Wealth Management Group
2022 Second Quarter
Investment Outlook

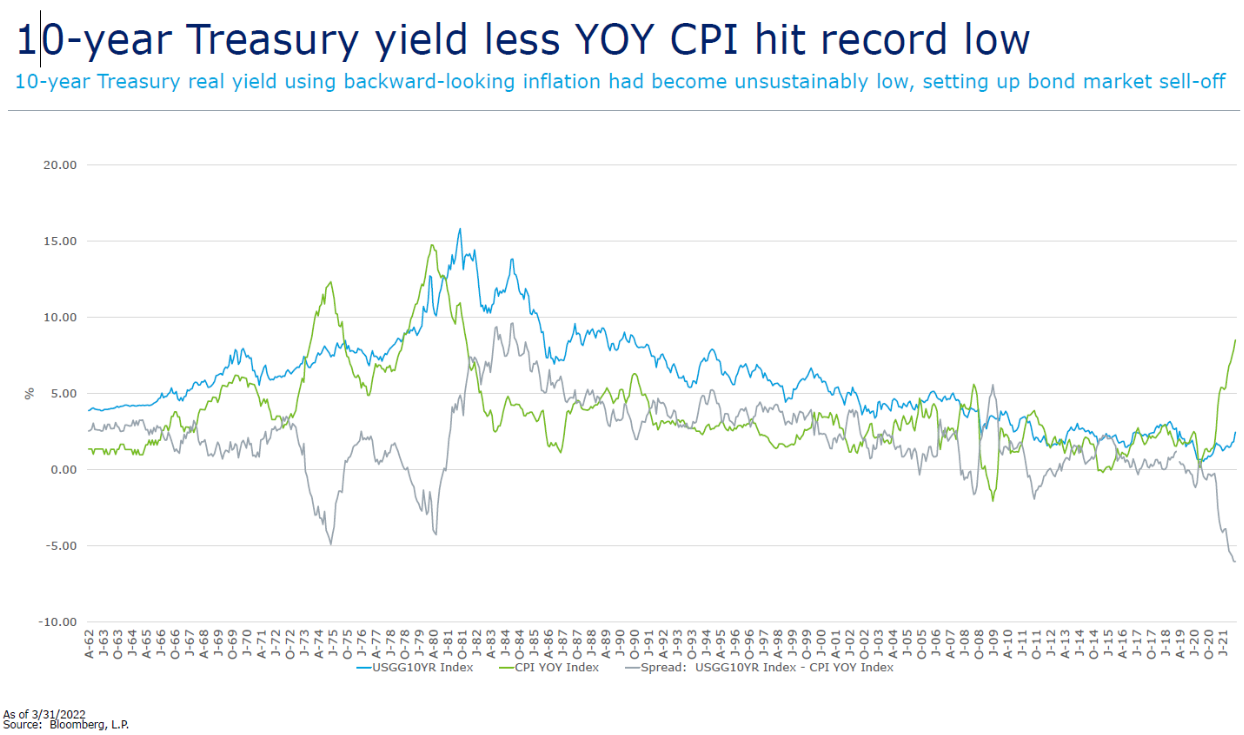
Chemung Canal Trust Company

CAPITAL BANK
A division of Chemung Canal Trust Company

Stock and bond prices fell in the first quarter as bond yields rose and consumer price inflation reached its highest level in more than four decades. Projections for future interest rate hikes by the Federal Reserve rose, prompting a number of analyst warnings that the risks of a recession are rising. Russia's brutal invasion of the Ukraine in late-February exacerbated all of these trends, further propelling energy and other commodity prices higher and injecting a "stagflationary" cloud over the long term global economic outlook.

The stock market's selloff would have to be considered rather mild, given the potential seriousness of these concerns and the likelihood that they will continue to hover over the capital markets for a longer period than once thought. The Standard & Poor's 500 Index fell just 4.9% in the first quarter, resulting in a negative 4.6% total return with dividends. The Index had fallen as much as 13% from its peak before rallying in mid-March. Meanwhile, investors who sought safe harbor in bonds were treated more rudely. The Bloomberg Aggregate Bond Index fell 5.9% in the quarter as bond yields soared.

The carnage in the bond market in the first quarter was the worst in more than forty years, and it has continued into the current quarter. That same index of investment grade bonds is now down more than 9.5% year-to-date, which is painful for investors who look to bonds for security and ballast in their portfolios. Even as the 10-Year Treasury rate has nearly doubled from 1.51% at year end to its current

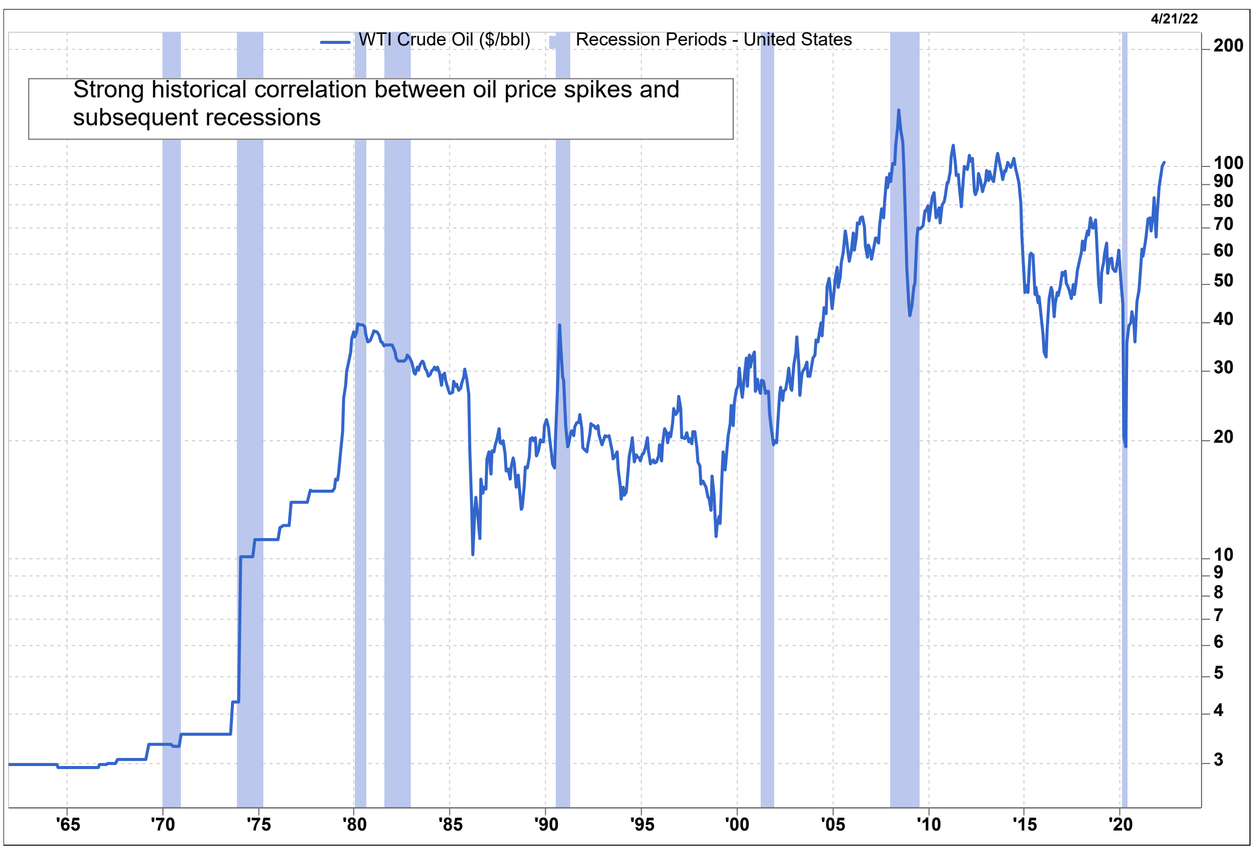


rate of 2.90%, real interest rates (relative to inflation) remain more deeply negative than they have ever been. The chart, above, measures the 10-Year Treasury yield (in blue) against the trailing one year rate of inflation (in green), over the last sixty years. The result is the "real" interest rate which has been above zero, except for the period during the OPEC oil embargo on the U.S. in the mid-1970s, the peak inflationary years of the early 1980s, and the aftermath of the global financial crisis of 2007-09. The current Treasury rate of 2.9% in the face of the March CPI reading of 8.5% results in a real interest rate of negative 5.6%, the lowest on record.

The War in Ukraine & Energy Prices

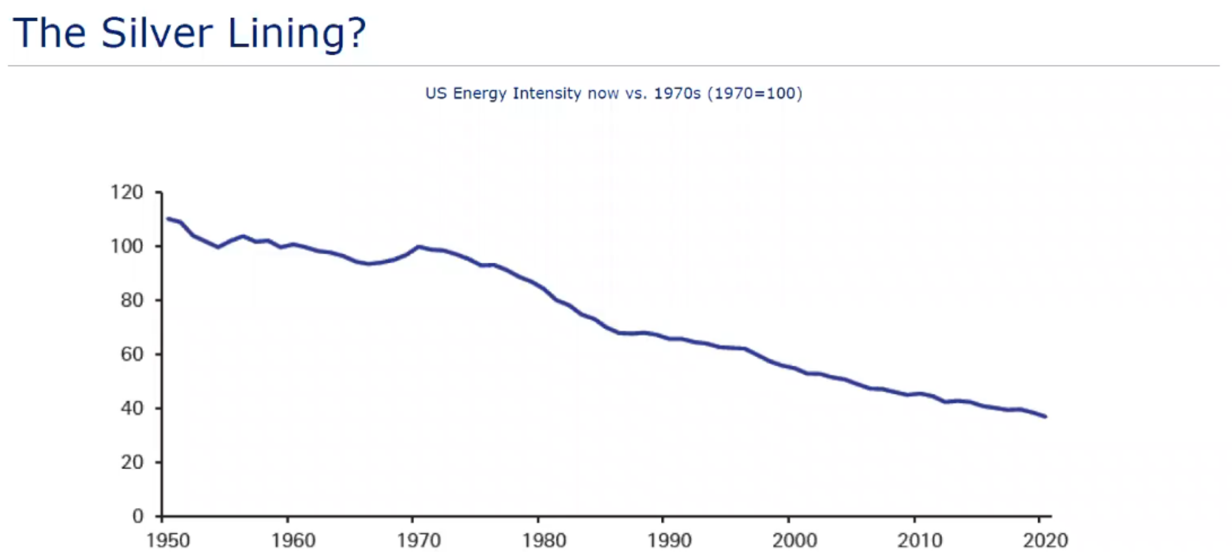
Before launching its brutal invasion of the Ukraine, Russia was one of the three largest energy producers in the world. The U.S. was importing 700,000 barrels a day from Russia, less than 4% of our total consumption, but we were also importing a greater share of other petroleum products such as unfinished oils and fuel oil. Russian oil is now banned by the United States and the U.K.

Europe has imposed punishing economic sanctions on Russia since the invasion began in February, but oil and gas exports to the E.U. have so far been spared due to a lack of support from member states that are heavily reliant on Russian energy. Germany, imports about 55% of its energy needs from Russia and the rest of Europe imports 40%. European officials have signaled that they may sanction Russia's energy exports after images emerged of mass killings of civilians near the Ukranian capital, and French President Macron has said that he would support a total ban on Russian coal and oil exports to the European Union. If the E.U. follows the U.S. and U.K. in banning Russian energy exports, then we're looking at another



upward spike in energy prices, with the potential to drive many western economies – including the U.S. - into recession. The idea that Europe would consider banning Russian oil and natural gas imports has seemed unlikely until now, but shocking images of unarmed civilians bound and shot may be driving E.U. leaders to their tipping point. Even Germany, which would be the country most affected by a total ban, has said that such a move "must now be up for discussion." The German Defense Minister said in a recent interview that, "There has to be a response, such crimes must not go unanswered."

Offsetting the risk, for the U.S. at least, that further increases in energy prices might tip the economy into recession, is the fact that our economy is less reliant on energy today than it has ever been. Energy intensity, or energy consumption as a percent of GDP, has declined steadily over the last 70 years due to increasing productivity and new technologies, including the greater use of alternative and renewable



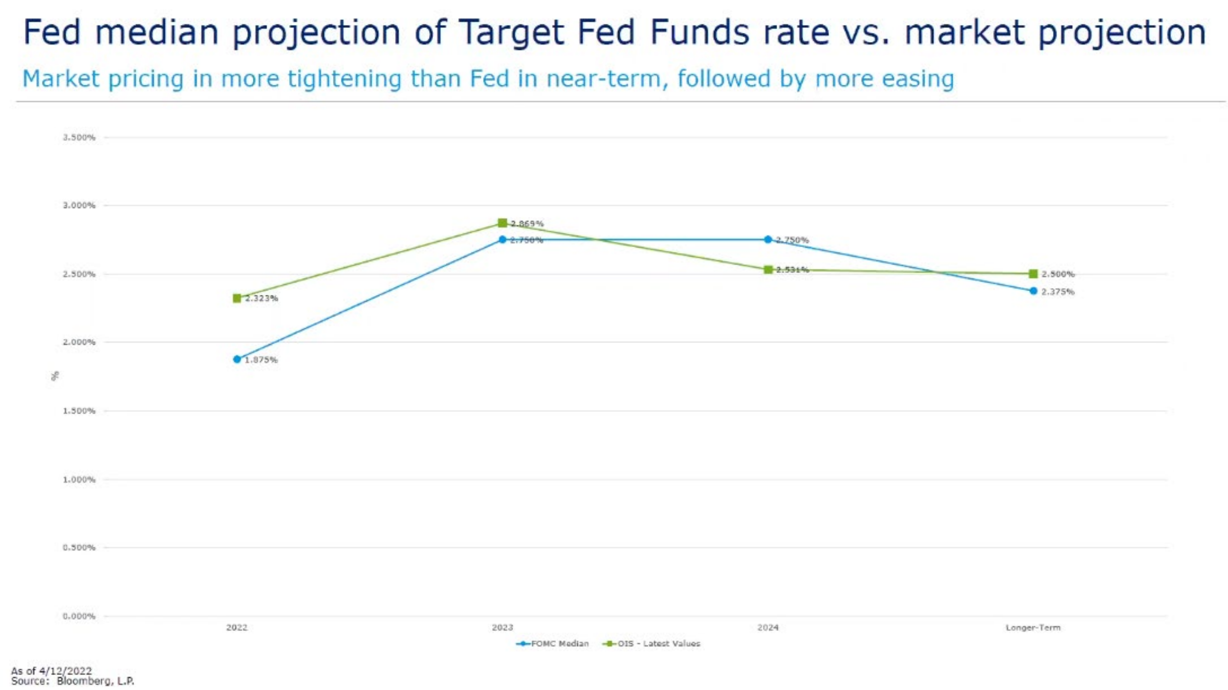
energy sources, so we should expect to be better able to withstand energy price shocks than has been the case in the past. We are also fortunate that these price spikes are occurring at a point in the economic cycle when unemployment is low and consumers are awash in savings.

Finally, it is worth remembering that the U.S. is the world's largest oil producer, and the world's second-largest energy producer overall. Domestic oil production reached an all-time high of 13 million barrels per day prior to the Covid-19 epidemic, and has since recovered to its current level of 11.9 million barrels per day. Current production levels are nearly a million barrels per day above what they were a year ago, and will likely continue to increase as prices rise. As has been said - the cure for high oil prices is high oil prices. Our assumption is that rising energy price increases, alone, will not be enough to drive the U.S. economy into recession. They are, however, part of a gathering perfect storm of war, rising inflation, and a hawkish Federal Reserve that is casting a pall over the capital markets.

<u>The Federal Reserve, Interest Rates & Inflation</u>

It's hard to imagine how differently the Fed operates today than it did in the past. Going back to the Paul Volcker years (1979-1987), which is the last time we had inflation levels this high, the Fed made very little effort to communicate directly with the markets or signal its intentions. Volcker simply testified in front of Congress once a year. It wasn't until 1994 that the Alan Greenspan led Fed began to publish a single paragraph statement after the Federal Open Market Committee (FOMC) meeting to announce whether it had changed course or not. That statement is now seven paragraphs long. The minutes of the FOMC meetings, which used to be published with a lag of many months, now come out within weeks of the meeting. Chairman Bernanke (2006-2014) began the practice of holding quarterly press conferences, the frequency of which has since doubled as they are now held following each of the FOMC's eight scheduled meetings. Additionally, between meetings, all of the FOMC members have become increasingly visible giving speeches and press conferences, and their statements are increasingly analyzed and parsed for the slightest hint of any change in the Fed's thinking. This visibility has at times been more of a curse than a blessing, but it's safe to say that seldom, if ever, has the Fed been as scrutinized or as un-nuanced in its pronouncements as it is now. And it is clear that the Fed will do whatever it must to rein in inflation.

The Fed projects that it will raise its target range for the Fed Funds rate, currently 0.25-0.50%, to 1.75-2.00% by the end of the year (blue line in the chart, below). Interestingly, the market is telling the Fed



that it will need to do more, and is pricing in a more aggressive series of rate hikes (green line, above) which, if the market's forecast holds true, would raise the target range to the 2.25-2.50% level. This is inferred from forward rates in the U.S. swap market where the swaps settle at the Fed funds rate, providing some expectation of where the market thinks the Fed will actually go. The point is that more tightening has already occurred in the market than what the Fed has indicated it will implement. And the consensus seems to be growing that *both* the Fed and the market are too conservative in their projections. A 50 basis point increase in May is almost a given at this point, and some models are now forecasting a 90% chance of a 75 basis point hike in June. A rate increase of this magnitude has not been implemented since 1994, but even the St. Louis Fed President James Bullard has opened the door for such a discussion.

In looking again at the chart of the Fed's projection of the Fed Funds rate vs. the market's projection, it is interesting to note that beyond 2023, the market projections are lower than the Fed's, which would suggest that the market is currently pricing in the possibility of a recession as a result of two years of Fed rate hikes, as well as the unwinding of its bloated $9-trillion balance sheet. That possibility is too far away and there will be too many twists and turns between here and there for this to have any bearing on our current outlook. But the possibility of a Fed-induced recession is receiving more and more attention in both the financial media and the press in general.

The first major bank to call for a recession, Deutsche Bank, which forecasts a recession in late 2023, has said that the Fed will have to "hit the brakes on the economy so hard" that it will inadvertently end the recovery that began just two years ago. The bank's chief economist said that, "We no longer see the Fed achieving a soft landing. Instead, we anticipate that a more aggressive tightening of monetary policy will push the economy into a recession."

One year ago, in his annual letter to shareholders, JP Morgan CEO Jamie Dimon issued an optimistic assessment of the global economy for 2022 and 2023, calling the confluence of newly available vaccines, high consumer savings and big increases in public spending a "goldilocks moment" for the U.S. economy. But for Dimon, that goldilocks moment has become a fairytale. In more recent interviews, he has cited the war in Ukraine, high inflation and the Fed's increasingly hawkish stance on monetary policy as combining to significantly increase the chances of a recession. In its first earnings release of 2022, JP Morgan set aside an additional $902-million in loan loss reserves "due to higher probabilities of downside risks." It's worth mentioning that the bank's earnings for the quarter fell 42% from a year ago, kicking off a series of major bank quarterly calls with similar results and cautionary comments. Goldman Sachs also announced a 42% drop in earnings and CitiGroup's earnings fell 46%. Citi also announced it was reserving an additional $1.9-billion for potential loan losses related to the bank's ties to Russia, and the "broader impact of the conflict in Ukraine on the macroeconomic environment."

Former Treasury Secretary Larry Summers, whose out-of-consensus views about the risk of inflation becoming persistent have come true, is reiterating his concerns about a potential downturn in the U.S. economy. In a recent Bloomberg interview, he said that a recession is "the most likely thing" because the Federal Reserve "is going to have to (continue to raise rates) until we see disinflation." He went on to say that "we're not going to see disinflation back toward the target range until we see unemployment rise, meaningfully." Summers also pointed out that there has never been a time in history when we have had inflation above 4% and unemployment below 5%, when we have not had a recession within two years, thus disputing the Fed's forecast that we could have continuing super-tight labor markets with 3.5% unemployment while inflation comes back to the Fed's 2% target rate.

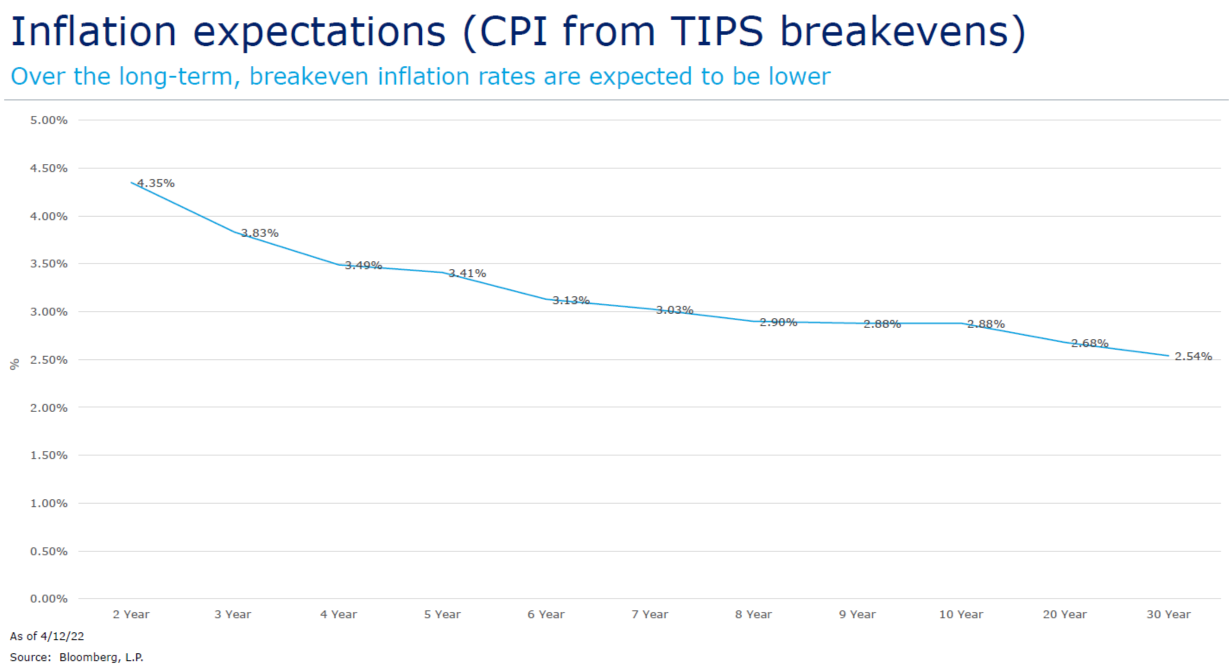
In a message to investors in early April, Bank of America opined that stocks are in for a "world of pain" as an inflation-induced recession will spark another correction in the market. The same message stated that after the inflation shock comes the rates shock, which ultimately leads to a recession shock. BofA's year-end target for the S&P 500 is 11% below its current level.

Even Chairman Powell has said that "No one expects that bringing about a soft landing will be straightforward in the current context," which is Fed-speak for "Hang on, it's going to be a bumpy ride."

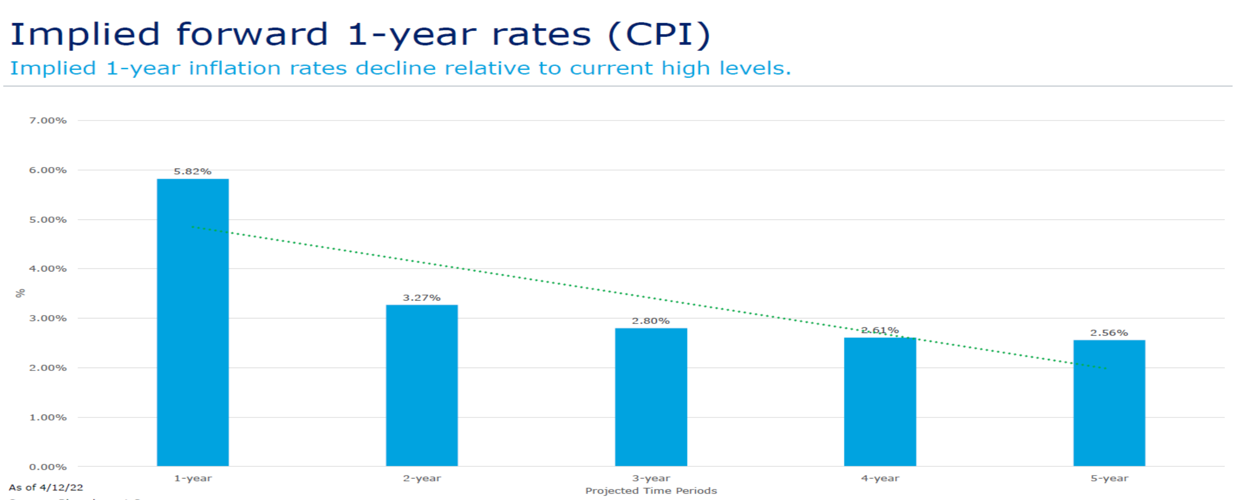
All of this boils down to a crucial two-part question: Will the Fed succeed at bringing down inflation, and at what cost?

Regarding the first part of the question, the bond market seems to believe that the Fed will, in fact, succeed in bringing down the rate of inflation, based on the spread between Treasury bonds and Treasury

Inflation Protected Securities (TIPS). Traditional Treasury bonds trade at a *nominal* yield-to-maturity, while TIPS trade at a *real* (relative to inflation) yield-to-maturity. Subtracting the real yield on TIPS from the nominal yield of a Treasury bond of comparable maturity provides an indication of the bond markets expectation of inflation over the maturity of the security. On the date this chart was prepared, for example, the 5-year Treasury yield was 2.70%, while the comparable TIPS closed at -0.71%, giving an implied inflation rate over the next five years of 3.41%. That the curve is downward sloping over time is an indication that the bond market is optimistic that the Fed will succeed in bringing inflation back closer to its target over time.

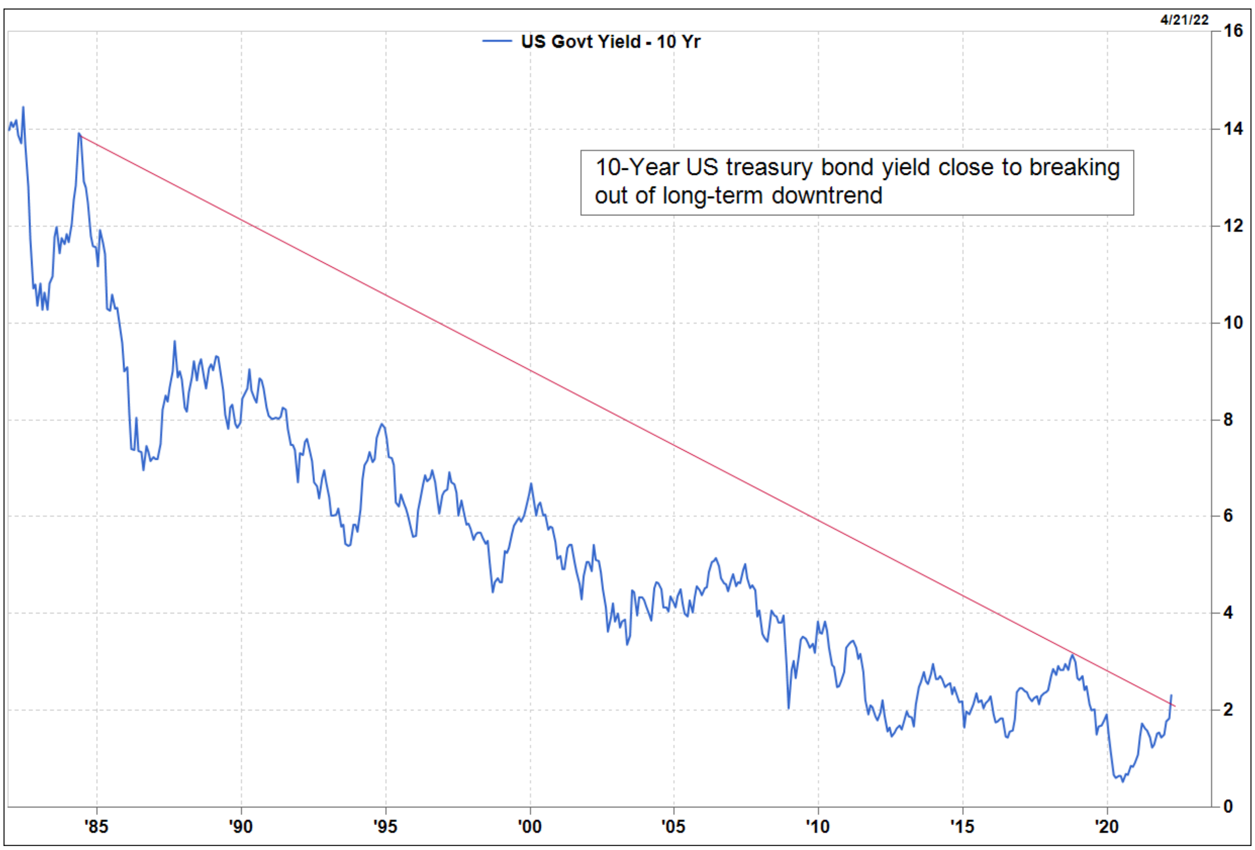


Of course, most of us don't think of average rates of inflation "over time", we think of it on a year-over-year basis. For the twelve months ended March 31, headline CPI inflation was 8.5%, the highest in more than forty years. But Federated Hermes, using a Bloomberg terminal and some tricky math has calculated



from the TIPS breakevens chart that the bond market is expecting that headline inflation will drop to 5.82% in March 2023, and 3.27% in March 2024. This may prove to be optimistic, and it may provide comfort to those who are focused only on peak inflation, but we would note that these projections of future inflation – even if they are achieved – would still be well above the average inflation rates experienced during the 2009-2020 recovery, as well as the Fed's own target of 2%.

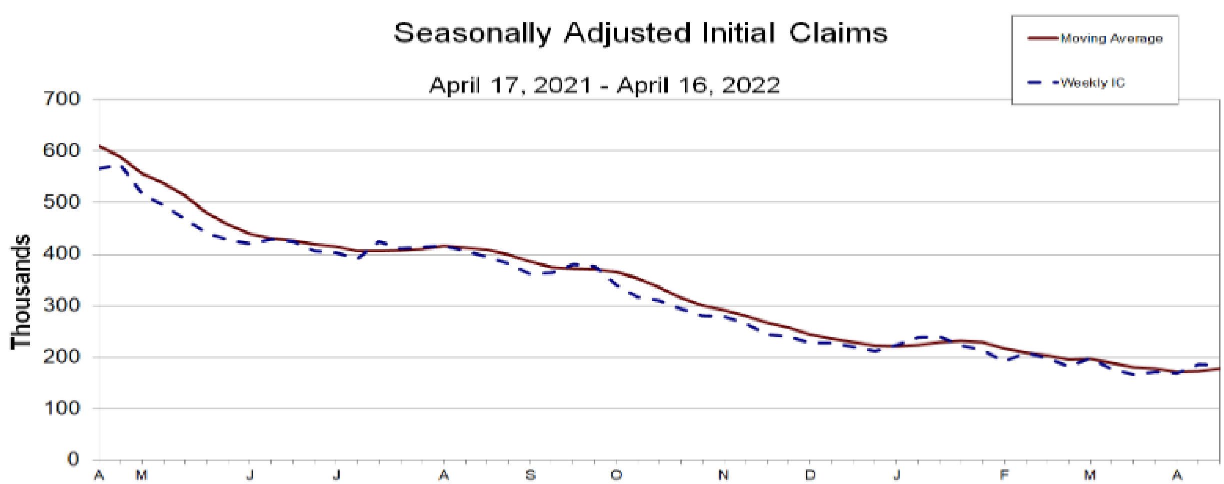
There are a number of caveats to this entire exercise. The first is that market trends are never as linear as the models would suggest, so we need to prepare for outliers along the way. Second, these assumptions aren't necessarily the consensus views of analysts or economists, they are inferences drawn from the rates that currently exist in the bond market which is forward looking. But they are fact-based, not opinion-based, so we need to pay attention to what the market is telling us. Third, they are also calculated at a point in time and, as we have often noted, what we don't know is more important than what we think we do know. Finally, and most importantly, if we don't see inflation coming down in the next few months such that it gives some affirmation to these expectations, then we're likely to have another reacceleration in bond yields and further declines in bond prices. The 10-Year Treasury is already close to breaking out of a 40-year downtrend.



As far as the second part of our question is concerned, at what cost will the Fed succeed in lowering inflation, we would answer simply that it is much less than the cost of *not* succeeding. The Fed is charged with promoting price stability and maximum employment, and it has indicated that it is committed to achieving the first of these goals even if it results in a temporary downturn in the labor market. As Ed Harris yelled to his team in *Apollo 13*, "failure is not an option." In any case, any consequences that arise from the Fed's hawkishness is more likely a 2023 problem as we think the risk of a recession in the near term is exceedingly low. The calls for a recession from Dimon, Summers, et. al. have nearly all cited the end of next year as the earliest time at which a downturn is likely to occur.

Admittedly, enough recession indicators are flashing yellow to explain the concerns of some over the near term outlook. Consumer sentiment surveys have registered declines of 25% in the last year, and more than 10% in the last month. The March Manufacturing Purchasing Manager's Index (PMI) declined 1.5% in March, the New Orders Index declined 7.9%, and the Production Index was down 4% compared to February, but all remained at levels that were indicative of continued growth in the economy. There is a striking lack of progress in resolving supply chain delays, which are instead being even more threatened as 400-million people in China are quarantined by Covid, and Shanghai, the world's largest port, is essentially closed for business.

Still, all of the manufacturing data cited above remain at levels that are indicative of continued growth in the economy, despite the March declines. The labor market remains strong with non-farm payrolls rising by 431,000 in March while the unemployment rate declined by 0.2% to 3.6%, climbing closer to the pre-pandemic low of 3.5%. The labor force participation rate has inched up in each of the last two months, signaling that more people were returning to their jobs or were looking for work, and job openings remain

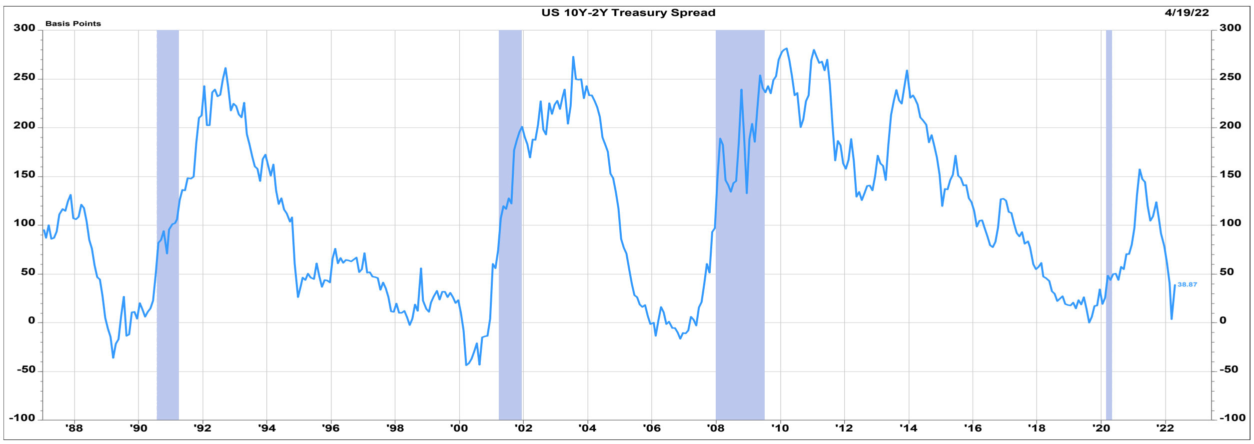


near record levels. Initial jobless claims are still at low levels and remain close to the all-time lows achieved in 1968, which is remarkable when you consider how much larger the labor force is now compared to 54 years ago. There has never been a recession without a large spike in jobless claims.

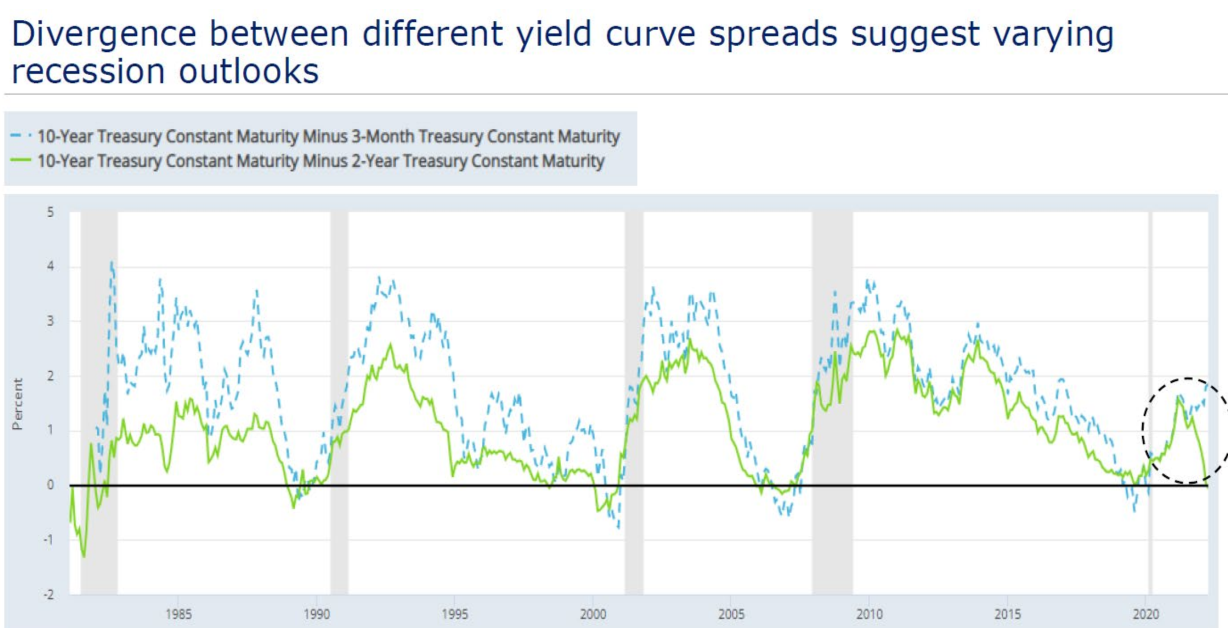
<u>The Yield Curve Inverts (In Case You Missed It)</u>

Finally, one of the most-watched recession indicators, the spread between the 10-year Treasury yield and the 2-Year Treasury yield, inverted on April 1st for the first time since 2019. Inversions occur when short term yields are higher than longer term yields, and inversions of the so-called yield curve have historically preceded the onset of recessions with a lag of 1-2 years. This is more than just coincidence, when you consider that short term rates are more indicative of the market's expectations for Fed monetary policy, while long term rates are more tied to expectations for the economy. So short term rates rising above long term rates is a sign that the market is expecting slower economic growth as the Fed raises the Fed Funds target rate.

It is usually dangerous to brush off indicators like this by asserting that somehow, this time is different. But in this instance there are some qualifiers that would cause us to disregard the most recent inversion, or at least relegate it to the category of background noise. The first is that when inversions have occurred



in the past, they have persisted for a period of weeks or months. This was not true in 2019, but the recession that followed in 2020 was not Fed induced. The inversion in early April barely touched the zero line and immediately righted itself.

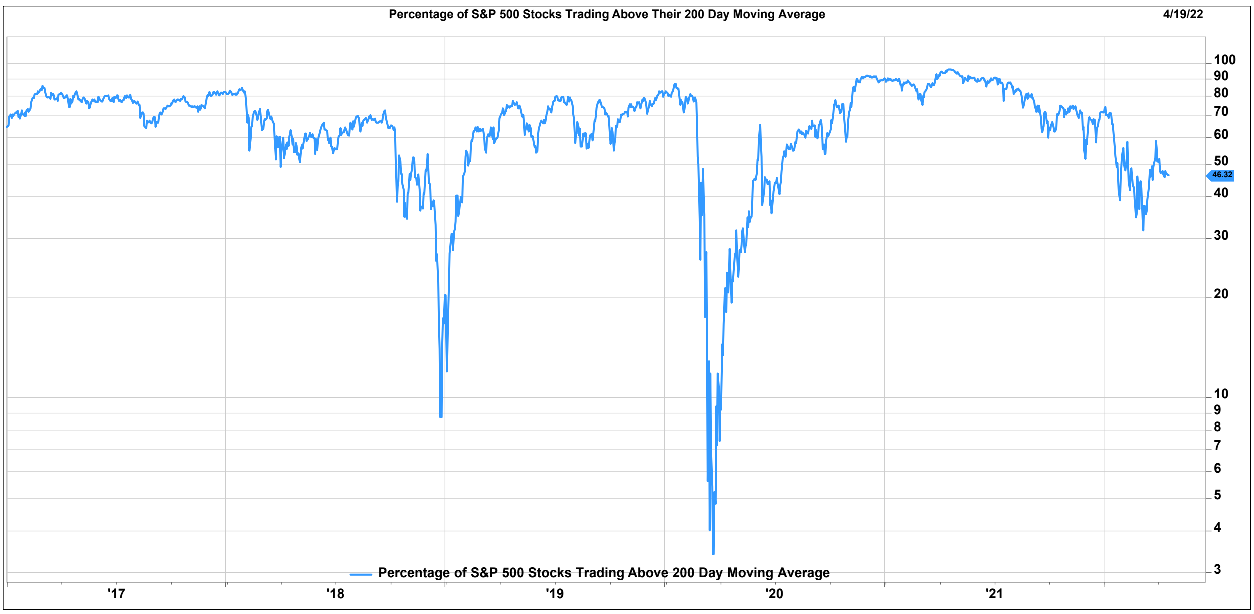


The second is that past inversions of the 10Yr-2Yr curve have occurred when the 10-Yr-3Month spread (blue line, above) was also inverted. That is clearly not the case now, but it bears watching as the Fed proceeds to tighten over the next several months.

The Stock Market

The first earnings reporting season of 2022 has just begun and early results have generally been in line with or ahead of estimates, but they are not achieving those results the way they would like. Revenues have generally exceeded expectations, aided by rising prices, but rising costs for materials, wages and transportation are beginning to put pressure on margins. Earnings estimate revisions are beginning to turn negative, but year-over-year comparisons are expected to remain positive for the rest of the year.

The S&P's muted response (so far) to rising interest rates and inflation means that the secular bull market is still technically intact, but its technical condition has deteriorated somewhat. Barely 50% of all stocks are now trading above their 200-day moving average, down from the 80-90% level that persisted throughout much of the markets recovery from the 2020 recession.



Although earnings are expected to grow, albeit at a slower pace, the market still has a valuation problem even after its year-to-date decline. The forward price/earnings ratio of the S&P 500 has dropped from 22 times to 20, but that is still more than one standard deviation above its average P/E ratio over the last 20 years, and is hard to justify given the growing list of potential headwinds the market is facing.

Meanwhile, the seven mega-cap growth stocks that comprise 26% of the Index, and about which we have written in virtually every *Outlook* over the last two years, has effectively been reduced to six with Netflix losing 64% of its market value this year due to subscriber losses. This should be instructive of the risks involved in holding high multiple stocks that don't meet expectations. And Netflix, it should be noted, was the cheapest of the group even before its price collapse. The remaining six still trade at a weighted forward P/E of 41 times earnings, a multiple that is unsustainable with interest rates rising across every part of the Treasury yield curve. Indexers need to be aware of their disproportionate ownership of these stocks, and that we are now in a stock pickers market where active management that avoids excessive valuations in uncertain times like this is the best way to lower risk while seizing opportunities as they occur.

Summary & Outlook

Eight of the last eleven Fed rate hike cycles have ended in recessions, so a hard landing is the rule rather than the exception. There are important differences in this cycle, though, starting with the fact that the Fed was (is) still easing even as the economy is at full employment and a record number of jobs remain unfilled. The last time an economic expansion drove the unemployment rate below 4%, the Fed was already two years into a rate hike cycle. The unprecedented amounts of fiscal and monetary stimulus needed to sustain the economy through a once-in-a-century pandemic is now creating a tug-of-war between the sticker shock of rising prices and a huge reserve of wealth and savings. It is thus not unreasonable to expect that the odds of a soft landing are better now than they have been in the past, but those odds will have meant little if a recession occurs. Even if it does, downturns haven't generally occurred until two years after a tightening cycle had begun, which would be consistent with the time frame we cited earlier, and equities have generally peaked just 6 months before the onset of a recession.

We don't expect to see the market rallying from these levels, and we are watching the March lows to see that they hold. If they don't, it may be time to further lower the risks in our clients' portfolios. But for now, we aren't inclined to react to the distress calls of the alarmists whose forecasts peer too far into the future to be actionable now. Bank of America, as we have noted, is now predicting that stocks will fall 11% from current levels, which are already 10% below 2021 year-end levels. But at the end of 2021, the same analyst had predicted that stocks would be "at or near" (then) current levels at the end of 2022. Of course, a lot had changed in that time, which is precisely the point.

There is the story of the Zen Master and the Boy, whose father bought him a horse for his birthday. Everyone in the village said, "Isn't that wonderful, the boy got a horse," and the Zen Master said, "We'll see."

A couple years later, the boy fell off the horse and broke his leg, and everyone in the village said, "How terrible, he won't be able to walk properly," and the Zen Master said, "We'll see."

Then a war broke out and all the young men had to go off and fight except the boy whose leg was still messed up and everyone said, "How fortunate!" But the Zen Master said, "We'll see."

The point is that the current condition is never permanent, and, more often than not, expectations are undone by events that are unforeseeable. We don't think the current market weakness is an opportunity to add risk back into our clients' portfolios. The sensible course is to remain defensive and preserve principal. But we urge our clients to ignore the growing number of calls for a looming and imminent recession.

Inflation is high and the Fed is tightening, how terrible. We'll see.

Joseph J. Tascone
Senior Vice President &
Senior Investment Officer
JTascone@chemungcanal.com

Michael D. Blatt, CFA
Vice President &
Senior Investment Officer
MBlatt@Chemungcanal.com

Peter M. Capozzola, CFA
Vice President &
Senior Investment Officer
PCapozzola@capitalbank.com

John E. Shea
Vice President &
Investment Officer
JShea@chemungcanal.com

Kevin W. Brimmer
Assistant Vice President &
Investment Officer
KBrimmer@chemungcanal.com

Shelby M. Fay, CFP®
Assistant Vice President &
Investment Officer
SFay@chemungcanal.com

Chemung Canal Trust Company

CAPITAL BANK

Chemung Canal Trust Company
chemungcanal.com

CAPITAL BANK
A division of Chemung Canal Trust Company
capitalbank.com

Main Office
One Chemung Canal Plaza | Elmira, NY 14901
Phone: (607) 737-3711 or toll free (800) 836-3711
Fax: (607) 737-3858

Binghamton Office
127 Court Street | Binghamton, NY 13901
Phone: (607) 771-6369
Fax: (607) 771-6971

State Street Office
132 State Street | Albany, NY 12207
Phone: (518) 434-1212
Fax: (518) 434-1242