Q2

2022

Market Commentary

Stocks and bonds posted large declines as high inflation and faster-than-expected rate increases weighed heavily on investor sentiment.

2Q 2022 Market Commentary

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Inflation surprise and the Fed's reaction

The second quarter of 2022 was a doozy. After a rough start in Q1 (S&P 500 -5.1%), U.S. equity markets sold off another -15.9% in the second quarter, falling into a bear market (peak-to-trough sell-off of at least -20%). Technology and consumer companies were hit hardest, with the Nasdaq Composite falling -9.4% in Q1 and another -22.1% in Q2 (its worst quarter since 2008). International markets also were weak, with the MSCI EAFE Index sliding -13.2%. Following the downward trend, the bubbles in cryptocurrency, SPAC stocks, and meme stocks burst, hurting speculative investors. At the sector level, defensive industries fell the least over the quarter. Consumer Staples (-4.8%) and Utilities (-5.1%) contracted slightly while higher growth areas, like Communication Services (-21.5%) and Consumer Discretionary (-25.3%), sold off dramatically.

Fixed income provided little protection for investors. The Bloomberg U.S. Aggregate Bond Index was down -4.6% through June. Typically, bonds support portfolios during periods of weakness, but the significant increase in interest rates (which move in the opposite direction of bond prices), wreaked havoc on fixed income portfolios.

Inflation, rising interest rates, and recession fears were the primary culprits of the horrendous quarter. High inflation has forced the Federal Reserve Bank (Fed) to hike rates faster than expected. In June, the Fed hiked rates by +0.75% and then again by another +0.75% in July — the Fed's most significant increases since 1994. The aggressive rate hikes were necessary to fight inflation; however, there is risk that increasing interest rates may cause a recession. Short-term U.S. Treasury bond yields trading higher than longer-term U.S. Treasury bond yields have further bolstered these fears. This phenomenon is called a yield curve inversion and has historically signaled a recession.

A slight recovery in July

Despite recessionary concerns, markets began to recover in late June and throughout July. The S&P 500 gained +8.8% for the month, and the Nasdaq Composite rose nearly +12.0%. Bonds stabilized

as well, up +2.7% over the month. Since the June 16th market lows, the S&P 500 has climbed +12.8%, staging its most significant recovery of the year.

The gains over the last six weeks were driven by better-than-expected corporate earnings reports and commodity prices retreating. Stock valuations are now more attractive, and investors have started to make incremental investments. Despite this positive news, we expect markets to be pressured by weak economic data through the summer, making it too early to declare a market bottom. Still, the current investment environment is substantially better than last quarter, and the probability of a second, substantial dip in the back half of the year is less likely.

Fed Rate Hikes – fast and furious

Since March, the Fed has raised rates four times, taking the federal funds rate from almost zero to 2.5%, about half a percent above pre-pandemic levels. For context, in the previous tightening cycle (2015-2018), it took the Fed four years to raise rates by 2.5%. It's only taken four months for this to happen this time! And rate hikes are not over. Current forecasts call for additional increases of 1.0% through the end of the year (link), bringing the total increase in short-term interest rates over the last nine months to 3.5%.

While the rate increases have been fast and furious, they may be over sooner than expected. Last week, Fed Chair Powell noted consumer spending has slowed significantly, business investment is weaker, and a softening in the housing market has commenced. The market is starting to think the Fed is about to pause rate hikes, which is likely why equity markets have rallied over the past few weeks and might signal we have already seen market lows for the year. On the other hand, if inflation continues to increase and labor data remains strong, rate hikes may be extended.

The economy is slowing

The U.S. economy shrunk at a quarterly annualized rate of -0.9% in the second quarter, marking the second consecutive quarter of contraction, the historical signal for a recession. Slow consumer spending, higher corporate inventory levels, and a decline in residential investment drove the contraction.

Consumer sentiment remains challenged – the University of Michigan's Consumer Sentiment Index picked up slightly to 51.1 in July but remains low. Business activity remains healthy but has slowed in recent months, particularly within the manufacturing sector. For example, the

ISM Manufacturing Purchasing Manager's Index (PMI) slowed from 56.1 in May to 52.8 in July.

The labor market, which has been a bright spot, added 375K jobs per month in Q2. Jobs data and wage growth have been remarkably resilient. Despite these stronger numbers, more recent high-frequency data, including weekly unemployment claims and employer termination rates, suggest cracks may be emerging in labor markets.

Inflation is 'less bad' but remains a significant risk

Inflationary pressures continued throughout the second quarter. Inflation hit 9.1% in June, the highest level since November 1981 (link). In July, energy and agricultural commodity prices began falling but have not retreated enough to impact the overall picture.

In the place of energy and agricultural price increases, other risks may prop prices up longer than anticipated. These risks include:

1. Shelter costs: Rent prices are expected to increase significantly.
2. Supply chain issues: Strict social distancing policies in China could further enflame manufacturing challenges.
3. Wage pressure: Heightened inflation expectations may result in employees demanding higher wages from their employers, who will increase product prices to protect their margins.

Putting all the pieces together, we expect the components that drive inflation to shift and inflation to remain high throughout the back half of the year. Year-over-year comparisons will become easier in the fourth quarter, making headline numbers less severe, but inflation will take time to return to normalized levels[1].

1. Inflation is calculated as the change in prices over the last year. Relative to price increases this year, the monthly price increases in Q3 2021 were minor. The year-over-year inflation calculation could temporarily jump when the months with small increases fall out of the prior twelve-month window. Conversely, when we reach early 2023, some of the large price increases that occurred in early 2022 will fall out of the calculation, pushing inflation rates lower.

Housing is slowing

Higher home prices (+20% over the last year) and rising mortgage rates (the 30-year average rate is now around 5.5%) have reduced affordability. The U.S. Mortgage Application Index is at its lowest level since 2000 (link), and the Buyer Traffic component of the NAHB's Housing Market Survey has fallen to 37, which it last reached in 2015 (link). We are now seeing a cooling in home prices, particularly in the "zoom-towns" such as Boise, Denver, and Salt Lake City, which attracted many out-of-state buyers in the

early days of the pandemic. As mortgage rates rerate, we expect house prices will moderate further, although we do not expect house prices to collapse. Today's environment is much different than the 2008-2009 mortgage banking crisis and does not have the speculation or leverage of the earlier period.

Recession – we're most likely already in one

There are a wide range of opinions (link) regarding the current state of the U.S. economy. Many economic indicators are flashing signs of a slowdown (consumer sentiment, manufacturing, labor costs) or even an outright contraction. We're not concerned if the economy shrinks temporarily because an economic decline is already priced into market expectations. Instead, we're focused on how deep and long the economy may contract. There is a risk that the Fed moved too aggressively, and the impact of tightened financial conditions will create a more severe recession. At the moment, though, a deep recession does not seem plausible. The job market remains strong, and inflation is starting to fall. If we continue to see evidence that price pressures are easing, the Fed may abandon planned rate hikes and shift back to promoting economic growth. The market now anticipates the Fed to become more accommodative by March 2023, about six months earlier than the September 2023 date predicted several months ago.

A lot of ground to cover before the fall

We could see a full market recovery in the back half of the year, but everything would have to line up serendipitously. This is unlikely. Between now and the end of the third quarter, we anticipate economic conditions will continue to deteriorate, and we are unsure how investors will absorb the negative news. The worst is likely behind us, but it is too early to declare an end to the bear market.

In addition to economic risks, geopolitical uncertainty and mid-term elections in the U.S. have the potential to impact markets. The risk of further declines due to the war in Ukraine appears muted. However, there is growing uncertainty in Asia due to saber-rattling in North Korea and potential tensions between the U.S. and China over Taiwan's sovereignty.

In the U.S., mid-term elections may raise investor concerns slightly, but the risk appears mild. Current forecasts for the upcoming election cycle indicate the Republican party gaining control of the House of Representatives (link) and a slight

majority in the Senate (link). With the Democrats retaining control of the White House and only a narrow Republican majority in Congress, it will be challenging to pass sweeping legislation. This condition is known as a "purple" federal government and has historically provided a favorable investment environment.

Portfolio Positioning

During the second quarter, we continued to reduce risk in conservative portfolios by shortening duration and reducing credit risk in bonds. We reduced equity exposure and allocated into defensive sectors such as Healthcare and Consumer Staples at the expense of Consumer Discretionary and Information Technology companies.

In higher-risk portfolios, we realized losses where possible and adjusted core holdings to maximize return potential. This led us to focus on high-quality companies and increase exposure in areas we believe will benefit most from the oversold environment at the end of June. These areas include higher growth technology, some consumer discretionary, smaller capitalization companies, and longer duration bonds.

In the third quarter, we expect a constructive investment environment. Market valuations, while not at trough levels, have contracted and appear reasonable. Corporate earnings have come in better than expected, and the last two rate hikes by the Fed have not phased investors.

Visibility into the fourth quarter is limited. Energy and food prices may increase as well as labor and shelter costs this fall. There is potential upside after the mid-term elections (link), but it is too early to position portfolios based on what might happen in November.

Cautiously looking for green shoots

Markets are forward-looking, and while the recent rally has been welcomed, we are cautious and are waiting to confirm we have reached an inflection point. Economic indicators are slowing, and much of the real-time data we track suggests that consumers and businesses have already pumped the brakes enough to tilt the economy into recession. We may have put in a market bottom on June 16th, but we will need to absorb weaker economic data over the next few months before we believe the storm has passed.

Despite these negative overhangs, the price compression in the market is creating attractive investment opportunities. We are especially encouraged by the second quarter earnings

reports of many companies, which have generally been better than feared. We anticipate adjusting portfolios throughout the third quarter to take advantage of the improving investment environment. As always, we will be methodical and deliberate in our approach.

We appreciate your support. We look forward to connecting with you in the months ahead.

Sincerely,

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