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COLONIAL TRUST
COMPANY

3RD QUARTER
2022

COLONIAL TRUST *Quarterly*

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2ND QUARTER OVERVIEW

THE S&P 500 ENTERED INTO CORRECTION TERRITORY IN THE FIRST QUARTER AND A LATE MARCH RALLY RESOLVED THE CORRECTION.

The second quarter saw no such quarter-end rally after the market entered a bear market in June. The high point of the quarter occurred two trading days into April and the markets then fell sharply. The S&P was down 16.4% for the quarter and 20.6% on a year-to-date basis. This has been the worst first half of a year since 1970. As was the case in the first quarter, the tech heavy Nasdaq fared worse than the S&P 500, down 22.4% for the quarter and 29.5% for the first half of 2022.

The bond market offered no shelter from the storm, with the Bloomberg US Aggregate Index down 4.7% for the quarter and 10.3% year to date. This is the worst six-month performance in the history of this bond index, dating back to 1976. The MSCI EAFE developed market index was down 15.4% for the quarter, while the MSCI Emerging Market index fell 12.4%.

THE MARKET STORY CONTINUES TO BE THE BATTLE BETWEEN INFLATION AND THE FED'S POLICY TO REDUCE THE INFLATIONARY PRESSURES IN THE ECONOMY.

The March CPI was up 8.5% and the April read fell to 8.3%. The market believed inflation peaked in March, but was caught off guard on June 10th when the May read was a new high at 8.6%. This led to the worst week in the markets since the pandemic lockdowns. Elevated inflation readings have resulted in higher bond yields and expectations for more Fed rate hikes and quantitative tightening.

The benchmark 10yr treasury yield began the quarter at 2.39% and reached a high of 3.49% intra-day on June 14th. The 2yr treasury, a gauge for the Fed Fund Rate in a year's time, began the quarter at 2.33% and reached 3.43% on June 14th. The 10yr and 2yr yields ended the quarter at 3.01% and 2.95%, respectively. Falling treasury rates are a signal markets anticipate slower growth and lower inflation in the future.

FOR THE QUARTER, ALL 11 S&P SECTORS WERE DOWN.

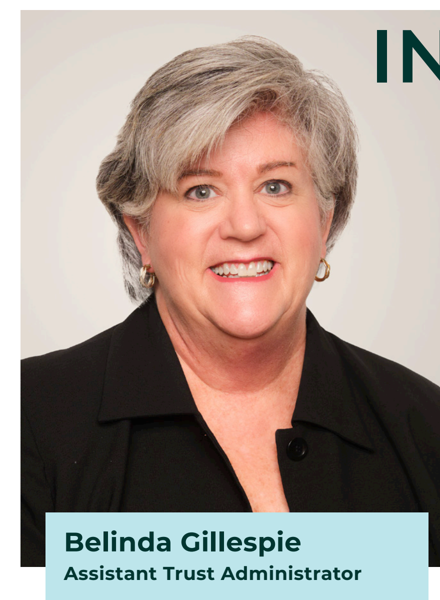
The best performing sector was consumer staples, down 4.9%, followed by utilities, off 5.8%, and healthcare down 6.4%. Companies within these sectors are less dependent on economic growth and can offer investors a place to hide during challenging times. The more cyclical sectors in the market performed far worse, with consumer discretionary, communication services, and technology down 20% or more. Higher interest rates and slower growth have an outsized impact on these sectors' earnings and share prices.

We believed the correction in the first quarter was the beginning of a re-rating of valuations due to higher interest rates. As the economy slows, the market is struggling to determine both the appropriate valuation as well as the future level of earnings. Wall Street analysts have maintained their earnings expectations for most companies for 2022. Investors are concerned that slower growth and higher costs will result in companies and analysts reducing their forecasts for earnings. This is causing markets to lower both the price to earnings ratio and the expected level of future earnings.

CONCERNS ABOUT GROWTH ARE CENTERED ON EXPECTATIONS FOR THE PATH OF INTEREST RATES.

The Fed Funds rate was increased twice during the quarter, first by 0.50% in May and again by 0.75% in June. This brought the rate to 1.75% at quarter-end. Expectations are for an additional 0.75% rate hike in July, followed by another 0.5% in September and 0.25% in both November and December. This would bring the Fed Funds Rate to 3.5% by year-end. If this proves to be the Fed's path, this would be the fastest hiking cycle since the early 1980's, increasing the Fed Funds Rate by 3.25% over 11 months. The size and pace of the Fed's action has caused market volatility and is slowing economic growth.

IN THE SPOTLIGHT



Belinda Gillespie
Assistant Trust Administrator

BELINDA GILLESPIE brings valuable insight to her role as an Assistant Trust Administrator. After graduating from the University of South Carolina, she spent 15 years in banking as a Consumer and Commercial lender and financial advisor in Florence. In 2000, she and her family moved to her husband's hometown of Spartanburg. Belinda joined our staff in January 2020 after working as the registrar at Spartanburg High School and secretary at Pine Street School. Belinda's role at Colonial Trust is to provide administrative and client service support to our Trust Administrators.

Belinda and her husband, Max, are members of the Church of the Mill, where Belinda serves as a Care Leader. Belinda is a past president of the Junior League of Florence, a former member of the Junior League of Spartanburg, and a prior President of the Pine Street School PTO. As a part of the Colonial Trust Team, she enjoys delivering meals for Mobile Meals, just as her in-laws did for many years. Belinda loves reading at the pool, lake, or beach. She enjoys spending time with Max, and her adult children, Mason, his wife, Erin, and Walker.

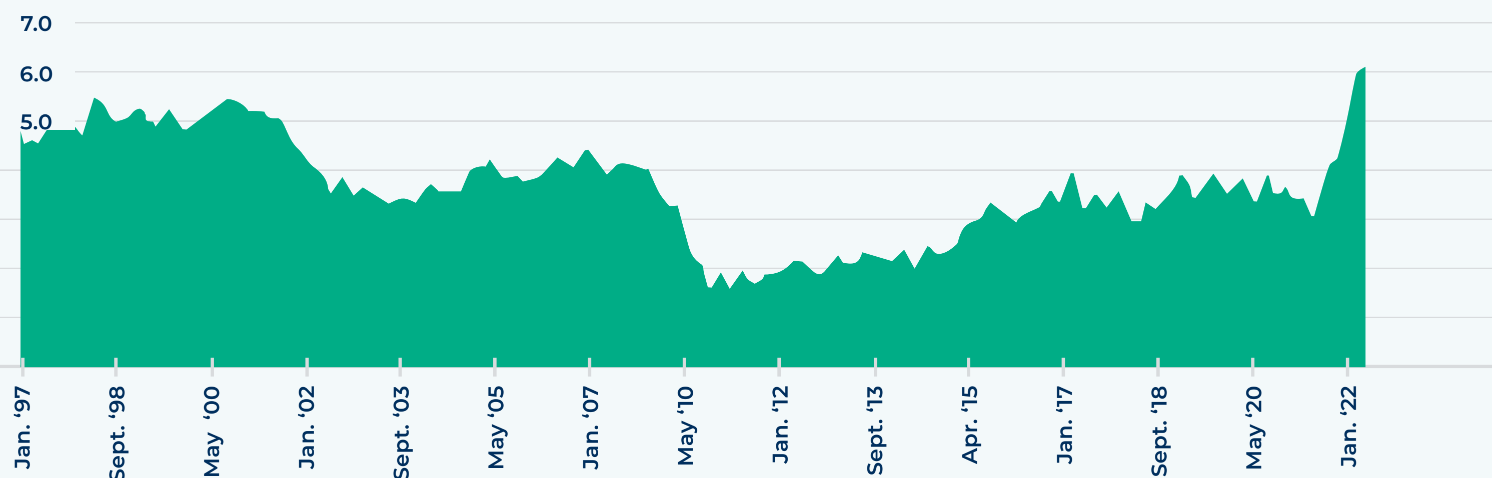
THE BACK HALF OF THE YEAR

The path of inflation is the most important data point for the second half of the year. We break the inflation picture into goods and labor. One input into goods inflation is commodity prices. The Bloomberg Commodity Index, which includes energy, metals, and agriculture commodities, rose 41.8% from year-end to June 9th and has since fallen 16.7% from that high. This index ended the quarter 18.0% higher for the year. Supply chains remain snarled, preventing lower commodity prices from quickly lowering goods prices; however, early June may have seen the peak in some commodities as higher rates reduce demand.

BLOOMBERG COMMODITY INDEX

Wage inflation has not rolled over, and real wage growth remains negative after adjusting for inflation. Average hourly earnings increased 5.2% in May and earnings for "Production & Non-Supervisory" workers rose 6.5%. With the labor force participation rate remaining below pre-pandemic levels at 62.3%, an unemployment rate of 3.6%, and 11.4 million job openings, we expect wage inflation to continue until we see an uptick in unemployment or participation, or a reduction in job openings.

ATLANTA FED WAGE GROWTH TRACKER

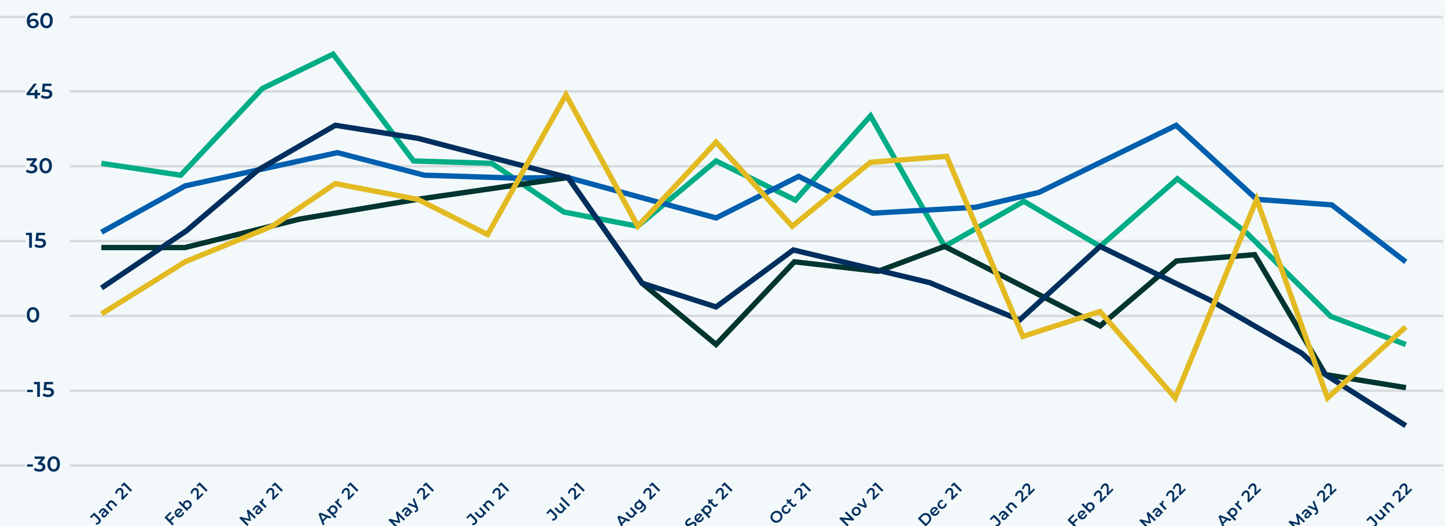


Until we see a demonstrable reduction in inflation, we expect the Fed to continue to tighten monetary policy. While they are trying to engineer a soft landing, a protracted period of higher wage inflation increases risk of recession. The Fed is focused on its price stability mandate and Chairman Powell conceded on June 29th that he is more concerned about inflation than a recession. He said, "Is there a risk we go too far? Certainly, there's a risk. The bigger mistake to make would be to fail to restore price stability."

Tightening monetary policy is beginning to achieve the Fed's goal of tightening financial conditions and reducing demand. Housing market activity has slowed, with sales of new and existing homes down 17% and 11%, respectively, since December due to higher mortgage rates. Permits for new homes were down 11% in May compared to December. Manufacturing activity, measured by the ISM PMI index, is at the lowest level of growth in two years. While this index continued to signal growth in June, the forward-looking new orders and employment sub-indices signaled a mild contraction. Five regional Federal Reserve Banks conduct surveys on manufacturing within their region and each report fell over the quarter. The internals of these surveys highlight activity and hiring slowing due to higher prices and reduction in demand. Without question, manufacturing is slowing throughout the economy and contracting in certain areas.

REGIONAL FED SURVEYS

NY Fed · Phili Fed · Dallas Fed · Richmond Fed · Kansas City Fed



THE SERVICE SIDE OF THE ECONOMY IS DEPENDENT ON CONSUMER SPENDING.

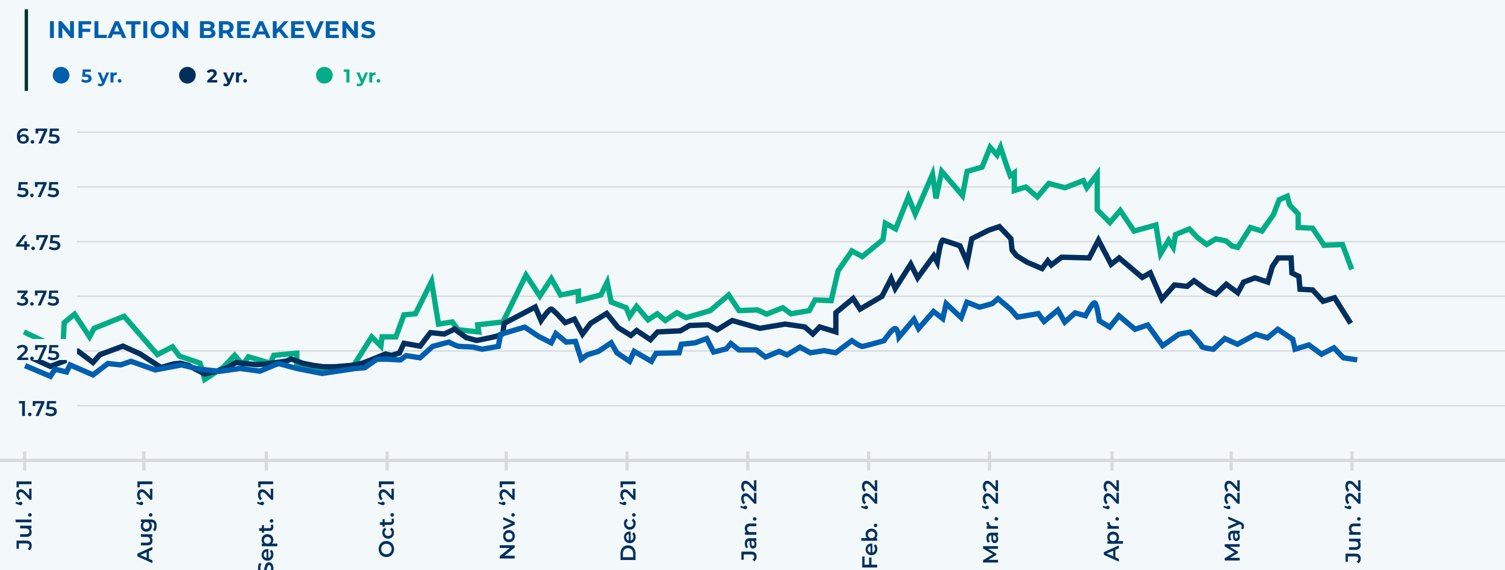
The US consumers remain employed, and income are rising, albeit slower than inflation. The pace of job gains has slowed during 2022, with three consecutive months of slower job growth through May and June, and is projected to fall further to 275k new jobs. Slower job growth has yet to result in a significant uptick in unemployment claims, indicating employers are attempting to maintain their staffing levels without growing their head count. Consumers' moods are dreary, with Consumer Sentiment at the lowest levels in the history of the index and Consumer Confidence at

post-pandemic lows. The consumer is still spending, with retail sales in May up 8.1% over last year, but the pace slowed in 2022. Spending has shifted from goods to food, fuel, and experiences as higher prices destroy demand for discretionary goods. Higher prices have also forced consumers to lower their savings rate to a decade low of 5.4% and increase the use of revolving credit, which has eclipsed pre-pandemic levels. While employment and wage growth are positives for the economy, inflation is causing a deterioration in consumer attitudes and financial situations.

The deceleration in growth follows a negative GDP print in the first quarter, largely due to rising imports and fiscal drag. This has increased concerns we are either in or heading into recession. The Atlanta Fed GDPNow Forecast reading at quarter-end was -2.1%, which, if true, would be two consecutive quarters of declining GDP – the hallmark of a recession. Given the increased possibility of recession, we wanted to outline how this recession could unfold.

Higher prices are causing the consumer and business to reduce spending. We believe inflation for many commodities peaked in June, which should begin to lower prices in the manufacturing sector. Within the retail chain, inventories are elevated. Inventories at Target, Wal-Mart, and Home Depot are up between 32% and 43% above levels from a year ago. Retailers are reducing prices on many discretionary goods to clear inventories. Chip manufactures warned the last week of the quarter that demand was slowing as sales of smartphones and PCs declined. Insufficient chip supply that plagued the economy for the last 18 months appears to be reversing, which should put downward pressure on chip prices. The housing slowdown should lower inflation for building materials and appliances. These factors will lower inflation across durable and non-durable goods.

On labor side, slower job growth will likely cause employees to reevaluate "job switching" for higher pay. Layoffs are likely to increase in sectors hardest hit by higher costs of capital, such as the mortgage sector and unprofitable tech companies. Job openings should fall as companies slow hiring. Additionally, lower asset prices are likely to bring some workers off the sidelines to increase the participation rate. These factors would work to raise the unemployment rate and reduce wage growth. In the Financial Crisis and the March 2020 recession, unemployment rose to 10% and 14%, respectively. We believe those scenarios are unlikely because companies have invested time, money, and effort in building their workforce and will attempt to maintain their workforces for the recovery and the 1.9 open jobs for every unemployed worker should prevent unemployment from reaching excessively elevated levels.



IF THIS COMES TO PASS, WE EXPECT INFLATION TO FALL IN THE BACK HALF OF 2022 AND INTO 2023.

The bond market seems to be hinting that this is the likely outcome. The 10yr treasury yield peaked at 3.49% on June 14th, days after the Bloomberg Commodity Index peaked, and has fallen to 2.88% on July 1st. The 2yr treasury followed the same path, peaking at 3.44% on June 14th and following to 2.83% on July 1st. Inflation breakevens are the market implied inflation rate at future points derived by subtracting inflation linked treasury securities from nominal treasury bonds of the same maturity. The 5yr breakeven has fallen from 3.73% to 2.63%, while the 1yr breakeven has fallen from 6.31% to 4.34%. This indicates the market expects inflation to fall from 8.6% to 4.3% over the next year and fall further over a two-year and five-year period.

The markets anticipated the economic slowdown and have repriced asset prices to reflect slower growth and elevated interest rates for the next several years. The S&P 500 sold off 23.6% from the all-time high through the June 16th. The median sell-off in postwar recessions is 24% and the average sell-off is 29%. The selloff has reduced equity market valuations considerably in 2022.

The S&P 500 began the year with a trailing price to earnings (P/E) ratio of 22.9x and the current trailing P/E ratio is 18.0x. During the first quarter, earnings grew 4.1% over last year and 77% of the companies in the index surpassed earnings forecasts from Wall Street. To date, Wall Street Analysts have not reduced their expectations for earnings growth for 2022, which are for 7.6% growth. We expect earnings estimates to fall in the back half of the year due to slower growth, but the 23% sell-off has already priced much of this into the market.

Time will tell if June 16th was the of the bottom of this bear market. We expect volatility to be with us as we see evidence the Fed's strategy to reduce inflation is effective. However, we expect the selling to be near exhaustion as market sentiment is deeply negative, a contrarian indicator. During the week June 21st, the Investor Intelligence Bull/Bear ratio was 0.6, which is a level last seen in March 2009. Companies are taking advantage of the sell-off to announce $709 billion in new share buybacks this year, a 22% increase over the same period last year.

IT IS SCARY TO READ A HEADLINE THAT THE 1ST HALF OF 2022 WAS THE WORST SINCE 1970 AND THE WORST SIX MONTHS IN THE HISTORY OF THE AGG BOND INDEX.

However, we encourage clients to continue to maintain a long-term view, even as volatility works to shorten our times horizons. Bear markets are frightening to experience; however, this is our tenth over the last forty-two years. In each case, they have been followed by a bull market. Over that period, the average bear market has lasted 236 days, while the average bull market lasts 852 days. Keeping those ideas suspended in our minds can be difficult in volatile times. However, remember those facts can keep investors positioned to reach long-term goals and prevent making rash decisions at inopportune times.

We value each of our clients and friends and we are moving through this challenging time with you. We are here to help see you through this period, as we did the recession in 1991, the tech bubble, 9/11, the financial crisis, and Covid. In each case, the market reached new highs after a period of consolidation and inventive companies brought new goods and services to markets that made our lives better and investors attractive returns. We firmly believe that will be the case again. As always, please reach out to us to discuss your situation and have further discussions about the economy and markets.

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