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Quarterly Investment Review and Monthly Outlook

Q2 2022 | JULY 2022

At a Glance

- **Persistent consumer price inflation drove the Federal Reserve to accelerate the magnitude and cadence of their monetary tightening program.**
- **Aggressive rate increases with a strong signal of more to come increases the risk that the U.S. economy will fall into a recession as certain sectors have already begun to slow or stall.**

A Review of the Quarter

Equities and most other risky asset markets sold off rather steadily throughout the quarter. The broad S&P 500 index broke into bear market territory and fell over 20% from its early January highs. It was the worst first six months of the year for this index since 1970.

The NASDAQ index, which is heavily weighted toward technology companies, had an even worse showing, down roughly 30%. The Dow Jones Industrial Average showed the best relative performance among the more closely followed U.S. indices yet was still down 15% for the first six months of 2022 as its higher weighting towards the more defensive sectors of the market cushioned some of the blow.

International equities, generally more skewed to the defensive sectors of the markets, outperformed their US counterparts in local currency terms. However, the currencies fell so much against the dollar during the quarter that the negative performance for these asset classes was, dollar terms, similar to equities in the U.S.

There have been few places to hide in this difficult market environment as rates across the U.S. treasury yield curve continued to rise over the quarter in reaction to both Fed tightening and the outsized inflation seen throughout the economy. The 10-year treasury note closed the first half at 3.00%, roughly double the level at which it began the year. Along with spread widening in the corporate and municipal bond sectors to reflect concerns about a slowing economy, the magnitude of rate increases has caused broad price declines in the fixed income markets. Total returns in these markets fell 6-12% over the first half of the year.

International bonds in developed markets saw a similar increase in yields and negative total returns. Higher inflation drove prices down, a global phenomenon resulting from commodity supply constraints and the excessive monetary accommodation provided by the central banks throughout most of this young century. Weak currencies, higher overall debt loads, and the effects of Chinese Covid-19 lockdowns further impacted emerging bond markets.

Commodities represented the only asset class with positive results for the quarter and year-to-date. The bulk of the appreciation was confined to the energy sector due primarily to the sanctions placed on Russia for its invasion and continued occupation of Ukraine. However, as fear of global recession grew, energy prices flattened, and prices began to decline in the industrial metals and agricultural sectors. This could be a strong harbinger of lower inflation rates as the economy enters the second half of the year.

Gold price movement over the quarter may be another indication of waning inflation. Prices surrendered all first quarter gains in a more aggressive monetary tightening environment. The dollar continued its steady rise in the second quarter due to its safe haven status in a world of rising geopolitical risk and also the relative aggressiveness at the Fed compared to most other global central banks. In the U.S. economy, a rising dollar also tends to relieve inflationary pressures because it reduces the price of imports and commodities priced in dollars.

A MORE AGGRESSIVE FED

Generationally high inflation rates with no clear sign of peaking or receding forced the Federal Reserve to accelerate rate tightening over the quarter.

After raising rates 25 basis points for the first time in this tightening cycle at the end of the first quarter, the Fed reacted more aggressively coming out of their two second quarter FOMC meetings. The May meeting was followed by a well telegraphed 50 bps rate increase while the Fed surprised markets in June by raising the fed funds rate 75 bps largely in reaction to the still rising 8.6% year over year CPI inflation rate reported for May. These interest rate hikes brought the fed funds rate up to 1.75% by the end of the quarter.

Further 50-75 bps increases are expected after both the July and September meetings in addition to continued balance sheet reduction. The Fed allows maturities and coupon/principal payments to roll off their bloated balance sheet in yet another form of monetary tightening.

By the end of the second quarter, market expectations of the terminal level — at which the Fed stops raising rates — moved to the 3.50%-4.00% range. This is notably above the 2.75% expected at the beginning of the quarter and the 2.50%-3.00% considered neutral by many market participants.

Looking to counter the worst rate of inflation in 40 years, Fed Chair Jerome Powell and his fellow Fed members are being forced to put a singular focus on controlling inflation. While still aiming for a "soft landing" of the economy, their task will be more difficult in light of such expected terminal rates.

Outlook for July and the Second Half of 2022

As it enters the second half of the year, the U.S. economy already appears to be teetering on the brink of recession.

After the requisite revisions, 1Q GDP was down 1.6% with most of that due to a burgeoning trade deficit. However, real consumer spending was notably revised down in a trend that continued into the second quarter. While the first estimate of second quarter GDP will not be published until the end of July, the Atlanta Fed produces a continuously updated GDP Now forecast which immediately incorporates the most recent data points. This indicator was calling for a 1.0% decline in 2Q GDP at the end of June.

A distinct trend that was seen throughout the May consumer and business spending reports was positive nominal sales and order growth that was below the rate of inflation. Real growth in areas such as retail sales, durable goods orders, and industrial production turned negative in May and is expected to remain so in June.

Housing is a sector that has begun to turn down in nominal terms due to a decline in affordability. This is due to rising mortgage rates combined with sharply higher prices. Both are finally beginning to impact the feverish demand seen over much of the past two years. Builders continue to mitigate high material prices as well as shortages of labor and land. These combined effects is likely to reduce the rate of price appreciation in the sector and we may also see some regional instances of price deflation.

However, housing is nowhere near as over supplied as it was prior to the 2007 bubble burst, so markets should not be concerned that housing will lead the economy into recession.

Consumer sentiment is probably flashing the biggest warning signals as both the University of Michigan and Conference Board surveys of expectations over the coming months have both dropped sharply. Rising food and gas prices and the media coverage around the worst inflation since the 1970's are frightening consumers at a rate not seen in many years.

This decline in sentiment does not always fully correlate with subsequent real spending, but higher prices were always expected to impact demand this year. The consumer is rarely a major swing factor in catalyzing recessions and recoveries, but a decline in consumer spending could contribute to a further contraction in economic growth over coming quarters.

Business spending is historically more volatile than consumer spending and, because of that, is usually a better indicator of the state of the economy around inflection points. U.S. corporations generally have strong balance sheets with ample cash which will provide some cushion in this slowdown environment. But they will also be watching the consumer outlook carefully when assessing future spending needs.

There has been a notable build in inventories so far in 2022. Most was to replenish depleted stockpiles, but some of it appears to be businesses reacting to 2021 demand levels and extrapolating them into 2022. With slowing demand this year, there is likely a certain level of involuntary inventory accumulation which will need to be worked off through slower order growth and aggressive discounting. While this dynamic should have a favorable impact on inflation, it could lead to a strong decline in capital spending over the next six months.

Supply manager sentiment surveys began to reflect the slowing of the economy at the end of the quarter with a distinct weakening in new orders growth. The labor market remains tight with low jobless claims and a low unemployment rate, but there are anecdotal instances developing of actual and planned layoffs as well as hiring deferrals in certain sectors of the economy. This should help close the gap that has widened between job openings and those looking for jobs and perhaps reduce wage inflation pressure on businesses.

COMMODITY PRICES

The war in Ukraine appears to be turning into a long, drawn-out stalemate with the Russian strategy pivoting from a quick takeover of the central government in Kyiv to a war of attrition on the eastern front. Sanctions on Russia will remain in place which should prevent oil and food prices from meaningfully declining. However, the global economic slowdown is likely to cap upside shocks while industrial metals prices fall as increasing supplies meet lower demand.

FIXED INCOME MARKETS

Despite the very weak year-to-date performance in fixed income markets, which was largely a function of rate increases across the yield curve, rates pulled back in June. The 10-year treasury yield dropped 50 basis points from its peak to close the quarter below 3.00%. This is likely a market indication that the economic slowdown is accelerating and perhaps more importantly, inflation is peaking.

The breakeven inflation rate, which is derived by subtracting the yield of a Treasury Inflation Protected Security (TIPS) note from its like maturity treasury note, has declined from peak levels across the yield curve. For example, the five-year breakeven rate peaked at 3.60% in late March and declined 100 basis points to 2.60% by the end of the quarter.

Other important economic indicators often found imbedded in fixed income market signals are the shape of the yield curve and the interest rate spreads to treasuries of non-investment grade bonds. Over the second quarter, the yield curve remained flat with the closely followed two- to 10-year spread at 6 basis points at the end of the quarter.

A flat yield curve indicates economic stagnation while an inverted curve is usually a sign of an impending recession. The high yield spreads may be more of a cause for concern in the economy as they widened approximately 250 basis points during the quarter to 585 basis points. For historical perspective, the spreads in the 2020 and 2008-09 recessions widened to over 1000 bps while growth slowdowns have caused the spreads to widen by a more moderate 500 to 800 basis points. Current levels can be viewed as a sign of a slowdown of growth or perhaps a moderate recession.

Weaker growth and moderating inflation should allow rates to continue normalizing but rise more gradually from current levels as Fed rate increases and higher commodity prices sap demand in the economy. The prospect of further spread widening in both investment grade and high yield markets should generate continued investor caution although the yield premiums are now much more attractive than they were coming into 2022.

EQUITY MARKETS

Stocks across the globe are looking to find a bottom in this bear market environment. A pause in rate increases across the yield curve appears necessary although markets will now focus on second quarter corporate earnings reports and the guidance provided by managements.

A dichotomy developed during the second quarter in the US equity market. Top-down Wall Street strategists reacted to the slower economy and aggressively lowered both second half 2022 and full year 2023 earnings estimates. The collective security analyst community has been much more hesitant to revise down their estimates as they await better guidance from companies as to the magnitude of revenue slowdowns and profit margin deterioration.

Companies in the goods producing sectors are developing concern from seeing slower demand as consumer spending skews more towards services just as inventories have become perhaps excessively replenished. The services sectors of the market should have strong quarterly earnings with the largest question being the sustainability of revenues into 2023 once pent-up Covid demand is sated.

Although a relatively light weighting within the equity markets, energy earnings are expected to grow quite nicely over the coming quarters given higher commodity prices within the complex and mild capital spending which should serve to maintain margins.

International equities tend to trade at cheaper multiples of earnings compared to the U.S. This is largely due to heavier exposure to the more cyclical and defensive sectors of the markets. The overseas central banks appear more cautious in implementing monetary tightening policies. The Bank of Japan is the remaining holdout by maintaining extremely loose policies and yield curve control strategies. This may help local equity market performance but produce further pressure on the yen and keep foreign buyers cautious to allocate to Japanese equities.

The Bank of England is on a similar tightening trajectory to the Fed albeit at a slower magnitude of rate increases. The European Central Bank (ECB) maintained a negative policy rate going into the third quarter despite the economy experiencing an over 8% year-over-year inflation rate in June. Rising energy and food prices, largely driven by supply constraints caused by the Russia/Ukraine war, are direct impacting demand, particularly in Germany which is the most reliant Eurozone member on Russian energy imports. This has kept the ECB more cautious in normalizing rates too quickly into an already weakening economy.

The Peoples Bank of China has more policy flexibility to slow down or even reverse tightening should the economy stall and begin to contract. In addition to higher prices tempering demand, the Chinese government policy of zero tolerance towards Covid and continued willingness to impose strict lockdowns on broad swaths of the population have slowed economic growth. While future outbreaks and the extent of resulting closures are highly uncertain, the government is in a stronger position to quickly respond with both fiscal and monetary policy support which can support equity markets.

What This Means for Investors

With inflation currently too persistent for the Fed to slow their tightening policies, the probability of a U.S. recession is growing. However, any recession should be mild given the strength of consumer and corporate balance sheets and may already be reflected in year-to-date equity market performance.

Inventory levels, labor markets, commodities, and breakeven inflation rates are all sending strong signals that inflation has peaked and should decline in the back half of this year into 2023. This should cause the Fed and other global central banks to reassess their policy response and allow markets to look forward to the end of the global tightening cycle.

		3Q21	4Q21	1Q22	2Q22	YTD	Annualized 1-Year	Annualized 3-Year	Annualized 5-Year	Annualized 10-Year
US EQUITY BENCHMARKS	**PRICE**									
Dow Jones Industrial	30,775	(1.46)	7.87	(4.10)	(10.78)	(14.44)	(9.05)	7.24	9.98	11.70
Nasdaq Index Composite	11,029	(0.23)	8.45	(8.95)	(22.28)	(29.23)	(23.43)	12.18	13.47	15.40
S&P 500	3,785	0.58	11.03	(4.60)	(16.10)	(19.96)	(10.62)	10.60	11.31	12.96
Russell 1000 (Large Cap)		0.21	9.78	(5.13)	(16.67)	(20.94)	(13.04)	10.17	11.00	12.82
Russell 1000 Growth		1.16	11.64	(9.04)	(20.92)	(28.07)	(18.77)	12.58	14.29	14.80
Russell 1000 Value		(0.78)	7.77	(0.74)	(12.21)	(12.86)	(6.82)	6.87	7.17	10.50
Russell Mid Cap		(0.93)	6.44	(5.68)	(16.85)	(21.57)	(17.30)	6.59	7.96	11.29
Russell Mid Cap Growth		(0.76)	2.85	(12.58)	(21.07)	(31.00)	(29.57)	4.25	8.88	11.50
Russell Mid Cap Value		(1.01)	8.54	(1.82)	(14.68)	(16.23)	(10.00)	6.70	6.27	10.62
Russell 2000 (Small Cap)		(4.36)	2.14	(7.53)	(17.20)	(23.43)	(25.20)	4.21	5.17	9.35
Russell 2000 Growth		(5.65)	0.01	(12.63)	(19.25)	(29.45)	(33.43)	1.40	4.80	9.30
Russell 2000 Value		(2.98)	4.36	(2.40)	(15.28)	(17.31)	(16.28)	6.18	4.89	9.05

		3Q21	4Q21	1Q22	2Q22	YTD	1-Year	3-Year	5-Year	10-Year
S&P GICS SECTORS	**WEIGHT**									
Consumer Discretionary	10.8%	0.01	12.84	(9.03)	(26.16)	(32.82)	(24.20)	5.37	9.75	13.52
Consumer Staples	7.0%	(0.31)	13.31	(1.01)	(4.62)	(5.58)	6.66	10.86	8.79	10.68
Energy	4.1%	(1.66)	7.97	39.03	(5.17)	31.84	39.99	10.15	7.00	4.29
Financials	10.7%	2.74	4.57	(1.48)	(17.50)	(18.73)	(12.68)	6.73	7.22	12.48
Health Care	15.1%	1.43	11.17	(2.58)	(5.91)	(8.33)	3.37	13.61	12.16	14.97
Industrials	7.7%	(4.23)	8.64	(2.36)	(14.78)	(16.79)	(13.42)	6.06	6.77	11.32
Information Technology	27.1%	1.34	16.69	(8.36)	(20.24)	(26.91)	(13.56)	18.71	20.22	18.69
Materials	2.5%	(3.51)	15.20	(2.37)	(15.90)	(17.89)	(8.72)	10.26	8.74	9.91
Communication Services	9.1%	1.60	(0.01)	(11.92)	(20.71)	(30.16)	(29.05)	5.35	6.15	6.00
Utilities	3.1%	1.78	12.93	4.77	(5.09)	(0.55)	14.30	9.01	9.78	10.47
Real Estate	2.9%	0.88	17.54	(6.22)	(14.72)	(20.02)	(5.17)	7.01	8.49	9.14

	YIELD	3Q21	4Q21	1Q22	2Q22	YTD	Annualized 1-Year	Annualized 3-Year	Annualized 5-Year	Annualized 10-Year
GLOBAL EQUITY BENCHMARKS										
MSCI ACWI		(1.05)	6.68	(5.36)	(15.66)	(20.18)	(15.75)	6.21	7.00	8.76
MSCI AC World x-USA		(2.99)	1.82	(5.44)	(13.73)	(18.42)	(19.42)	1.35	2.50	4.83
MSCI EAFE		(0.45)	2.69	(5.91)	(14.51)	(19.57)	(17.77)	1.07	2.20	5.40
MSCI EAFE Growth		0.07	4.09	(11.94)	(16.88)	(26.81)	(23.76)	1.32	3.47	6.29
MSCI EAFE Value		(0.97)	1.17	0.33	(12.41)	(12.12)	(11.95)	0.18	0.52	4.25
MSCI Emerging Markets		(8.09)	(1.31)	(6.97)	(11.45)	(17.63)	(25.28)	0.57	2.18	3.06
MSCI BRIC		(11.28)	(5.01)	(13.28)	(4.32)	(17.02)	(30.07)	(2.20)	2.25	3.08
MSCI Japan		4.56	(3.96)	(6.61)	(14.63)	(20.27)	(19.93)	1.01	1.76	5.59
INTEREST RATES	**YIELD**									
3m Treasury Bill	1.67	0.04	0.05	0.32	1.67	0.05	0.04	2.14	0.93	0.05
US LIBOR 3m	2.29	0.13	0.21	0.96	2.29	0.21	0.14	2.33	1.30	0.46
US Treasury 3m	1.64	0.04	0.05	0.52	1.64	0.05	0.04	2.12	1.03	0.09
US Treasury 10yr	2.98	1.53	1.51	2.32	2.98	1.51	1.47	2.04	2.27	1.65
US Treasury 30yr	3.12	2.09	1.90	2.45	3.12	1.90	2.09	2.56	2.81	2.78
FIXED INCOME										
Citi 3-month T-bill		0.01	0.01	(0.02)	0.01	(0.02)	0.01	0.58	1.05	0.59
BC U.S. Gov't & Related 5-7		(0.00)	(0.65)	(5.36)	(3.11)	(8.30)	(8.91)	(0.32)	1.53	1.92
BC Municipal Bond 1-10 Year		(0.01)	0.18	(4.76)	(0.84)	(5.55)	(5.39)	0.21	1.32	1.79
BC TIPS		1.75	2.36	(3.02)	(6.08)	(8.92)	(5.14)	3.04	3.21	1.73
BC Aggregate		0.05	0.01	(5.93)	(4.69)	(10.35)	(10.29)	(0.93)	0.88	1.54
ML High Yield Master II		0.94	0.66	(4.51)	(9.97)	(14.04)	(12.66)	(0.04)	1.95	4.41
Citi World Gov't Bond Index		(1.24)	(1.10)	(6.46)	(8.91)	(14.79)	(16.77)	(4.27)	(1.17)	(0.69)
JPMorgan EMBI Global		(0.53)	0.02	(9.26)	(10.55)	(18.83)	(19.25)	(4.33)	(1.00)	2.05

		3Q21	4Q21	1Q22	2Q22	YTD	Annualized 1-Year	Annualized 3-Year	Annualized 5-Year	Annualized 10-Year
REAL ESTATE										
MSCI US REIT		0.75	16.02	(4.28)	(17.16)	(20.71)	(7.32)	2.90	4.08	6.04
FTSE EPRA/NAREIT Europe		(2.01)	5.81	(7.15)	(28.22)	(33.35)	(30.90)	(5.53)	(1.92)	4.30
COMMODITIES										
Bloomberg Commodity Index		6.59	(1.56)	25.55	(5.66)	18.44	24.27	14.34	8.39	(0.82)
Energy		20.99	(13.03)	47.91	7.02	58.29	66.55	11.70	9.99	(4.68)
Agriculturals		(1.03)	6.26	19.91	(5.72)	13.05	18.89	18.80	6.86	(1.16)
Livestock		(2.01)	1.85	5.77	(8.68)	(3.42)	(3.61)	(6.75)	(6.64)	(4.33)
Softs		16.54	5.67	7.92	(4.30)	3.28	27.18	16.80	5.31	(3.16)
Industrial Metals		2.05	8.61	22.73	(26.35)	(9.61)	0.18	11.88	7.51	1.20
Precious Metals		(4.56)	4.33	6.88	(10.54)	(4.39)	(4.80)	7.18	5.62	(0.84)
CURRENCIES	**PRICE**									
ICE Dollar Index	104.69	1.76	2.06	2.44	6.14	9.08	13.05	2.63	1.83	2.52
Euro / US Dollar	1.05	(2.35)	(1.94)	(2.16)	(5.27)	(8.07)	(11.91)	(2.63)	(1.73)	(1.92)
Pound / US Dollar	1.21	(2.15)	0.04	(2.79)	(7.35)	(10.34)	(11.87)	(1.35)	(1.34)	(2.53)
US Dollar / Yen	135.86	0.03	3.78	5.40	10.58	17.98	21.80	7.85	3.87	5.47

Source: Morningstar Direct

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