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THE PINNACLE FINANCIAL GROUP'S

ECONOMIC INSIGHTS

The Pinnacle Financial Group

SECOND HALF OUTLOOK: IT'S A SACK RACE

The US financial markets have been witnessing a race between slowing Growth and Inflation.

The Fed hopes at worst that the race is a tie.

We'll explore the scenarios.

Is the US in a recession? That's the question that seems to be on the minds of many investors. The US Gross Domestic Product (GDP), which measures economic growth, declined for two consecutive quarters — a commonly cited definition of a recession. However, with consistently strong job growth, historically low unemployment and solid growth in consumer spending, that doesn't sound like a normal recession. So, what's the simple answer?

It depends on who you ask...and of course nothing is simple when it comes to the economy. With food, energy and the cost of shelter all rising faster than wages, the average American consumer is feeling the pinch.

While the crystal ball is not always clear, I want to take an opportunity to lay out some of the things we see, and how it will affect the way we invest your portfolios.

We also want to take the opportunity to say **thank you**. We are honored and privileged to have your trust and confidence.

The Economic Scorecard

Growth	👍 👎	The economy contracted at a 0.90% annual rate in 2Q22 after a contraction of 1.6% annual rate in 1Q22. Weakness was primarily led by volatile trade and inventory data. The good news was strong consumer and business spending. Looking forward, we do see a softening in demand which could pose headwinds to growth in the 2nd half of the year.
Jobs	👍	The labor market has remained very tight with unemployment dropping in July to 3.5%. In July, the economy gained 528k jobs — more than double expectations. This number contradicts the thought that we are in a recession. Job openings exceed the number of unemployed persons by about 5.45 million. Continued worker shortages are likely the result of aging baby boomers and immigration declines. As a result, wage growth has been much higher across most sectors of the economy. Looking forward, the stronger employment number increases the likelihood that the Fed will continue to be aggressive in raising interest rates in an effort to slow down the economy.
Profits	👍	Profits remain surprisingly high despite higher wages and higher commodity and inputs costs. A softening demand will likely begin to weigh on profits.
Inflation	👎	The Fed's inflation target is 2%...but we are well past that. The latest figures put inflation (CPI) at 8.5% YoY. Much higher inflation is being driven by higher energy and food costs, ongoing semiconductor and materials shortages and a broadening of inflationary pressures across the economy. Inflation should decline in the months ahead, but will likely remain sticky enough to keep the Fed raising rates.
Rates	👎	A very tight labor market and persistently hot inflation have pushed the Fed to tighten aggressively in an attempt to tame inflation. In our opinion, the Fed started late in raising rates and is behind the curve. Can they now time things correctly, or will they be too aggressive and push the economy into a recession?
Risks	👎	1. An overly aggressive Fed could push the economy into a recession. 2. Markets will likely remain depressed and volatile until investors receive clarity on the pathway for inflation and the Fed. 3. Drawn out geopolitical tensions with China, Russia and Iran could result in energy shortages, semiconductor shortages and dampened growth.
Investment Opportunities	👍	1. Keeping diversified and high quality at the base of the Pinnacle Investment Triangle is wise. 2. For long-term investors, remaining focused on the world that is developing in the next 5-10 years should pay off handsomely.

Remember the Sack Race?

When I was a youngster in school we used to have what was called “Field Day.” For most students, this was one of the best days of the year. We all got out of class (always a winner) and the day was spent competing in various track and field events in the field next to the school. The competition was always fierce, but I also remember how much fun it was socializing with all of my classmates. No event seemed to capture the excitement of the day like the Sack Race. This race always seemed to be the great equalizer. The best athlete didn’t always win, and the laughter of those both in the race and those watching always reverberated across the field. The goal, of course, was to get to the finish line first. But those doggone sacks weren’t easy to work with, and invariably most participants would bite the dust along the way.

The US financial markets have been witnessing the equivalent of a sack race between two teams — Growth and Inflation. Both are going to bite the dust before the finish line, but who gets to the tape first is important.

Let's take a step back and set the scene in (overly) simple terms:

Stage 1	Financial Crisis of 2008 to COVID

What Was Happening?	• Coming out of the financial crisis of 2008, the Fed made historic moves to increase the liquidity in the economy. They did this using various tools but the main ones were:
	  • Cutting the Fed rate to 0%. This is the interest rate banks pay the Fed to borrow money from the Fed.
	  • Greatly increasing the Fed balance sheet from $1 trillion to close to $9 trillion by buying Treasuries and mortgage-backed securities. This infused trillions of dollars into the economy.

Helicopter View:	• Overall, there was plenty of money that could be borrowed by businesses and consumers at historically low rates. Supplies were plentiful — so growth and profits were therefore plentiful. The stock market liked this and rose accordingly led largely by technology stocks.

Stage 2	COVID

What Was Happening?	• COVID rears its ugly head and economies shut down. The Fed continues to act as they did in Stage 1, and more money is infused into the economy with Congress's $1.9 trillion COVID aid package.
	  • Consumer spending remains strong considering, and the savings rate increases since consumer spending on leisure, travel and entertainment is no longer an option. Many families and businesses also received stimulus money.
	  • Globally, manufacturing shuts down or is widely curtailed due to the pandemic. Inventories begin to decrease quickly (remember supplies usually came "just-in-time"). Supplies are not replenished because factories are shuttered.
	  • Consumer demand begins to build as people get sick of being "cooped up."

Helicopter View:	• The markets have a "V-shaped" recovery as corporate profits rise. Inventories are depleted.

Stage 3	Opening Up

What Was Happening?	• Demand soars as economies open back up. In particular, the demand for travel, leisure and entertainment skyrockets as people have been "cooped up too long."
	
	• However, not all economies open at the same rate. Some states are more willing to open up compared to others. Europe and China open up... then shut back down as COVID variants take hold.
	
	• The demand cannot easily be met due to many reasons, including:
	
	  • Supply chain issues — inventories are depleted and some manufacturing plants (namely in China) remain either closed or not at full capacity. Shipping and transportation are also an issue.
	  • The unemployment rate falls to historic lows. The US has twice as many job openings as people looking for work. Many baby boomers choose not to return to the workforce, and immigration does not fill the gap.
	  • There are issues in all sectors of the US and global economies.

Helicopter View:	• The markets drop as they are shocked by the inflation numbers and fear of lower profits. Closely watched is the Fed and Administration response. Fed tightening begins...but worries that they are behind the curve persist and are reflected in the bond market. Geopolitical issues exasperate the problem.

Stage 4	The Sack Race

What Was Happening?	• In simple terms, inflation occurs when too much money is chasing too few goods. As you have seen above, the Fed and multiple Administrations have flooded the economy with money over the years in order to facilitate economic growth. Currently, there is too much money in the economy.
	• Due to the supply issues caused mainly by COVID, we have too few goods. This has caused inflation to run at 8.5% year-over-year — a 40-year high.
	• The Fed's main goals are to promote maximum employment, keep prices stable, and ensure moderate long-term interest rates. Prices are not stable due to inflation. So, to bring inflation down, the Fed wants to increase the Fed funds rate (that they charge banks) in order to:
	  • Lower inflation. The question is how high to go with rate increases and at what pace?
	  • Decrease the pace of growth to slow the economy.
	• A longer-term view suggests that both less demand and more supply will erode inflation in the years ahead returning the US economy to pre-pandemic levels. The key question — will the Fed be satisfied with this inflation easing timetable or, by being too aggressive, will the Fed tip the economy into a recession?

Helicopter View:	• In the ideal world, the pace of growth slows at the right amount needed to bring down inflation — but not too fast and not too slow.
	• That leads to three scenarios:
	  • Timed-perfectly
	  • Inflation comes down faster than growth slows
	  • Growth slows faster than inflation comes down.

The Three Scenarios

	Perfect Timing	Inflation Falls First	Growth Falls First
Expected Market Reaction	👍	👍	👎
Why?	The Fed did it right, and as inflation drops, growth then can continue at a reasonable pace.	Inflation falling faster than growth is ideal. That leaves more growth (and profit) potential without a greater risk of inflation returning.	Slowing growth with high inflation and unemployment leads to stagflation and recession. The question then becomes "How long and how deep?"
Potential Portfolio Overweights — Short Term	• Base of the Triangle remains constant. • **Overweights focused on current geopolitical issues and Going Mainstream focus.**	• Base of the Triangle remains constant. • **Overweights focused on current geopolitical issues and Going Mainstream focus.**	• Base of the Triangle remains constant. • **Overweights focused on current geopolitical issues and defensive holdings including cash.**
Potential Portfolio Overweights — Long Term	• Base of the Triangle remains constant. • Overweights focused on Going Mainstream investments, China and India.	• Base of the Triangle remains constant. • Overweights focused on Going Mainstream investments, China and India.	• Base of the Triangle remains constant. • Overweights focused on Going Mainstream investments, China and India.

<u>The Bottom Line</u>:

Time will tell which scenario occurs. The Fed can only do so much. Geopolitical risks, COVID, and commodity prices don't respond to the Fed. Therefore, our portfolios are leaning to the "Growth Falls First" scenario in the short-term. However, it would be unwise to not also be positioned for the long-term. For long-term investors, it is ultimately more important to be well-positioned for expansions than to try and tactically trade around recessions.

Make Sure Your House is in Order

The world post-COVID may change other aspects of your life, too. I would be remiss if I did not recommend the following:

1. Review the beneficiaries of all retirement plans, IRAs, Life Insurance, Annuities, etc.

2. Revisit and update, as needed, your wills, Power-of-Attorney, Healthcare Power-of-Attorney, Living Wills, Trusts, and other Estate Planning, Elder Care and Advanced Directive items.

3. Get your financial organization in order.

4. Let's sit down to make sure you continue to be on the best path and can answer the question, "Am I on track?"

5. Review and adjust your budget, as needed.

6. Review and insure you have the correct amounts and types of Life Insurance, Disability Insurance, and Long Term Care Insurance.

7. Consider multi-generational planning. Make sure the next generation is ready.

Let us know if you would like to discuss any of these issues.

We are here to help.

Who We Serve:

Our clients seek solid financial planning advice with a continual relationship with our firm. We specifically focus our wealth planning and investment management services on an exclusive number of clients. The types of clients we work with are People in Transition, Families, and Savers hoping to "Live a Life of Significance."

We Welcome Your Referrals!

Again, we thank you for your trust and confidence. It is our commitment to provide you with the insights and advice that will not only help you today, but most importantly, put you on the right path toward your future objectives.

We wish you all the best for the remainder of the year and beyond.

Every Best Wish,

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