INVESTMENT PERSPECTIVES

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>> THIRD QUARTER 2022

Even in a bear market, it's important to stay fully invested

By Michael A. Tyler, CFA
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The twin demons of high inflation and rising interest rates led the S&P 500 to one of its ugliest six-month stretches in decades; indeed, the January-to-June period was worse than 98% of all prior rolling six-month periods since 1992. As the Fed has raised interest rates, earnings yields and dividend yields have also correspondingly risen — taking stock prices down in the process. Almost all of this year's bear market can be attributed to falling valuations, i.e., how much investors were willing to pay for a dollar of earnings. Only in recent weeks have investors also begun to wonder whether the earnings themselves might be due for a haircut. Both the "P" and the "E" of a price/earnings ratio are now under pressure.

As if bad stock markets weren't enough, the bond markets also crumbled under the weight of rising interest rates. While diversified accounts usually benefit because stock prices and bond prices typically go in opposite directions, so far this year they have gone down together: There was nowhere to hide.

So now what? The Ramones, as always, have useful advice: *You've got to pick up the pieces, pull yourself back together — maybe you've got too much cash.* Stocks are on sale, sharply discounted from earlier prices. Maybe the merchandise is a bit damaged — earnings estimates are likely to need some trimming — but stocks and bonds both still represent better value today than they did at the beginning of this year, when we warned of overly rich valuations.

No one can know with certainty when the bear market will end, or how long it will take stock prices to regain their January highs. What we do know, however, is that sticking with a proven discipline is the only smart approach to the situation. Stay fully invested or risk missing the recovery; it won't be advertised in advance. Rebalance back to long-term targets every year; rebalance again whenever the markets skew too heavily toward one asset class over another. Be patient and wait out the storm; markets always recover. It's a simple formula, but it has always worked in the past and it will work again in the future.

>> PERSPECTIVES ON THE ECONOMY

Consumer spending remains healthy, but for how long?

By Ananya Pierce
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Eastern Bank Wealth Management

More than two-thirds of U.S. gross domestic product consists of consumer spending. Whether our economy will expand or contract largely depends on our household financial situation and propensity to open our wallets. Personal consumption expenditures (PCE), the government's preferred measure of consumer spending, have been very strong in the recovery from the Covid-19 recession; retail sales have jumped more than 15% annually for the past two years, compared with 4% for the decade prior to the pandemic.

Even though inflation has skyrocketed and real incomes have dropped, Americans have sustained their spending habits by dipping into their savings; consequently, the personal savings rate in the U.S. has now reached its lowest level since the 2008 Great Recession. Consumer credit has climbed about 10% as CARES and ARP support has ended.

As prices of everyday items such as food and fuel oil have surged this year with no signs of cooling down, we are cautious that strong consumer spending may dissipate, especially among lower-income Americans. The ripple effect if the consumers stop spending will hit businesses as they will experience a decrease in sales. That's why we look closely at purchasing managers indexes as good leading indicators; so far, they remain positive, albeit on a downward trend.

Other clouds are forming: We are seeing increasing numbers of job freezes and layoffs in the tech sector, and it's questionable whether consumers will continue dipping into their savings during a bear market. We think consumer spending will slow, resulting in weaker economic growth, and our portfolios have become more defensive.

U.S. RETAIL SALES ($MM)

After decades of steady 4% growth, retail sales have accelerated since the pandemic.

Source: Commerce Department

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>> FOCUS ON EQUITIES

Where are consumer and retail sales going?

By Jia Min, CFA
Equity Analyst,
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With the rapid rise of gas and food prices, and with overall inflation at a four-decade high, consumer confidence and spending are showing signs of cracking. The latest round of earnings from major retailers, department stores, and discount stores all point to changing consumer behavior: Those in the lower-income cohort are feeling the pinch of high prices, while a post-pandemic dynamic continues to drive certain pockets of spending.

It has been a difficult environment for retailers. Companies are navigating through profit margin pressures due to higher freight, input, and wage costs, while concurrently trying to manage prices and inventory levels. Given the six- to eight-month lead time required for order fulfillment, accurate forecasts of consumer demand are crucial, but they have proven to be especially difficult in this dynamic environment. The latest reports from major retailers showed a softening in the lower-income cohort from elevated inflationary pressures and the lapse of stimulus payments; these consumers are shifting their spending away from higher-margin discretionary items to essential products such as food, and at the same time trading down to more cost-effective private-label options.

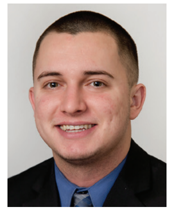
The pace of change caught many companies by surprise. Target cut its full-year earnings guidance twice in just three weeks, ultimately lowering it by 40% due to the higher cost pressures and excess inventory levels. Even Amazon was not immune, as the company overestimated demand seen during the pandemic, which led to over-building and staffing.

Certain pockets of opportunities remain, however. The trade-down and focus on value have benefited the dollar stores, which have boosted their full-year outlooks. The resumption of activities such as back-to-office work, social gatherings, and leisure and business travel benefitted companies such as Ulta Beauty, Marriott, and upscale department stores such as Nordstrom; Higher-end consumers continued to spend, and they have shifted their overall allocation away from stay-at-home apparel, home furnishings, and electronics toward dressier attires, makeup, and travel.

We will be closely monitoring higher-income household spending trends. In the foreseeable future, we expect the $1.5 trillion in excess savings, stabilizing housing prices, and pent-up demand to continue to support spending in this cohort. However, risks are certainly rising as inflationary pressures persist.

>> FOCUS ON FIXED INCOME

The Fed switches focus: Implications of a single mandate



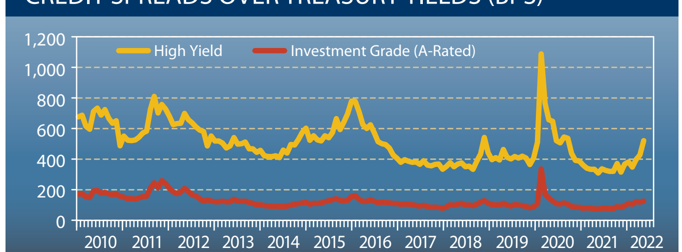
By Timothy Garvey, CFA
Vice President — Fixed Income,
Eastern Bank Wealth Management

The Federal Reserve operates under a multifaceted mandate — to promote "maximum employment, stable prices, and moderate long-term interest rates." However, it is increasingly clear that stabilizing prices has become the Fed's solitary objective for the foreseeable future. This shift is warranted. Monthly job gains continue to be robust, jobless claims remain at subdued levels, and the unemployment rate is near pre-pandemic lows. The Fed is even suggesting that the labor market is too tight, as demand for workers far exceeds the supply.

Interest rate futures suggest a total of about 15 quarter-point rate hikes by year end, more than half of which are already in place. The Fed is also reducing its holdings of Treasuries and mortgage-backed securities. Tighter monetary policy will likely lead to softer retail sales, reduced durable goods orders, and pressure on the housing market. Corporate profit margins will be squeezed. And as earnings deteriorate, companies will likely slow hiring or begin layoffs, leading to an increase in the unemployment rate. A recession seems highly probable.

The yield curve has risen dramatically on the short end and flattened on the long end, while real yields remain negative. This dynamic implies the economy is prone to a downturn. On the other hand, corporate credit spreads have widened but remain relatively tight. Investors see healthy balance sheets and believe defaults will be limited. So the bond market continues to send mixed signals to investors. The futures market is telling us the Fed will begin cutting interest rates in early 2024, implying the likely recession will be short. In anticipation of a slowdown, we have upgraded the credit quality and slightly extended the duration of our fixed income portfolios.

CREDIT SPREADS OVER TREASURY YIELDS (BPS)



Corporate spreads have widened lately but remain relatively tight.

Source: Bank of America Merrill Lynch, Federal Reserve