06/2022	07:00		Unemployment Rate APR	3.7%	3.8%
14/06/2022	13:30		PPI MoM MAY	0.5%	0.5%
15/06/2022	13:30		Retail Sales MoM MAY	0.9%	0.9%
15/06/2022	19:00		Fed Interest Rate Decision	1%	1.5%
15/06/2022	19:00		FOMC Economic Projections		
15/06/2022	19:30		Fed Press Conference		
16/06/2022	12:00		BoE Interest Rate Decision	1%	1.25%
16/06/2022	13:30		Building Permits MAY	1.823M	1.812M
17/06/2022	10:00		Inflation Rate YoY MAY	8.1%	7.5%
17/06/2022	07:00		Retail Sales MoM MAY	1.4%	
21/06/2022	15:00		Existing Home Sales MAY	5.61M	5.65M
22/06/2022	07:00		Inflation Rate YoY MAY	9.1%	9%
22/06/2022	15:00		Consumer Confidence Flash JUN	-21.1	-21.9
23/06/2022	09:30		S&P Global/ CIPS Manufacturing PMI	54.6	
24/06/2022	12:00		Gfk Consumer Confidence JUN		
24/06/2022	15:00		New Home Sales MAY	0.591M	
27/06/2022	13:30		Durable Goods Orders MoM MAY	0.4%	
30/06/2022	10:00		Unemployment Rate MAY	6.8%	
30/06/2022	13:30		Personal Income and Personal Spending MoM MAY	0.40%	0.90%
07/01/2022	13:45		S&P Global Manufacturing PMI Final JUN	57	
07/01/2022	14:00		ISM Manufacturing PMI JUN	56.1	
07/01/2022	14:00		Construction Spending MoM MAY	0.20%	
07/06/2022	15:00		ISM Non-Manufacturing PMI JUN	55.9	55.2
07/06/2022	15:00		ISM Non-Manufacturing Employment JUN	50.2	50.6
07/06/2022	19:00		FOMC Minutes		
07/08/2022	13:30		Unemployment Rate JUN	3.60%	3.60%
07/08/2022	13:30		Non Farm Payrolls JUN	390K	310K
07/08/2022	13:30		Participation Rate JUN	62.30%	62.30%
07/08/2022	13:30		Average Hourly Earnings MoM JUN	0.30%	0.40%
07/08/2022	13:30		Average Hourly Earnings YoY JUN	5.20%	5.20%
07/08/2022	18:00		Baker Hughes Oil Rig Count 08/JUL		
07/08/2022	15:00		Wholesale Inventories MoM MAY		
07/12/2022	16:30		52-Week Bill Auction		
07/12/2022	18:00		10-Year Note Auction		
07/12/2022	21:30		API Crude Oil Stock Change 08/JUL		
13/07/2022	12:00		MBA 30-Year Mortgage Rate 08/JUL		
13/07/2022	13:30		Core Inflation Rate YoY JUN		
13/07/2022	13:30		Inflation Rate YoY JUN		

Jasmyn Leong

Higher prices are acting as a crippling and immediate tax on consumers, which is estimated to deliver a ~$200 billion hit to U.S. consumption by the end of the year. However, as we continue to transition away from COVID-19, we are yet to see the fullest extent of recovery spending, a promising long-term factor given the presence of $2 trillion in U.S household savings. Furthermore, while rising prices and interest rates continue to suppress businesses, the labour market remains strong with record job openings and unemployment back at pre-pandemic levels. Thus, whilst many may be fearful of an imminent recession, we should not be too pessimistic as if the Fed manages 'thread the needle' and pull us out of this inflationary spiral, we may be able to avert the economic storm.

Aaradhya Gupta

With markets being in a state of turmoil and inflation persistently rising, the economy's future is looking particularly bleak. An estimated $5 T wealth shock has hit America in the last 2 years, which has been exacerbated by the incoming strict monetary policy plans set out by the Fed. This shock is evident in the -1.5% GDP Growth Rate recorded in Q1, which was supposedly due to supply chain issues, COVID-19, inflation and the Russia-Ukraine crisis. With this in mind, I believe a recession is likely to be imminent with stocks continuing to fall over the coming months. Investors should be wary when investing in sectors such as the technology sector which are prone to high volatility in times of uncertainty.

Laurynas Ivanauskas

The current volatility in the markets and the clashes between good and bad news from the corporate world and the economy make it difficult to predict the outlook for financial markets. Yet, ravaging inflation and upcoming further interest rate hikes heavily influence tightening financial conditions and it is our prediction that US equities will provide modest returns for the upcoming fiscal year.

Habibullah Abdulrazak

The Fed's decision to maintain aggressive interest rate hikes in an effort to tame inflation and maintain balance has clouded the economy with uncertainty. Uncertainty is likely to grow in the economy after the Fed announced plans to initiate quantitative tightening starting in June, shrinking it's $8.5 trillion balance sheet. These plans will undoubtedly reduce market liquidity, increasing treasury yields further from their decade high. It is safe to say that with the steep interest hikes and quantitative tightening, we are expecting dampened economic growth. Consequently, whilst stocks may continue to fall, investors may take this period of uncertainty as a purchasing opportunity for a number of undervalued stocks.