Quarterly Recap Q2 -2022

During the past quarter, stocks fell sharply as the Federal Reserve aggressively raised interest rates to combat the highest inflation in over forty years.

The S&P 500 Index endured its worst quarterly decline since the start of the pandemic and officially entered a bear market, ending the quarter down more than 21% from its high in January. As a result, the index posted its worst first half start to a calendar year since 1970.

As interest rates increased, investors were forced to discount future earnings at a higher rate, punishing high-growth stocks the most. The hardest hit included mega-cap technology and internet-related stocks with some losing more than 50% of their value, a major contributor to the notable underperformance of the Nasdaq Composite Index. **Within the S&P 500 Index, defensive sectors, such as utilities, health care, and consumer staples, were some of the best performers.** Energy stocks gave back their early gains as oil prices retreated, however, the sector still remained the best-performer year to date.

The quarter ended with investors bracing for major earnings downgrades as firms navigated a difficult supply chain, with high input and wage costs, and what looked like a softening economy. There were significant declines in

consumer driven companies such as Target and other major retailers as earnings misses mounted on elevated inventory levels and the potential for softer consumer spending on the horizon. Investors also started assigning less weight to year-over-year earnings comparisons due to 2021's surge in profits. As of the end of the quarter, consensus estimates showed expectations for the weakest quarterly profit growth since late 2020.

Macroeconomic Highlights

U.S. & Global

From an economic standpoint, the same factors pressuring the markets early in 2022 persisted into the second quarter keeping volatility elevated, including high inflation, the prospect of sharply higher interest rates, geopolitical unrest, and rising recession fears.

Unlike most other countries, China continues to enforce a stringent COVID policy, as small outbreaks have been met with intense lockdowns. At the peak of recent COVID outbreaks and subsequent lockdowns throughout China, it was estimated close to 50 separate cities and provinces, equating to nearly 80% of China's economic output, were shut in halting the world's second-largest economy.

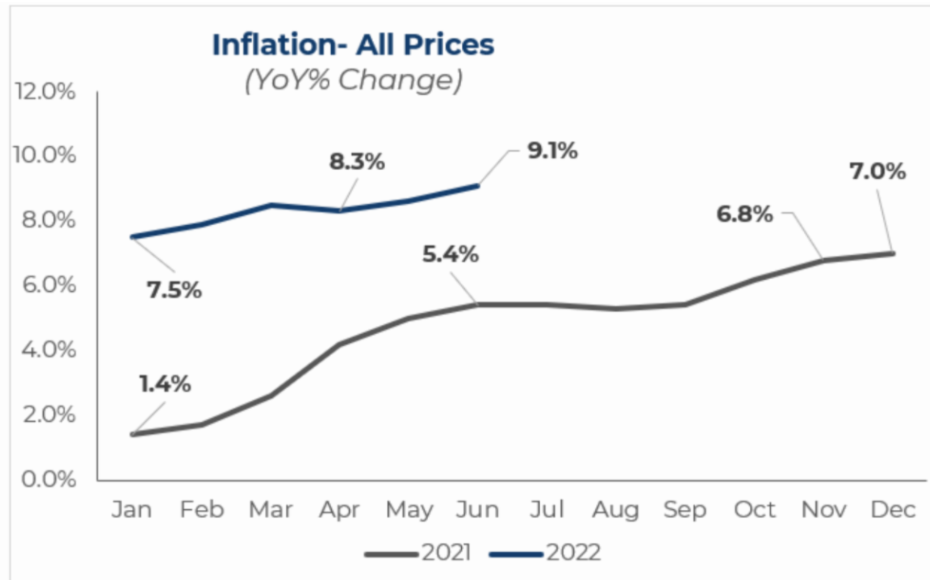
The sharp drop in China's economic activity increased the possibility of a global recession, compounding global supply chain problems, as major port cities operated far below capacity as a result of the lockdowns. **The decline in economic activity in China combined with concerns around rising interest rates and persistent inflation hit stocks hard and the S&P 500 Index fell 8.7% in April.**

In the U.S., the Federal Reserve raised interest rates by 50 basis points at its May meeting, making it the single-biggest rate hike in 22 years, leading to more selling during the month. At a post-meeting press conference, Fed Chair Jerome Powell signaled continued aggressive rate hikes in an attempt to rein in inflation which led to more pressure on stocks. However, bright spots emerged as investors saw potential softening in multiple economic headwinds leading to a modest rebound by month-end.

Inflation

In June, as the Chinese economy started to reopen and new inflation data implied price pressures might be peaking, investors were hopeful of a less hawkish Fed. This led to a brief rally in stocks before the May CPI report proved it was too soon to claim victory over high prices. Further, on the heels of the high CPI report, **Fed Chair Powell again warned that more aggressive rate hikes were possible in the coming months if inflation did not materially decline.** This hit stocks hard causing most indices to drop sharply to lows not seen since 2020.

Markets began to stabilize later in June as commodity prices started to retreat and U.S. economic data showed moderation in activity. This rekindled hopes around an inflation peak and a sooner end to the rate hike cycle. However, it was not enough, as price headwinds remained heavy on investor minds causing major indices to finish deep in negative territory for the quarter.



Market Performance - Stocks & Bonds

U.S. & Non-U.S. Equity

All major stock indices posted negative returns for a second straight quarter, and **like the first quarter, the tech-heavy Nasdaq Composite Index underperformed due to rising interest rates, while the Dow Jones Industrial Average outperformed on a relative basis.** Also, similar to the first quarter, rising rates and fears of slowing economic growth fueled a flight-to-quality from high valuation, growth-sensitive stocks, to sectors more resilient in the face of rising rates and slowing economic growth.

By market capitalization, large-cap stocks again outperformed small-cap stocks, albeit by a smaller margin than what was seen during the first quarter. Large-cap relative outperformance was driven by the rise in interest rates as well as growing recession fears. Small-cap stocks, having higher leverage due to heavy reliance on debt financing, are inherently more sensitive to rising interest rates and recessionary environments than their large-cap counterparts.

From an investment style standpoint, both value and growth ended in negative territory across the board for the quarter. However, despite being negative on an absolute basis, value significantly outperformed growth by almost 2-to-1 on a relative basis.

At the sector level, all S&P 500 sectors finished with negative returns for the quarter. The best of the worst included historically defensive sectors, such as utilities, consumer staples, and healthcare, which are less sensitive to economic slowdowns. Energy was also a relative outperformer, due to high oil and gas prices, until a late-June drop in energy commodity prices left the sector to finish with a small loss.

Internationally, equity markets declined as the Russia-Ukraine war continued with no signs of ceasefire in sight by the end of June. However, non-U.S. markets outperformed U.S. markets as foreign central banks were expected to be more accommodative compared to the Federal Reserve. Emerging markets outperformed their developed market counterparts due to high commodity prices, which are a staple export of these economies, despite rising global recession fears.

Returns as of 6.30.22				Trailing (Annualized)		
	JUN %	QTD %	YTD %	1-Yr %	3-Yrs %	5-Yrs %
U.S. Equity						
S&P 500 Index	-8.3	-16.1	-20.0	-10.6	10.6	11.3
DJ Industrial Average Index	-6.6	-10.8	-14.4	-9.1	7.2	10.0
Russell 1000 Index	-8.4	-16.7	-20.9	-13.0	10.2	11.0
Russell Mid Cap Index	-10.0	-16.8	-21.6	-17.3	6.6	8.0
Russell 2000 Index	-8.2	-17.2	-23.4	-25.2	4.2	5.2
Non-U.S. Equity						
MSCI EAFE Index	-9.3	-14.5	-19.6	-17.8	1.1	2.2
MSCI Emerging Markets Index	-6.6	-11.4	-17.6	-25.3	0.6	2.2
Fixed Income						
Bloomberg US Agg. Bond Index	-1.6	-4.7	-10.3	-10.3	-0.9	0.9
Bloomberg US Agg Int. Bond Index	-1.3	-2.9	-7.5	-7.9	-0.6	0.9
Bloomberg US Int. Corporate Index	-1.8	-3.6	-8.5	-9.0	-0.1	1.4
ICE BofA US High Yield Corp Index	-6.8	-10.0	-14.0	-12.7	0.0	2.0

[1] Source: Morningstar

Fixed Income: Sovereign, Corporate, and Emerging Market

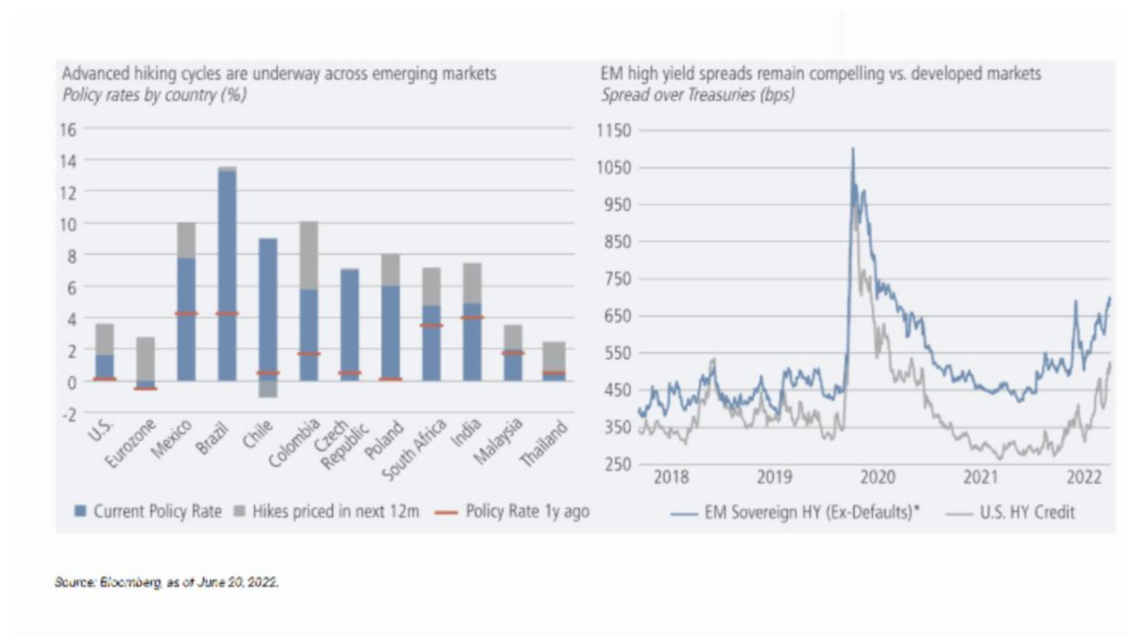
During the second quarter, as inflation wreaked havoc on expectations, bonds continued their worst performance in 40 years with all major bond indices posting negative returns.

As investors pondered an accelerated pace of rate hikes, yields increased at their fastest pace in years, with the curve inverting briefly, only to steepen again by quarter-end. A steep yield curve, associated with strong economic growth, implies

interest rates in the future will be higher than today, and an inverted yield curve, associated with slowing economic growth, implies future rates will be lower than today.

Corporate bonds underperformed as rising recession fears paired with already-high inflation weighed considerably on the sector. For much of the quarter, high-quality investment-grade bonds and lower-quality high yield bonds were both negative performers as investor concerns about a recession were broad based.

However, in June, disappointing economic data hit high-yield bonds harder leading to a sharp selloff and significant spread widening on a relative basis. Emerging market bonds, both USD-denominated and those denominated in foregin currency, widened significantly over the period as well. A bond spread is the interest rate difference paid over Treasuries to compensate investors for default risk, with higher spreads implying greater risk. Traditionally, periods of strong economic growth have narrower spreads as compared to weak, or slowing, economic growth environments.



Investment Outlook

We maintain our expectations for volatility to remain elevated for the remainder of the year, especially as the summer travel season winds down and investors are back at their desks full time. We do see the potential for

both equity and bond markets to end the year higher, if inflation begins to slow and there is more visibility into the activity by the Federal Reserve. However, we do think bonds are better positioned to outperform if recession fears persist and inflation slows at a faster pace. Further, the Fed Fund futures market is pricing in a rate cut as early as March 2023 which could be a significant potential tailwind to the bond prices if realized. As interest rates fall bond prices go up.

For stocks, while softening company fundamentals remain healthy, the consumer is strong despite mounting inflation, and monetary policy is still relatively loose compared to historical standards. As of this commentary's publication, the S&P 500 Index forward 12-month P/E ratio is 17.3, above the long-term average of 15.1 (since 1982). While we are closer to fair value versus the start of the year, we do not expect it to remain here long as investors look for any real opportunity to buy at these levels.

For bonds, the severe periods of dislocation seen thus far in 2022 can be followed by strong reversals to the upside in the next calendar year as shown by the performance following 2008, 2013, and 2017. However, the biggest difference relates to how much of the dislocation is due to spread widening versus an overall increase in interest rate levels, i.e., risk-free interest rates (U.S. Treasury). While current spread levels are not as wide as 2008, where spread levels pushed past 2000 basis points (or +20%), there has been enough of an increase to suggest an opportunity for a reversal at some point. **On average, when looking out five years, higher yield levels have an almost perfect correlation to increased bond returns, which is good news for patient bond holders.**

We do see the potential for more selling in equity markets as we close out the third quarter and are currently more defensive in client portfolios as a result. In the meantime, we are maintaining an overweight to bonds, as they exhibit healthy yields and the prospect of short-term outperformance, if stock market volatility spikes and investors look for safe havens. This has not been the case in recent past, as bonds and stocks have moved together both to the upside and the downside for almost three quarters. However, since April, historical asset class correlations have returned with bonds once again acting as a portfolio ballast in the face of stock market selloffs.

Overall, we expect stocks to perform better over the next 12-18 months, assuming no surprises from the Federal Reserve or a significant escalation in the Russia-Ukraine war. Further, we see interest rates as peaking near current levels and providing support for bond prices as investors take advantage of multi-

decade high yields. Unfortunately, given the many exogenous variables weighing on investor sentiment, we must remain flexible with our short-term investment strategy. Stay tuned.