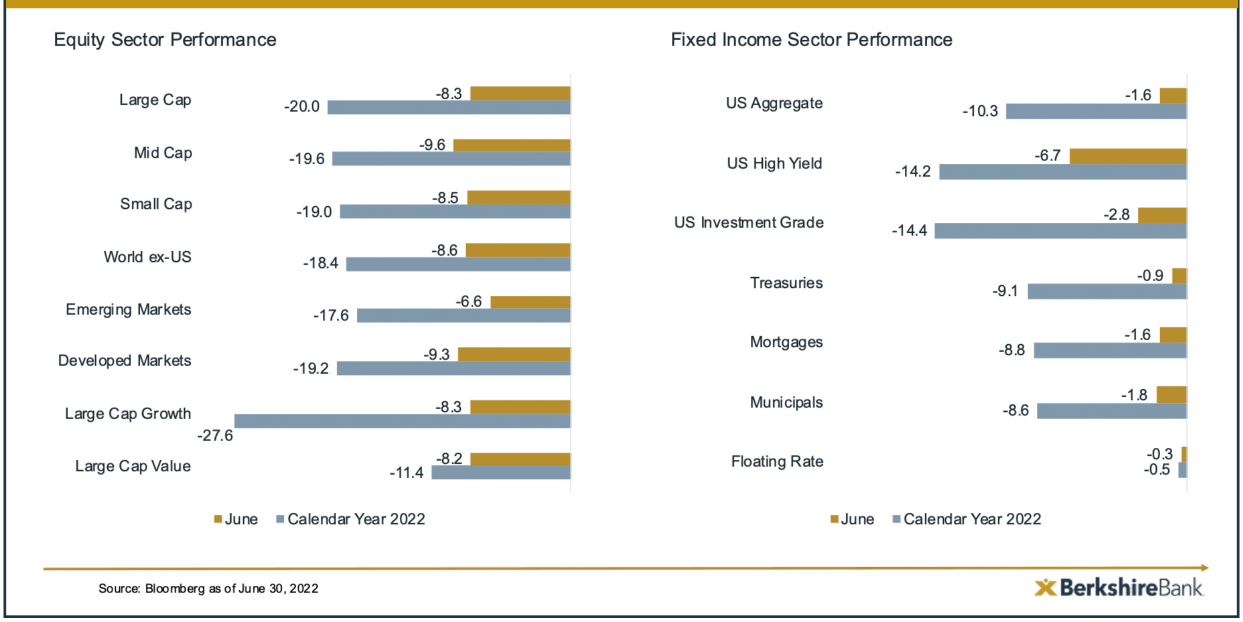
Summer 2022 Market Commentary

Global asset class performance in the first half of 2022 was record-setting, but not in a way deserving of accolades. Prices for both equities and fixed-income securities moved lower to the downside, leaving nowhere to hide for investors long accustomed to these two core asset classes moving inversely to each other. Energy related commodities and the US Dollar index were the only major asset classes to post positive performance in the first six months of 2022.

Financial markets are forward looking and typically move in advance of economic cycle turning points. Lately, global equity and bond markets have been struggling in tandem as market participants attempt to gauge the impacts of a global economic slowdown plus higher-than-normal price inflation on corporate earnings and creditworthiness.

ASSET CLASS PERFORMANCE



Market Performance

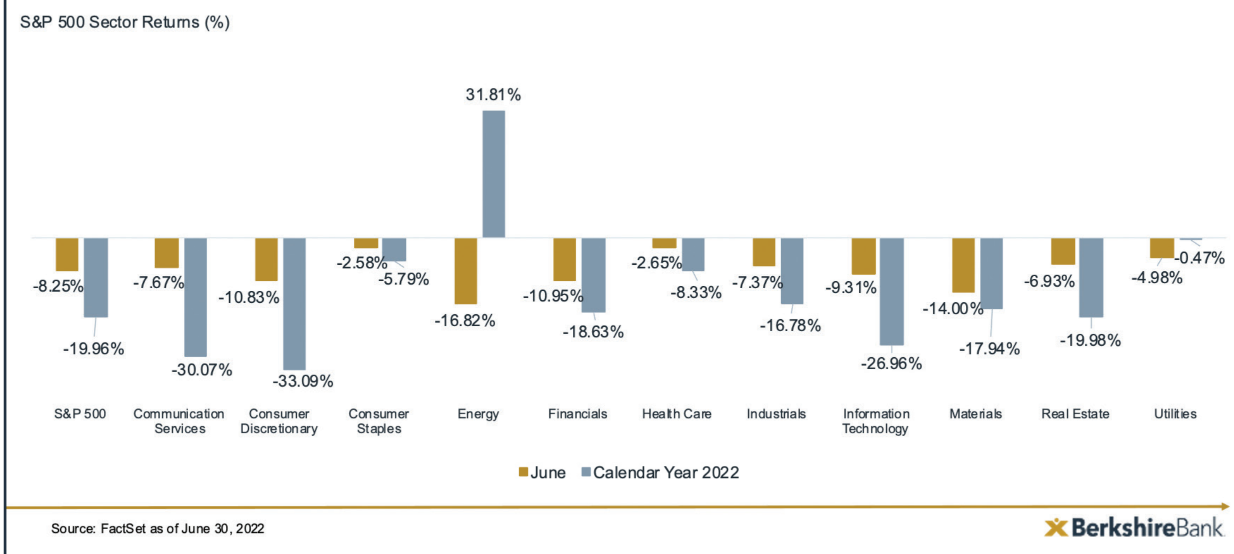
Digging into the details, the S&P 500 index posted its worst first half since 1970 of -20.6% while the tech-heavy Nasdaq index and small-cap focused Russell 2000 indices posted their largest first half declines ever recorded of -29.5% and -23.9%, respectively. Notably, fixed income as an asset class suffered its worst half since 1788—all the way back to when George Washington was President![1]

US government securities broadly fell by -15.4% while investment grade corporate bonds dropped -15.8%. It comes as no surprise that the ubiquitous 60/40 investment portfolio mix (60% equities and 40% fixed income) realized its worst performance since tracking began in 1976, roughly 10% worse than the 2008 loss experienced by investors in this portfolio allocation.[2]

Market Performance *continued*

Technology and Consumer Discretionary sectors, home to many of the high-flying, "bubble" stocks suffered losses greater than -30% during the first half. The lower volatility Utility and Consumer Staples sectors suffered only single-digit losses, reflecting investor rotation from Growth as a factor exposure into Value and into positive cash-flow generating companies. Similarly, high quality and established companies with low leverage outperformed highly levered smaller sized entities. The only sub-sector of the S&P 500 with positive performance was the Energy sector.

US EQUITY SECTORS

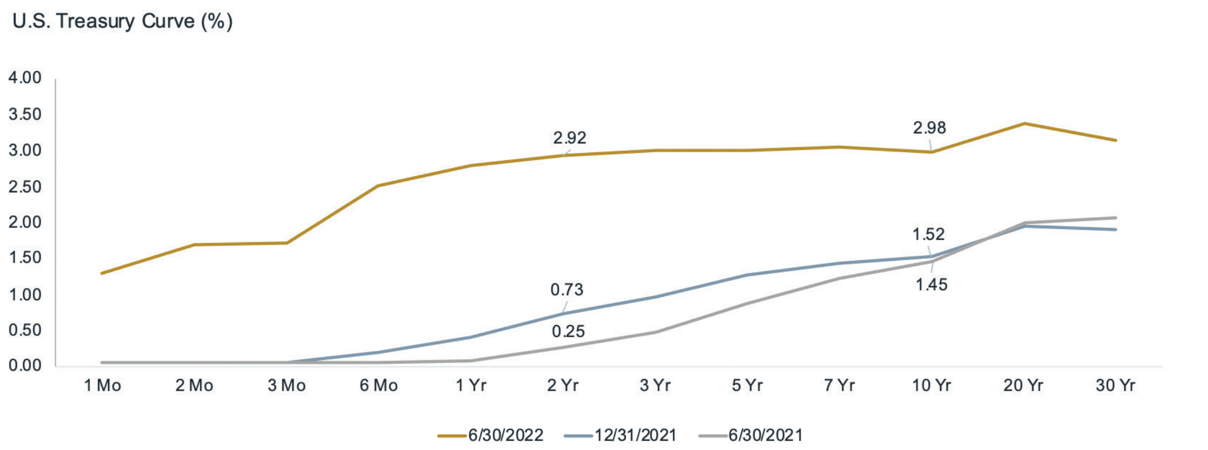


A similar flight to quality activity was seen in the corporate bond arena. Credit spreads for below investment grade "junk" bonds have ballooned by more than 2.50% in recent months as higher interest rates make it more costly for these companies to refinance outstanding debt, possibly putting some of the riskiest firms in jeopardy of a credit default.

Monetary Policy: Potential Impacts on Growth and Inflation

To combat runaway inflation and to prevent inflation expectations (that drive worker wage demands) from rising further, the Federal Reserve has pledged to aggressively tighten financial conditions by raising short-term borrowing costs for consumers and businesses. The Fed has raised the Federal Funds rate by 1.50% (from zero) to date and is expected to continue to raise rates through the end of the year by a similar amount to eventually reach a "terminal" Fed Funds rate of close to 3.25% by the end of 2022. As the Fed begins to remove liquidity from the system by increasing borrowing costs and letting balance sheet holdings of fixed income securities shrink in size, what was a major expansionary tailwind to the economic system has now become a contractionary headwind.

YIELD CURVE



Source: U.S. Department of the Treasury as of June 30, 2022

Typically, the Fed initiates tighter monetary policy to throw cold water on an economy that is showing signs of overheating. However, in today's environment the inflation fire may already be flaming out with many commodities dis-inflating, most notably industrial metals, agricultural "softs", lumber, and oil. Consumers are already pulling back consumption in the face of declining real disposable income (nominal less inflation). A recent consumer confidence survey posted its lowest reading ever recorded in the 38 years of data collection. A recent survey of small business owners registered a very dismal forward outlook—the lowest reading since that survey began in 1990. The Fed may possibly be tightening monetary policy into an ongoing economic slowdown, risking the result that economic stagflation or recession will follow.

The major question facing markets is whether the Fed will moderate and back off its pledge to bring inflation back to its 2% target. Will the Fed pivot, as it has done before, if the market crash deepens or if cracks begin to develop within the financial system? More time and more reported data will be needed to determine the probable path forward. For now, the labor market appears to be healthy, but since the labor statistics are reported on a lag, this data set is not very useful as a forecasting input. The Fed will need to see a major deterioration in employment plus make significant progress in bringing inflation under control before it considers a pause to its policy tightening program.

Looking Ahead

Markets will likely continue to see-saw throughout the next half of the year as the growth and inflation dynamics play out, with elevated volatility becoming the norm. Periods of extreme uncertainty are often uncomfortable for investors, particularly those with a shorter investment time horizon. For investors with a conservative objective or for those wishing to invest excess cash, short-term fixed income securities may be worth a look. Coupon interest rates on US Treasury and FDIC insured bank CDs have risen to levels that now produce meaningful income. If held to maturity, there will be no principal loss in these two types of fixed income instruments, barring any highly unusual adverse credit event. In the event the economy does fall into a recession, these securities could even appreciate as interest rates level off or even decline over time. As always, we recommend that investors reassess their investment objectives and risk tolerance and notify their advisor if anything has materially changed in their financial or personal circumstances.

1 Source: Global Financial Data, Deutsche Bank
2 Source: Bianco Research

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