Q2 2022
INVESTMENT PERSPECTIVES

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- **BEAR MARKET BLUES:** Stocks around the globe tumbled in Q2 and fell into bear market territory during the quarter—as defined by a drawdown of more than 20%. Every S&P 500 sector was negative during the quarter and only the energy sector was in the black on a YTD basis. Bonds failed to provide the traditional ballast for diversified investors as rising rates sent prices lower.
- **RED HOT INFLATION:** Headline inflation showed no signs of abating in Q2 with the Consumer Price Index (CPI) annual rate of change hitting its highest level since the early 1980s. The Fed continued to reiterate a commitment to fighting rising prices by raising interest rates and draining liquidity from the financial system.
- **THE "R" WORD:** With cyclical indicators weakening, consumer confidence measures deteriorating, and financial conditions tightening, fears of the dreaded "R" word—a recession—came to the fore in Q2. A strong labor market and upbeat consumer spending data quelled near-term pessimism, but how long the consumer can support the economy remains to be seen.

MARKET RECAP

Markets around the world foundered in Q2 as persistently high inflation readings triggered concerns about the resilience of the global economy. With most central banks pivoting towards a more hawkish stance, investors grappled with a rollback of the monetary largesse that had underpinned the sharp post-COVID recovery of risk assets. Not only did stocks decline, but bond prices continued to fall as prevailing interest rates moved higher and credit spreads widened. There were few bright spots for diversified investors during one of the most difficult difficult three- and six-month stretches in recent history.

With elevated inflation continuing to plague households and businesses alike, the Fed followed through on its aggressive forward guidance by raising rates 125 basis points during the quarter—including an unusually large 75 basis point hike in June—taking its benchmark Fed Funds rate to 1.75% at the end of Q2. Fed Chair Jerome Powell emphasized the Fed's determination to quash inflation which caused market participants to push interest rate expectations even

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FIXED INCOME

	USD Total Return (%)	
Index	**Q2**	**YTD**
Bloomberg 1-10 Yr Muni	-0.8%	-5.6%
Bloomberg US Agg. Bond	-4.7%	-10.4%
ICE/BofA HY Master II	-10.0%	-14.0%

EQUITIES

	USD Total Return (%)	
Index	**Q2**	**YTD**
Russell 3000	-16.7%	-21.1%
S&P 500	-16.1%	-20.0%
Russell 2000	-17.2%	-23.4%
MSCI All Country World	-15.7%	-20.2%
MSCI EAFE	-14.5%	-19.6%
MSCI Emerging Mkts	-11.5%	-17.6%

Source: Bloomberg (Data as of 6/30/2022) higher. In fact, since the beginning of the year when futures markets were anticipating the Fed Funds rate to end the year at roughly 0.75%, rate expectations have surged to roughly 3.25% at year-end.

As rates markets recalibrated to the Fed's more hawkish outlook, bond prices felt the pain from higher yields across maturities. The benchmark 10-year Treasury yield jumped from 2.3% to nearly 3.5% before closing the quarter just under the 3.0% level. Longer duration securities—i.e., those with greater sensitivity to changes in interest rates—once again bore the brunt of the price declines and have experienced deeply negative total returns in 2022. The Bloomberg US Aggregate fell -4.7% during the quarter, taking its YTD loss to -10.4%. This was easily the index's worst start to a year since its inception in 1976, and its third-worst six-month stretch overall behind two periods in 1979-1980.

After a relatively benign start to the year considering the broadly elevated levels of volatility, credit spreads—or the excess yield that investors demand for holding riskier debt relative to Treasuries—widened materially in Q2. Investors began to revise their outlook for defaults based on an increased probability of a recession. For the quarter, the ICE BofA High Yield Index declined -10.0%, bringing its YTD return to -14.0%. The most credit-sensitive segments of the market, CCC-rated bonds, fell nearly 16% during the quarter—evidence of the concerns surrounding lower quality companies in an economic slowdown.

The effects of a more hawkish Fed and the specter of a recession had equity markets reeling during Q2. The S&P 500 fell -16.1% and the Russell 2000—comprised of more economically sensitive small cap stocks—tumbled -17.2%. Losses were felt most acutely among growth stocks, whose valuations tend to be more sensitive to interest rates. The Russell 3000 Growth Index tumbled -28.2% to start the year relative to its value counterpart down -13.2%. With rates near zero and little expectation of moving significantly higher, investors were eager to pay up for earnings many years into the future—a defining feature of the 2010s and post-COVID recovery. Now, with rates moving meaningfully higher, investors are faced with a higher opportunity cost for financing companies with little near-term cash flow.

Non-US stocks broadly outperformed their US brethren in Q2. Despite Europe grappling with ongoing energy issues resulting from Russia's invasion of Ukraine, relative strength in Chinese markets helped buoy international indices during the period. After a wave of COVID lockdowns raised concerns about economic growth, Chinese authorities began to ease financial conditions and provided indications that they would be willing to inject stimulus to prevent further weakness. To the extent China can buck the broader trend toward restrictive, anti-inflation policy settings seen around the world, investors may be compelled by its "out of sync" economy.

NOWHERE TO HIDE

The YTD stock market declines are unlikely to come as a shock for casual market-watchers opening their June statements, but even attentive investors may be surprised to see the breadth of declines when reviewing their 1H 2022 performance. Notwithstanding idiosyncratic strategies that managed to skirt the broad downturn, there has been nowhere for investors to hide outside of cash—and its deeply negative real returns (i.e., adjusted for inflation). Diversified investors counting on some portion of their portfolio faring well will be disappointed that the confluence of rising interest rates, contracting equity valuations, and geopolitical flashpoints essentially amounted to a perfect storm.

To illustrate just how rare this situation has been in recent decades, the chart on the following page looks at the difference between the best and worst returning asset classes returns during the first and second halves of each year since 1992. We used five major indices to proxy a diversified portfolio of stocks and bonds:

- Taxable bonds: Bloomberg US Aggregate Index
- US large cap stocks: S&P 500
- US small cap stocks: Russell 2000
- Developed international stocks: MSCI EAFE
- Emerging markets stocks: MSCI EM

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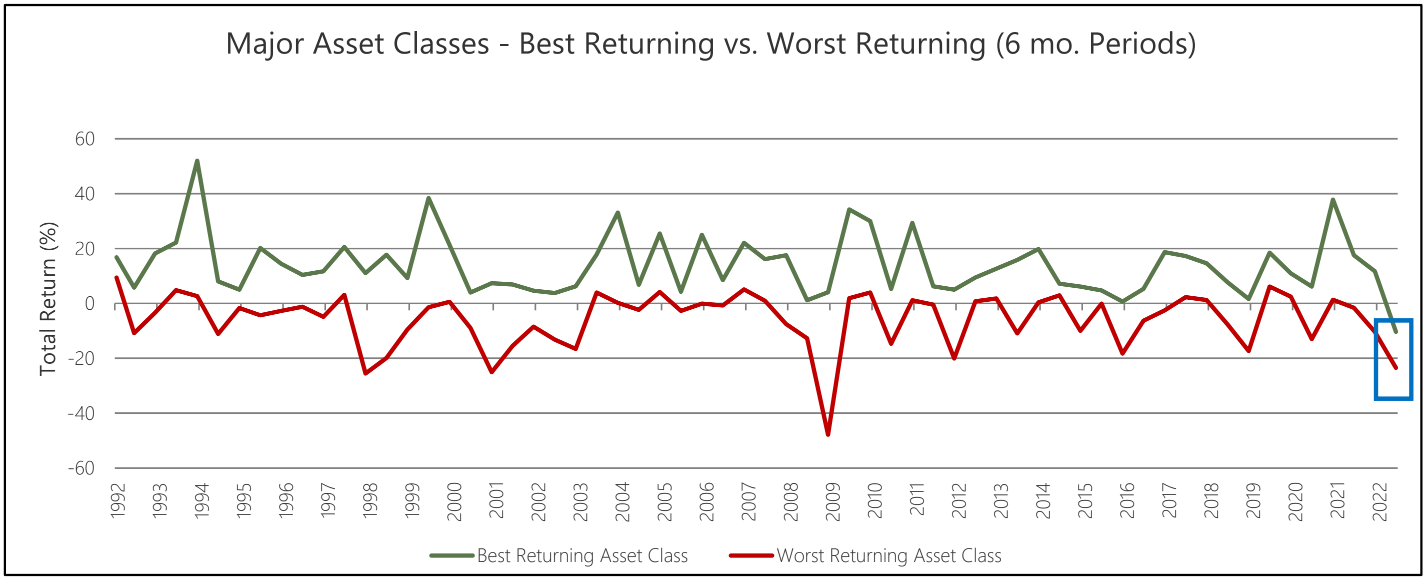
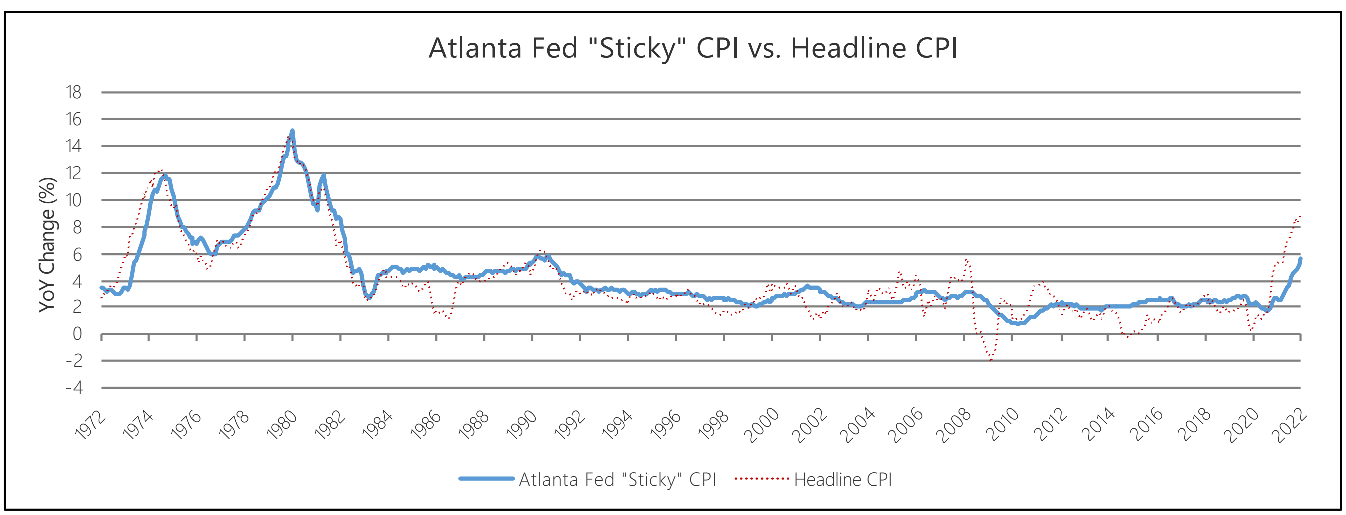
The green line shows the best performing index's returns during a given period, and the red line shows the worst performing index's returns. Historically, even in a period when one asset class performs very poorly, another asset class has generated positive returns to help offset the pain. This has traditionally been best represented by the counterbalancing effect of having both stocks and bonds in a portfolio; when equity markets perform poorly, bonds have historically acted as a safe haven. Alas, the orthodoxy broke down in this period of rapidly rising rates and growing economic headwinds. As highlighted by the blue box, this was the first time in the past 30 years that the best and worst index were both negative during the same six month stretch.



Source: Bloomberg (Data as of 6/30/2022)

A STICKY SITUATION

With high inflation proving to be a much more formidable foe than initially anticipated, investors have become increasingly attentive to each Fed news conference for hints at how far the central bank will go to fight rising prices. Much has been written on the topic, but we want to highlight a novel metric from the Atlanta Fed that may offer a unique insight on the path forward. Specifically, the chart below shows the Atlanta Fed's "Sticky CPI" reading (blue) over the last 50 years. Unlike the traditional Consumer Price Index (dotted red), the Sticky CPI only looks at the inflation rate for goods and services that historically exhibit muted price changes. For instance, energy costs or commodities may experience dramatic price swings, but categories like rents and food costs generally experience less volatility from period to period. After decades of quiescent readings, this metric has broken out to multi-decade highs and is approaching levels last seen in the 1970s and 1980s.



Source: Bloomberg (Data as of 6/30/2022)

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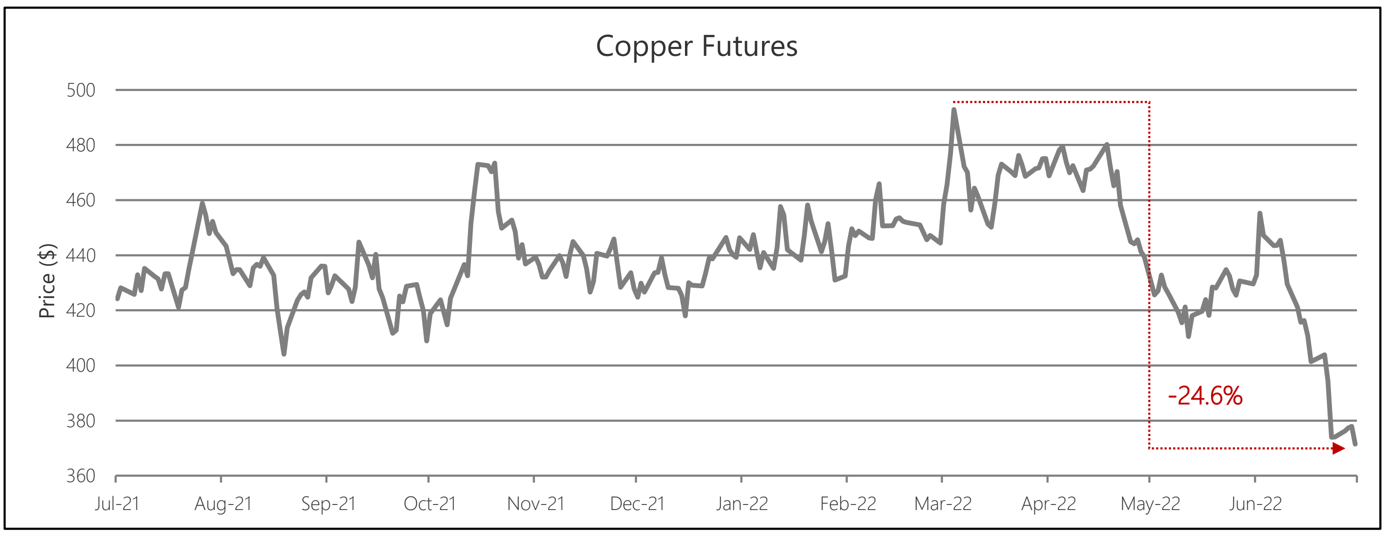
Headline CPI approaching 10% rightfully attracts a great deal of attention, but the policy implications of elevated "sticky inflation" might be even more important for investors to consider. If elements of the economy that traditionally help to keep inflation moored around the Fed's 2% target become unanchored to the upside, the Fed may have to work even harder to get the proverbial inflation genie back in the bottle. Practically speaking, that could mean more interest rate hikes than currently anticipated and a dogged commitment to getting runaway prices under control—even if it means causing more pain in the stock market.

THE METAL WITH A PH.D.

With inflation running stubbornly hot, investors have looked to real assets, like commodities, as a way to profit from rising prices. Oil and gas prices have surged in the wake of Russia's invasion of Ukraine, but a curious, divergent trend has emerged within the industrial metals sector. Specifically, the price action of copper is worth noting. Given its extremely broad set of uses—ranging from automotive manufacturing to housing to electronics—copper has "a Ph.D. in economics", providing investors with real-time insights into the health of the global economy and business cycle. When copper prices are rising, it generally reflects cyclical strength and robust growth. Conversely, when copper prices begin to fall, it can be an early warning sign that a period of economic weakness is on the horizon.

What is Dr. Copper telling us about the current situation? As seen on the chart below, prices are down nearly 25% since the end of Q1. Perhaps some of this can be attributed to the world's largest consumer of copper—China—experiencing ongoing economic headwinds, but the bigger concern for investors is that copper may be signaling a deeper growth slowdown than many are predicting.



Source: Bloomberg (Data as of 6/30/2022)

As we will discuss in the next section, if the "valuation reset" phase has already concluded, perhaps the weakness in copper represents the next phase of the cycle—an economic downturn that will hamstring corporate earnings. Alternatively, copper could be signaling an inflationary peak and impending price declines, which would be a welcome development. While the exact prognosis remains unclear, Dr. Copper is suggesting that a regime shift is underway.

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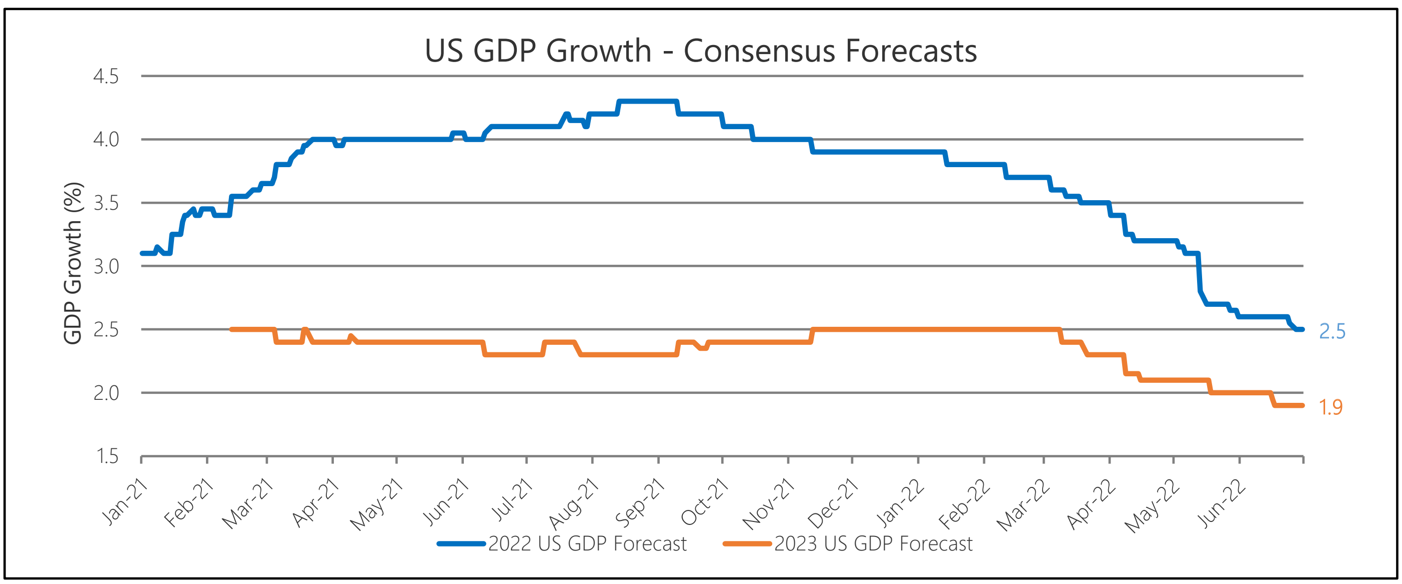
The Next Shoe to Drop?

On the heels of a painful decline across asset classes to start 2022, investors have rightly wondered if dismal performance in Q2 marked the denouement of a short-lived market reset or if it simply concluded act one of an extended bear market. Optimists will point to the huge amounts of excess savings accumulated during the pandemic and household balance sheets that are in strong shape. After all, consumption represents roughly 70% of US GDP, so a resilient consumer could keep an otherwise vulnerable economy afloat. The pessimists will point to stubbornly high inflation sapping spending power and consumer confidence, emboldening the Fed to continue its aggressive tightening trajectory. If the Fed is powerless to fix supply chains, then it must moderate inflation by tamping down demand—implicitly a mandate to reduce growth.

The optimistic scenario is relative straightforward; the selloff reset market valuations so they were appropriate relative to the Fed's more hawkish posture, and the irrepressible US consumer will keep corporate earnings buoyant. In that case, stocks should resume their upward trajectory off the new, rationalized baseline.

Alternatively, the negative scenario would suggest that the valuation reset was the first of a two-step process. The next shoe to drop would be a wave of negative earnings revisions—companies slashing guidance and analysts cutting expectations. If the "E" of the P/E, or price/earnings, ratio starts to deteriorate, valuations would no longer look like bargains, necessitating another re-rating of stocks. How would this process play out? We unpack the key elements via a series of charts below.

- The first chart shows economists' consensus real GDP estimates for 2022 (blue) and 2023 (orange), per Bloomberg. After reaching nearly 4.5% last year, 2022 growth forecasts have been slashed dramatically, now sitting at roughly 2.5%. While not as dramatic, 2023 growth estimates have also been revised lower, suggesting that the economic slowdown will not be a short-lived phenomenon. Nominal growth may remain elevated thanks to high inflation, but declining real growth reflects a fundamental economic deterioration.



Source: Bloomberg (Data as of 6/30/2022)

- The second chart illustrates a proxy for S&P 500 margins. Specifically, the green/red bars plot the difference between the Consumer Price Index (CPI) and the Producer Price Index (PPI). If producer price inflation is exceeding consumer price inflation, it would suggest that companies are unable to fully pass-through higher input costs—materials, labor, capital, etc.—to their customers and that margins will compress. As evidence of this relationship, we have also included S&P 500 operating margins in blue on a

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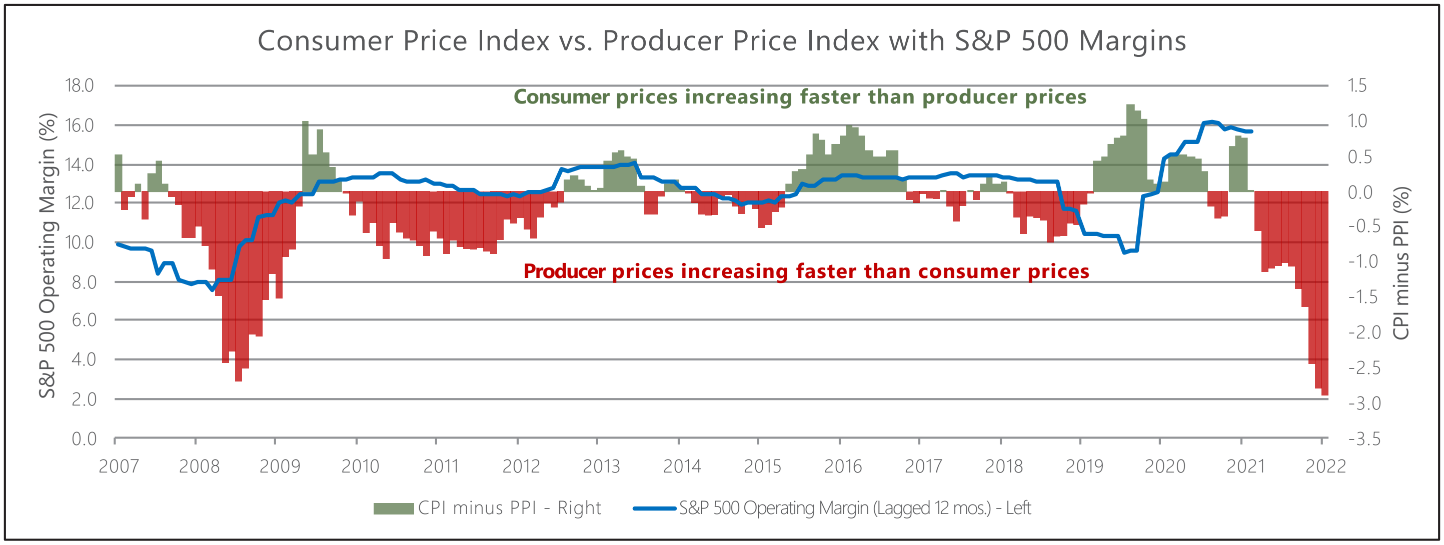
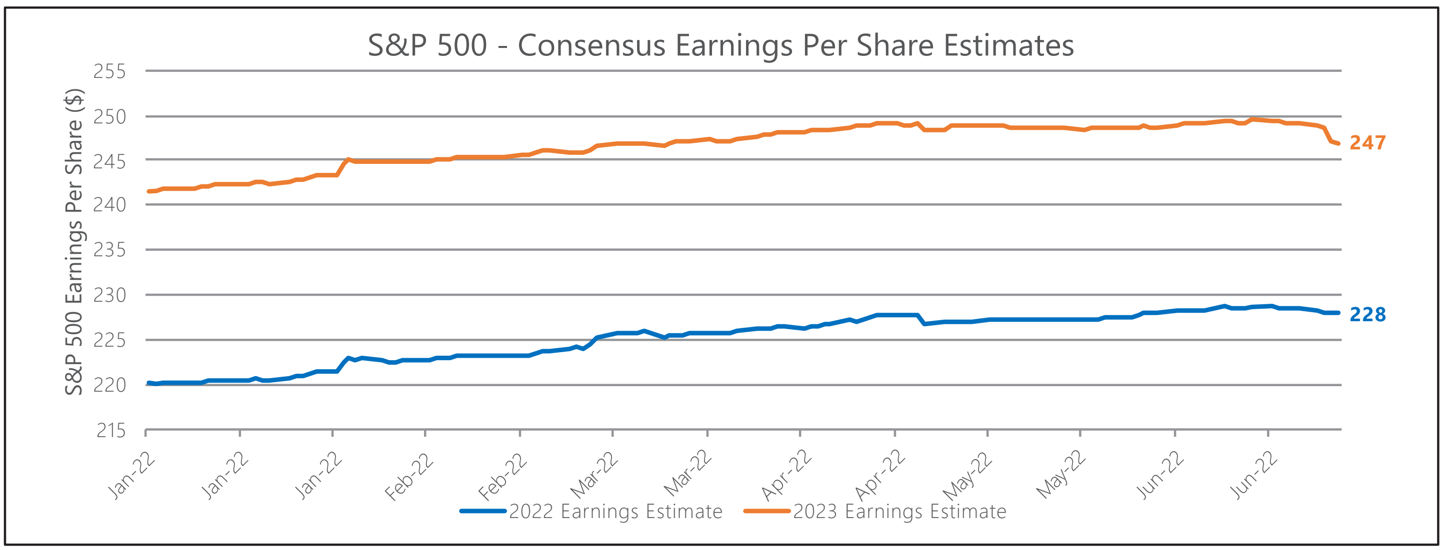
12-month lag. While the fit is not precise, our CPI/PPI proxy has been directionally predictive for margins and would imply that S&P 500 earnings are likely to be squeezed over the coming quarters.



Source: Bloomberg (Data as of 6/30/2022)

- The final chart shows consensus estimates for S&P 500 earnings in 2022 (blue) and 2023 (orange), per Bloomberg. With the economy's "top-line" growth (i.e., GDP) decelerating and operating margins looking vulnerable, some investors may find it difficult to reconcile the positive revisions to earnings expectations YTD. A wave of earnings downgrades could be the catalyst for the final leg down in this bear market.



Source: Bloomberg (Data as of 6/30/2022)

The US has an impressive track record of consumption—sometimes of a "conspicuous" nature—even when facing economic headwinds. However, the current high inflation regime is unlike anything Americans have experienced in recent decades. How markets respond to the current environment remains to be seen, but we would advise considering all scenarios in what amounts to uncharted territory for most investors.

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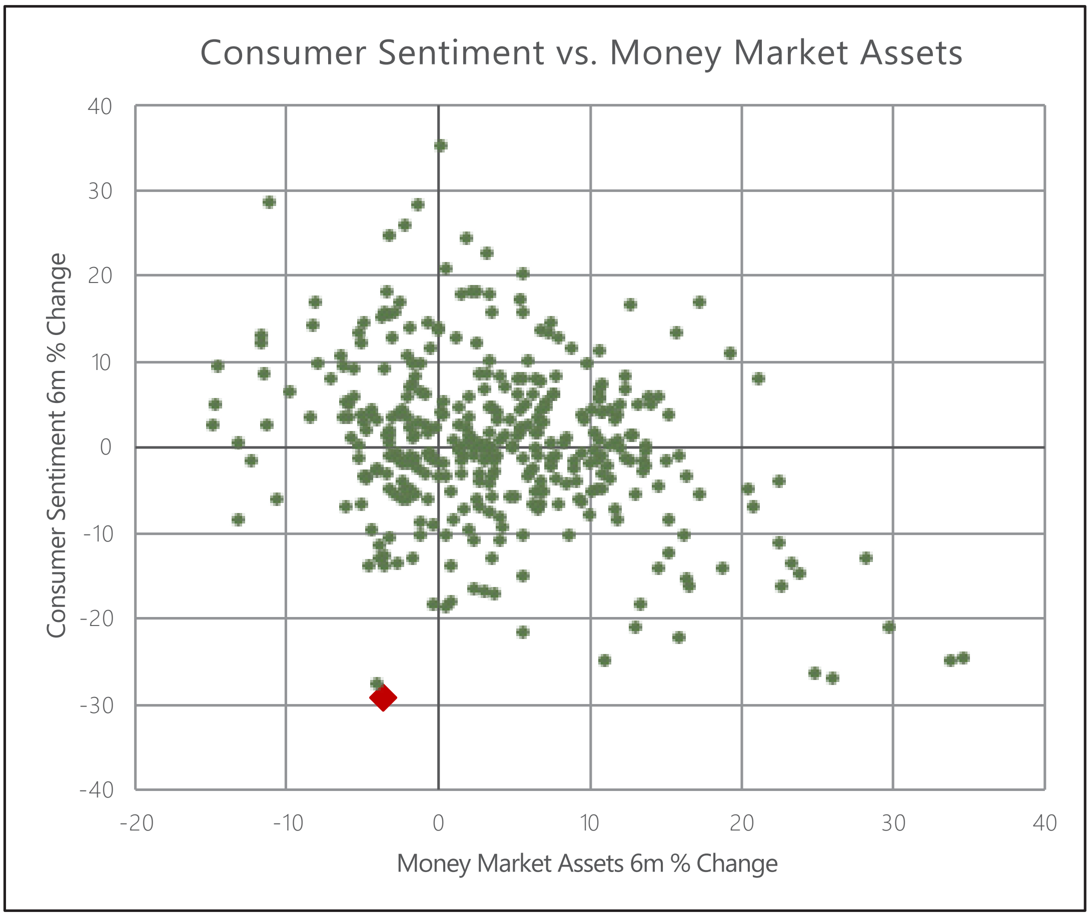
Chart of the Quarter

A narrative being discussed more frequently in the financial media is that sentiment has become so negative that it should be difficult for risk assets to trade much lower. If everyone is already bearish, who will be the marginal seller? While we are sympathetic to this brand of contrarianism—i.e., being greedy when others are fearful à la Warren Buffet—we also like to question an argument's underlying assumptions. In that spirit, the Q2 Chart of the Quarter explores the concept of investor sentiment in greater detail. While it may be true that sentiment measures have hit stretched levels in a historical context, what investors are saying appears to tell a different story than what they are doing.

The chart below looks at the six-month change of consumer sentiment (as measured by the University of Michigan Consumer Sentiment Index) relative to the six-month change of assets held in money market funds for the last 30 years. This is a noisy data set, but a trend becomes apparent in the lower-right quadrant of the chart. Specifically, when sentiment data experiences a dramatic decline—i.e., a 20% or more drop for the U of M survey—there tends to be a large inflow of assets into money market funds. Intuitively, this makes sense; as investors become more fearful about the state of the economy, they sell risky assets and hoard cash.



Source: Bloomberg (Data as of 6/30/2022)

That brings us to where we sit today. The red diamond on the scatterplot shows the June 30, 2022 reading. The trajectory of consumer sentiment this year has been definitively downbeat, with the U of M survey falling nearly 30% over the last six months. However, money market funds have seen net outflows YTD—hardly consistent with a broad state of panic and fear. Perhaps this is an indication that investors have been conditioned to "buy

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the dip" in recent years, counting on the Fed to backstop markets after enough pain has been felt. Equity mutual funds and ETFs have seen net inflows of roughly $67 billion YTD (per Investment Company Institute data), which would suggest that at least some of the cash has ended up in stocks.

The other similar data point came in August 2011 and offers a more upbeat comparison. At that time the US had just experienced a downgrade of its credit rating, investors were worried about a double-dip recession post-financial crisis, and the S&P 500 had already fallen roughly 15%. Markets continued to tumble over the ensuing month but finished higher by the end of the year before posting heady gains in 2012.

Whether you choose the optimistic interpretation or the skeptic's view in this case, perhaps the bigger point is not fixating on reductive narratives that can miss important context.

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