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# Market Commentary Q2 2022

The S&P 500 declined -20% for the first half of 2022, while most long-term bond indices lost more than 10% over the same period.[2] To put perspective around these numbers, this is the worst first half for the S&P 500 since 1970.[1] Also, the first half of 2022 marks the first time since 1981 that both bonds and stocks suffered double-digit losses in the same year.[2]

| Leading US Indices (Total Return) | 1Q'21 | 2Q'21 | 3Q'21 | 4Q'21 | 2021 | 1Q'22 | 2Q'22 (sorted) | YTD |
|---|---|---|---|---|---|---|---|---|
| S&P/Citigroup Value | 10.8% | 5.0% | -0.8% | 8.3% | 24.9% | -0.2% | -11.3% | -11.4% |
| S&P 600 Small-Cap | 18.2% | 4.5% | -2.8% | 5.6% | 26.8% | -5.6% | -14.1% | -18.9% |
| S&P 400 Mid-Cap | 13.5% | 3.6% | -1.8% | 8.0% | 24.8% | -4.9% | -15.4% | -19.5% |
| **S&P 500 Total Return** | **6.2%** | **8.5%** | **0.6%** | **11.0%** | **28.7%** | **-4.6%** | **-16.1%** | **-20.0%** |
| S&P 100 Mega-Cap | 5.1% | 9.4% | 1.0% | 11.3% | 29.4% | -4.6% | -16.9% | -20.8% |
| Russell 2000 | 12.7% | 4.3% | -4.4% | 2.1% | 14.8% | -7.5% | -17.2% | -23.4% |
| Dow Jones Wilshire 5000 | 5.8% | 8.1% | -0.6% | 8.1% | 22.8% | -5.9% | -17.6% | -22.5% |
| S&P/Citigroup Growth | 2.1% | 11.9% | 1.9% | 13.4% | 32.0% | -8.6% | -20.8% | -27.6% |
| Nasdaq | 3.0% | 9.7% | -0.2% | 8.4% | 22.2% | -8.9% | -22.3% | -29.2% |

| S&P 500 Sectors (Total Return) | 1Q'21 | 2Q'21 | 3Q'21 | 4Q'21 | 2021 | 1Q'22 | 2Q'22 (sorted) | YTD |
|---|---|---|---|---|---|---|---|---|
| Staples | 1.1% | 3.8% | -0.3% | 13.3% | 18.6% | -1.0% | -4.6% | -5.6% |
| Utilities | 2.8% | -0.4% | 1.8% | 12.9% | 17.7% | 4.8% | -5.1% | -0.6% |
| Energy | 30.9% | 11.3% | -1.7% | 8.0% | 54.6% | 39.0% | -5.2% | 31.8% |
| Health Care | 3.2% | 8.4% | 1.4% | 11.2% | 26.1% | -2.6% | -5.9% | -8.3% |
| Real Estate | 9.0% | 13.1% | 0.9% | 17.5% | 46.2% | -6.2% | -14.7% | -20.0% |
| Industrials | 11.4% | 4.5% | -4.2% | 8.6% | 21.1% | -2.4% | -14.8% | -16.8% |
| Materials | 9.1% | 5.0% | -3.5% | 15.2% | 27.3% | -2.4% | -15.9% | -17.9% |
| **S&P 500 Total Return** | **6.2%** | **8.5%** | **0.6%** | **11.0%** | **28.7%** | **-4.6%** | **-16.1%** | **-20.0%** |
| Financials | 16.0% | 8.4% | 2.7% | 4.6% | 35.0% | -1.5% | -17.5% | -18.7% |
| Technology | 2.0% | 11.6% | 1.3% | 16.7% | 34.5% | -8.4% | -20.2% | -26.9% |
| Communication Services | 8.1% | 10.7% | 1.6% | 0.0% | 21.6% | -11.9% | -20.7% | -30.2% |
| Discretionary | 3.1% | 6.9% | 0.0% | 12.8% | 24.4% | -9.0% | -26.2% | -32.8% |

*Source: Strategas Securities, LLC*

The probability of a U.S. recession has increased recently as the Federal Reserve ("Fed") aggressively hiked interest rates to tame stubbornly rising inflation. But while inflation hurts the economy, so does fighting it: higher rates discourage borrowing/spending and encourage saving, which should cool consumer demand and prices. They also lower companies' growth expectations, which have slumped stocks into a bear market. And historically most S&P 500 bear markets have been accompanied by recessions. All eyes are on whether the Fed can cool the economy without igniting a downturn, which seems increasingly more difficult.

Valuations are now broadly below historic averages. Forward price-to-earnings (P/E) for the S&P 500 is around 15x, compared to 21.5x to

start the year and well below its five-year average of 18.9x.[2]

While uncertainty remains, primarily centered around whether the Fed can execute a soft landing, much uncertainty has been taken out of the equation with the Fed affirming their path of "expeditiously" raising rates. Markets are forward-looking, and we believe the Fed's aggressiveness has been communicated and continues to be priced-in. And while consumer demand has shifted throughout these past two years, it remains robust.

Yet, many uncertainties exist, such as when does inflation retreat and by how much, how long does the consumer remain resilient, and what do second half earnings look like? While demand has been strong and bottlenecks are getting fixed, the slowdown in the economy and the tighter Fed could lead to lower revisions going forward.

Even with these uncertainties, fear is vastly overpowering greed in the markets as shown across a variety of fear-gauge indicators like CNN's Fear and Greed index or Bank of America's Bull and Bear indicator. As you see below, according to the University of Michigan, consumer sentiment is at a multi-decade low.[1]

*Source: Strategas Securities, LLC*

Turning to the bond market, most indices registered negative returns as elevated inflation and the prospect of faster-than-expected rate increases from the Fed weighed on the sector.

Taking a deeper dive, you will see that shorter-term Treasury Bills again outperformed longer-duration Treasury Notes and Bonds as high

inflation and the threat of more Fed rate hikes weighed on products with longer durations.

Corporate bonds underperformed in the second quarter as rising recession fears paired with already-high inflation had a negative impact on corporate debt. For much of the quarter, high-quality investment-grade bonds and lower-quality high yield corporate bonds had similar negative returns, implying investor concerns about a future recession were broad-based.

Often considered one of the safest fixed income asset classes, municipal bonds experienced one of the worst first half-year periods in recent history. The catalyst for the sell-off was over $80 billion in redemptions from municipal bond mutual funds and ETFs through mid-June, as investors sold shares amid losses from rising interest rates.[2] In general, credit quality in the municipal market remains quite high, as well as the current attractiveness of yields compared to U.S. Treasuries.

The Fed has rapidly raised its benchmark rate to 1.75% from 0.25% through consecutive rate hikes, which are expected to continue through the end of the year.[2] This comes after the Consumer Price Index ("CPI") rose 8.6% in May, signaling the highest inflation in 40 years.[2] Despite global bond yields rising, U.S. Treasury yields are among the highest in the developed world.

Higher market interest rates are having an impact – slowing growth in housing market activity, limiting deal activity in capital markets, and slowing business expansion, according to the Institute of Supply Management (ISM) Purchasing Manufacturers Index (PMI) and regional economic activity surveys.[1]

| US Yields | 1Q'21 | 2Q'21 | 3Q'21 | 4Q'21 | 1Q'22 | 2Q'22 | Q/Q Chg (bps) | Y/Y Chg (bps) |
|---|---|---|---|---|---|---|---|---|
| Fed Funds Target Rate | 0.25 | 0.25 | 0.25 | 0.25 | 0.50 | 1.75 | 125 | 150 |
| 3-Month T-Bill | 0.01 | 0.05 | 0.04 | 0.05 | 0.52 | 1.65 | 113 | 161 |
| 2-Year Note | 0.11 | 0.25 | 0.28 | 0.73 | 2.28 | 2.92 | 64 | 267 |
| 5-Year Note | 0.74 | 0.69 | 0.74 | 1.07 | 2.51 | 3.00 | 49 | 231 |
| 10-Year Bond | 1.70 | 1.40 | 1.46 | 1.44 | 2.36 | 2.98 | 62 | 158 |
| 30-Year Bond | 2.42 | 2.07 | 2.09 | 1.89 | 2.44 | 3.12 | 68 | 106 |

*Source: Strategas Securities, LLC*

The Fed projects its target rate to be 3.4% by year-end, indicating roughly 1.75% further in rate hikes this year.[1] This rising rate environment has negatively impacted the broad fixed income and equity markets, but especially longer-duration growth assets. Duration is defined as a security's price sensitivity to changing interest rates and being short-duration tends to outperform when rates rise, something we have focused on in portfolios.

Goods demand accelerated during the pandemic, but demand has now shifted to services, and supply chains have remained challenged throughout. The shifting consumer is being pressured now by combined inflation and tightening monetary policy, even as some supply chains show signs of easing.

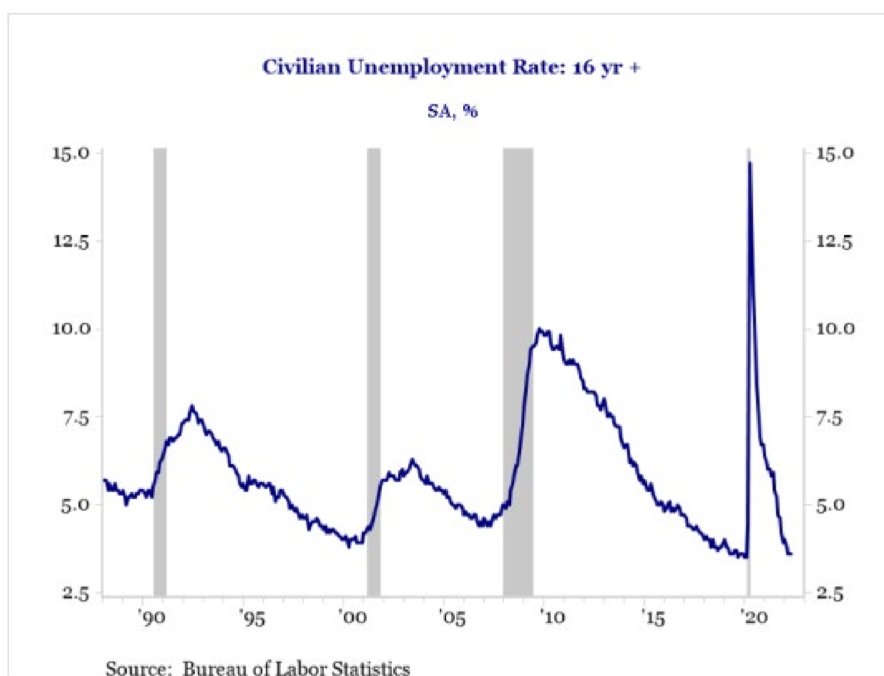
We're paying close attention to consumer demand data and whether the consumer can remain resilient. We are confident in the consumer…for now, backed by healthy balance sheets and rising wages. This equation could set the stage for a soft landing but ignores a

significant factor of bringing down inflation, supply.

The Fed does not have control over supply-side shortages. From energy materials to food, and from shelter to labor, there are sticky components to inflation that the Fed will struggle to reign in. Food and energy combine for over one-fifth of the consumer's wallet share, while shelter costs represent roughly one-third.[1] With widespread job availability and negative annualized productivity growth, wages are continuing to rise in tandem.

Growth names, particularly non-earners, tend to be more impacted by rising rates and higher labor costs, as can be seen in the bifurcation of returns between value and growth as S&P 500 Value has returned 12% compared to S&P 500 Growth returning -28% year-to-date.[2] We've adjusted portfolios to remain short duration on the fixed income side, and reduced exposure to growthier names, while shifting to more value and income generative strategies. Our portfolios are focused on companies with healthy balance sheets, pricing power, and attractive shareholder return programs.

On the employment front, it has been a tale of two labor markets. While rebounding sectors like hospitality and travel couldn't hire fast enough, pandemic thrivers slowed hiring and cut positions. The technology industry made 8x more job cuts recently than it did during the first four months of the year combined.[1] Unemployment is at record lows and wage growth has doubled from 2019.[1] But with two job openings for every unemployed person, job seekers should be better off than in previous downturns. From a historical perspective, the U.S. economy has experienced 12 recessions since World War II, and each one included two features: economic output contracted and unemployment rose. Making this downturn a strange one.




*Source: Strategas Securities, LLC*

Looking to housing, home-buying demand is finally cooling as mortgage rates spike to the highest levels since 2009.[2] Last month, mortgage applications fell to a 22-year low, while large well-known brokers had mass layoffs.[1] Average mortgage payments are now 31% higher than rent, which could speed the cooldown.[1] As rates rise, fewer people will be eligible/willing to take out loans. Yet home prices won't cool until supply improves, and that could take some time.

After years of struggling to get products on shelves, big retailers now have too much stuff. Big box retailers have been quoted saying that nearly a quarter of its inventory is "unwanted" as shipments meant for stay-at-home season (think puzzles, throw pillows) arrived months too late. Those same companies are now having huge sales events to shed extra merchandise. The discounts could lure shoppers to stores and help cool inflation.

Looking abroad, markets were not much better as the Russia-Ukraine conflict continued with no signs of a ceasefire in sight. However, several foreign markets relatively outperformed U.S. markets as foreign central banks are expected to be less aggressive with future rate increases compared to the Fed.

The second quarter saw further steep declines for eurozone shares as the war in Ukraine continued and concerns mounted over potential gas shortages. A flash estimate signaled inflation at 8.6% in June, up from 8.1% in May, with energy the biggest contributor to the rise.[2] Higher inflation is denting consumer confidence, with the European Central Bank ("ECB") poised to raise interest rates in July.

Ongoing elevated inflation means the ECB is poised to lift interest rates at its meeting on July 21st, with a further rise likely in September. Concerns over the higher cost of living and possibility of recession saw the European Commission's consumer confidence reading fall to -23.6 in June, the lowest level since the early stages of the pandemic in April 2020.[1]

| International Indices (Price Chg) | 1Q'21 | 2Q'21 | 3Q'21 | 4Q'21 | 2021 | 1Q'22 | 2Q'22 (sorted) | YTD |
|---|---|---|---|---|---|---|---|---|
| Shenzhen SE A Shares (China) | -4.8% | 11.2% | -2.9% | 5.6% | 8.6% | -16.3% | 5.0% | -12.1% |
| Hang Seng (Hong Kong) | 4.2% | 1.6% | -14.8% | -4.8% | -14.1% | -6.0% | -0.6% | -6.6% |
| IBEX 35 (Spain) | 6.3% | 2.8% | -0.3% | -0.9% | 7.9% | -3.1% | -4.1% | -7.1% |
| FTSE 100 (UK) | 3.9% | 4.8% | 0.7% | 4.2% | 14.3% | 1.8% | -4.6% | -2.9% |
| Nikkei 225 (Japan) | 6.3% | -1.3% | 2.3% | -2.2% | 4.9% | -3.4% | -5.1% | -8.3% |
| Sensex (India) | 3.7% | 6.0% | 12.7% | -1.5% | 22.0% | 0.5% | -9.5% | -9.0% |
| OMX Stockholm 30 (Sweden) | 17.0% | 3.2% | -0.2% | 7.1% | 29.1% | -13.4% | -10.6% | -22.6% |
| CAC 40 (France) | 9.3% | 7.3% | 0.2% | 9.7% | 28.9% | -6.9% | -11.1% | -17.2% |
| Swiss Market Index | 3.2% | 8.1% | -2.5% | 10.6% | 20.3% | -5.5% | -11.7% | -16.6% |
| All Ordinaries (Australia) | **2.4%** | **8.1%** | **0.6%** | **2.0%** | **13.6%** | **0.1%** | **-13.4%** | -13.3% |
| DAX (Germany) | 9.1% | 1.5% | -1.8% | 4.1% | 13.0% | -9.5% | -13.8% | -22.0% |
| S&P/TSX (Canada) | 7.3% | 7.8% | -0.5% | 5.7% | 21.7% | 3.1% | -13.8% | -11.1% |
| Kospi (South Korea) | 6.5% | 7.7% | -6.9% | -3.0% | 3.6% | -7.4% | -15.4% | -21.7% |
| Bolsa (Mexico) | 7.2% | 6.4% | 2.2% | 3.7% | 20.9% | 6.1% | -15.9% | -10.8% |
| Bovespa (Brazil) | -2.0% | 8.7% | -12.5% | -5.5% | -11.9% | 14.5% | -17.9% | -6.0% |

*Source: Strategas Securities, LLC*

Emerging market equities experienced a fall in Q2, with U.S. dollar strength a key headwind. They outperformed foreign developed markets thanks to high commodity prices and despite rising global recession fears. With COVID in retreat (for now), the economy and logistics reopening, and an ongoing stimulus rollout, China's economy has gained momentum.

The Latin American markets were among the weakest markets in the MSCI Emerging Markets Index. A combination of rising concern over a global recession, domestic policy uncertainty, and later in the quarter weaker industrial metals prices, contributed to declines in equities and currencies.

China was the only emerging market to generate a positive return over the quarter.[2] Lockdown measures in certain cities were eased and macroeconomic indicators began to pick up. Meanwhile, additional economic support measures were announced. The authorities also outlined a significant reduction in quarantine for close contacts and visitors to China, which should help to ease supply issues even if the zero-COVID policy seems set to remain in place.

The U.S. has banned Russian oil imports, and the EU is phasing them out. G7 leaders want to cap Russian oil prices to shrink Russia's oil sales without shrinking global supply…i.e., countries all agree to pay a lower price for Russian oil. Western sanctions are hurting Russia's access to cash. Recently, Russia reportedly defaulted on $100M of foreign debt payments for the first time in a century. But Russia's economy has been relatively resilient: the ruble has rebounded, and shelves have stayed stocked thanks to domestic production and increased trade with Turkey, India, and China, who are snapping up Russian oil.

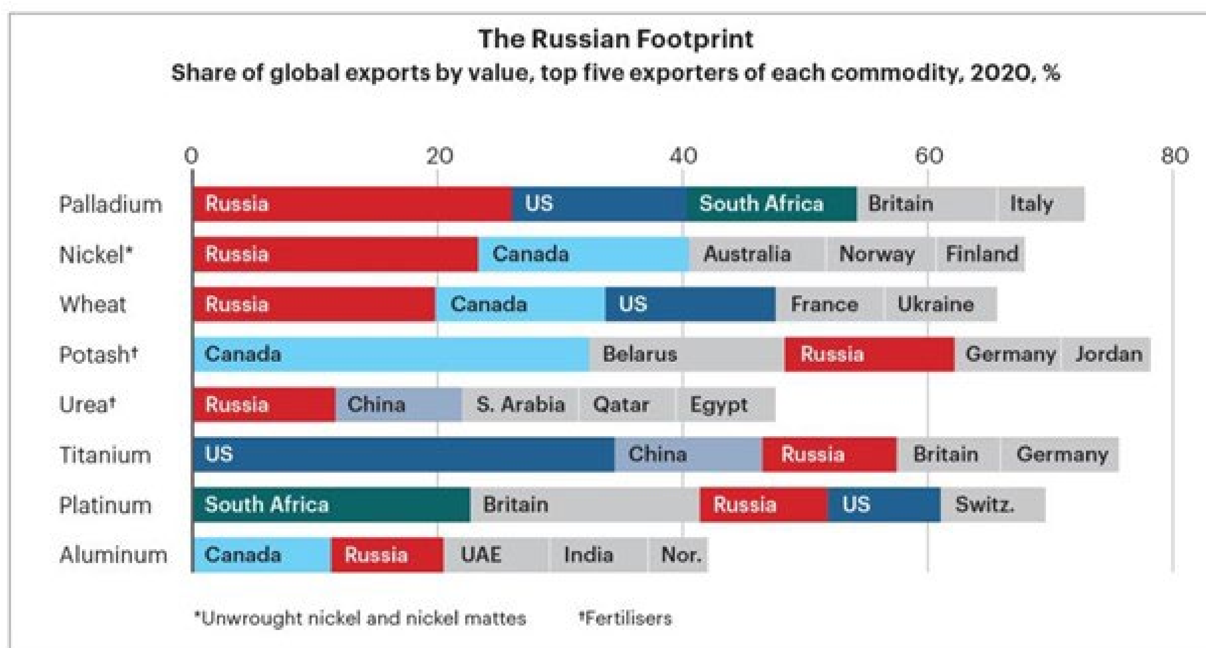
It's a delicate balancing act. So far, Western sanctions haven't shut down Russia's economy or forced it to end its war. But if enough countries agree to participate in an oil-price cap, they could curb Russia's oil sales immediately without hurting consumers. It's not a risk-free strategy, if Russia cuts production in response to the cap, global oil prices could soar even higher!

Today's high energy prices are a consequence of global supply and capacity. Why is that capacity constrained, and why can't we bring more oil into market quickly? The answer lies in the tug-of-war between "short cycle" investments for more immediate-term oil production and "long cycle" investments in natural gas and renewable energy sources.

A perfect storm of headwinds, including a lack of investment, low excess capacity, and the first European land war since WWII, collided with fiscal stimulus spending, pandemic-related spikes in demand and low interest rates to drive prices of oil and select metals to levels not seen in decades.

In June 2014, energy comprised 10.7% of the S&P 500.[2] At the end of 2021, it represented just 2.7% and now, after returning almost 34% YTD, represents about 5% of the S&P 500.[2]

The tragic Russian attack of Ukraine has broad but, as of now, unknowable consequences for the energy and commodities complex remain. While Russia represents only about 2% of global Gross Domestic Product, it has a much larger share of food and energy production.[2] Russia's economy is driven by commodity exports and the global economy relies on these products to operate. Both Russia and Ukraine export large quantities of energy (oil, natural gas, and coal), agriculture (wheat and corn), and commodities (aluminum, nickel, palladium, and platinum).




*Source: The Centre for Prospective Studies and International Information.*

Consumer pain from inflationary pressures in both food and energy will come down hardest on developing nations and those lower on the economic ladder. Because developing economies spend a greater portion of their income on food-based commodities, inflationary pressures from demand elsewhere will cause increasing costs and slowing global economic growth. Increasing food insecurity in many parts of the world is a growing concern.

As sanctions target the Russian regime, its oligarchs and Putin's inner circle, the measures taken by key demand centers including the U.S., Europe, China and India will dictate how much of Russia's products are exported and thus the price of each commodity. While the current trajectory of the war looks to be drawn out, its direction and duration will determine how global supply and demand shape up and influence global pricing. Russian crude is trading at a significant discount of around $28 per barrel versus the price of Brent crude and, even at a significant discount, is finding a limited set of buyers.

Towards the end of the quarter, many commodity prices started to fall, leading to hopes that inflation has peaked.

Money growth is finally slowing as well, an important step towards getting inflation out of the system. Although not everyone in the economics profession agrees on the relationship between M2, which is the measure of money supply that includes cash, checking deposits and easily convertible money, and inflation, M2 is considered to be an important metric for understanding the direction of inflation. In the 1970s M2 growth led the CPI by two years and, while that relationship broke down in the

interim, it reemerged with the massive increase in COVID-19 aid. That lag is a reminder that inflation is going to be with us for some time. Still, we remain encouraged that M2 growth is getting back to its pre-COVID year-over-year growth rate and it looks like we are starting on the path to finally draining excess liquidity.

We would be remiss not to mention the cryptocurrency (“crypto”) winter that has arrived. "Contagion" became the quarterly buzzword as the crypto market continued to tumble along with stocks, losing $2T in market cap since its November high.[1] Algorithmic stablecoin TerraUSD's crash wiped out $40B in market value seemingly overnight, while crypto lender Celsius froze billions in customer funds.[1] The trouble spread to other crypto companies like Coinbase, Crypto.com, and Gemini, all of which laid off employees as investors jumped ship. Bipartisan crypto regulation proposed in the Senate could be a win for the struggling industry, though with contentious midterm elections approaching, no one's holding their breath.

To be clear, a rerun of 2008 is likely not in the cards. U.S. households have strong balance sheets, low leverage, and high cash holdings. Therefore, the risk of another housing slump causing a severe blow to the banking system is small. That said, the signaling from housing does point to a deterioration in both demand and financial conditions.

The bottoming process certainly appears to be taking place. Or at least attempting to. Of course, plenty can happen along the way to derail this outlook. But the economy is slowing, and inflation will roll over. Did we already see the bottom? Do these bear market rallies we have witnessed have legs? We’d like to see some better leadership and participation when you peel back the layers.

The bottom line is that inflation may stay elevated for another month or two, but given the trends listed above, the probability is rising that inflation going into the second half of this year could come down faster than the market currently expects.

So how does this translate into real world investing? Let’s start with the 60/40 examination.

The well-known 60/40 portfolio strategy has been the default for many investors for years. It’s a strategy designed around the idea that stocks, the 60%, produce most of the returns in an investment portfolio but are risky, and by including a 40% allocation to bonds, with their historically low correlation to stocks and lower price volatility, returns higher than inflation can be generated with just moderate levels of risk. This strategy has had an awful first half of the year so far with losses around -17%, compared with losses in the S&P 500 of -20%.[2]

With that said, how should investors deal with inflation, rising interest rates and declining earnings growth in stocks? Investors should focus on diversification and position their portfolio to take advantage of future opportunities. Bonds are likely to continue to decline as rates rise and stocks are also at risk of continued decline. Investors should consider an underweight allocation to bonds and keep the proceeds in cash or cash equivalents like short-term Treasury Bills, while adding an allocation to alternatives such as gold, hedge funds, private equity/credit, managed futures, and real assets, which will likely decrease portfolio risk and may generate positive returns in a market where they are hard to come by.

When the facts change your portfolio should change, even if it means deviating from the classic and comfortable 60/40.

Given a pandemic that shuttered the world's economy, and the overwhelming fiscal and monetary responses employed to combat the concomitant recession that followed, perhaps it's not all that surprising that the bill for the global economy would come due sooner or later. The real question now is whether that debt has been paid, at least metaphorically, or whether a balance remains. Currently, we are more inclined to believe in the latter rather than the former.

This is the most anticipated recession in a long time. Maybe it is so anticipated that firms and households are so prepared for a slowdown that we may end up not having a recession. Time will tell.

Given the long-term nature of our investment decisions, we think it is fitting for our overall portfolio performance objective to be equally long-term. After all, it would not make much sense to make our portfolio decisions looking three to five years out, and then measure our performance, say, monthly, quarterly, or even annually. That is why we generally do not put too much emphasis on short-term performance. Analogous to the discussion of benchmarks above, we think analyzing short-term performance results would be a distraction from our long-term decision-making, akin to staring in the rear-view mirror while you drive on the highway.

Investors are understandably spooked by the current market conditions and economic forecasts. While the implications of these scenarios may appear daunting and the environment has been undeniably difficult for investors, we have entered a period of better risk/reward for investors and emphasize that now is not the time for emotion to impact decision-making.

Remaining focused on the long term is important through the onslaught of a bear market. Stocks lose on average 36% in a bear market and, by contrast, gain 114% during a bull market.[2] Further, the length of a bear market tends to be just 9.6 months, while a bull market, on average, lasts 2.7 years.[1] Bear markets have occurred roughly every 5.4 years.[1] It's important to stay invested during these bear markets because half of the S&P 500 strongest days in the last 20 years occurred during a bear market, while 34% of the market's best days took place in the first two months of a bull market.[2] Timing the market is difficult and often unfavorable, since missing out on these best days is likely to have destructive effects on long-term compounded returns.

If investors all entered a "halftime locker room," you'd likely sense fear, uncertainty, emotions and maybe panic from one team, and another team that remains level-headed, diligent, experienced, and seeking opportunity. Who would you bet on to win the game?

There's still another half to play, and it will remain challenging. The macro environment is likely to outweigh any company news in the near term, and we think investors should stay selective. We think now is a great time to stick to the game plan.

**To discuss this commentary further, please contact us at 914-825-8630.**

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[1] Strategas Securities, LLC
[2] FactSet

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