Economy & Market Review

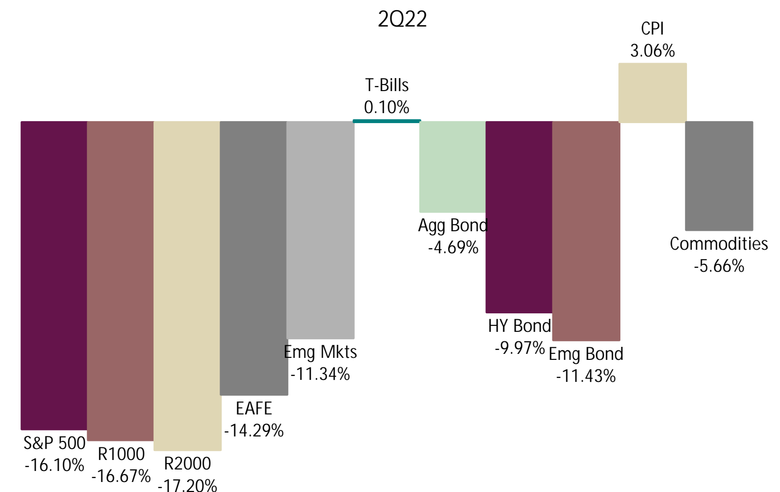
Second Quarter 2022

The rocky first quarter of the year now appears tame compared to the tumultuous second quarter. With historically high inflation presenting a challenge for household purchasing power, the Federal Reserve (Fed) proceeded to increase the Fed Funds Rate in the first half of the year. Increasing interest rates reduce the attractiveness of current bonds sending their prices lower and returns negative. Normally, when equity markets fall as they have over the first half of the year, the economy is on the brink of recession and US treasuries become a haven in the storm. This obviously hasn't occurred as rising rates have caused bonds to lose money in coordination with stocks. US large cap stocks dropped 16.1%, US small caps fell even further down 17.2%, non-US stocks were down 14.3%, and emerging market equities fell 11.3%. After plummeting 5.9% in the first quarter of the year, bonds fell another 4.7% during the 2nd quarter. Those back-to-back quarters produced one of the worst returns for the Bloomberg Aggregate Bond Index in history.

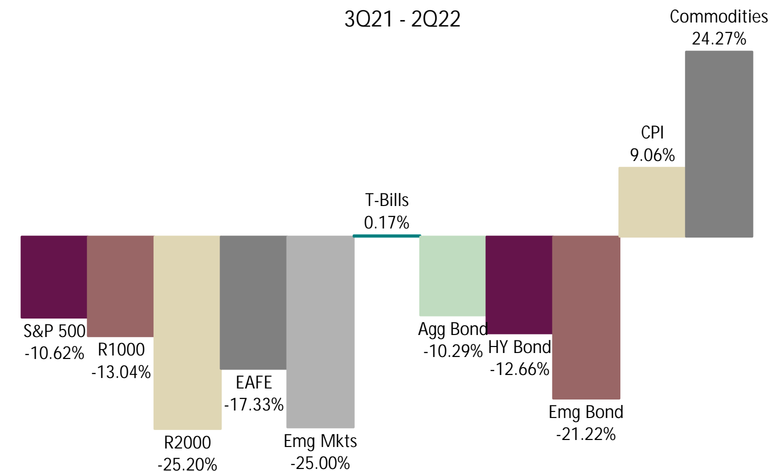
Not only is the Fed raising rates to quell inflation, but it is also attempting to reduce its balance sheet. Both of these should cool aggregate demand and minimize inflationary pressures by pulling liquidity from the system. Investors question whether the Fed can accomplish the task of reducing inflation without sending the economy into a recession. This so called “soft landing” will be experimental for a Fed that has historically been a bit out-of-touch. So far, the job market remains strong. The unemployment rate recently held steady at 3.6% (near the pre-pandemic low) and the US Labor Department showed 372,000 jobs added in June above the 368,000 estimate. Many other areas of the economy don't look as rosy. In the first quarter, US Gross Domestic Product (GDP) contracted 1.6% and the Atlanta Fed estimates second quarter GDP declining by 1.2%. Technically, two quarters of negative growth is a recession, but the National Bureau of Economic Research (NBER) may point to the strong labor market and waive off the official recession proclamation. Investors that were all too happy to buy stocks and bonds at the recent peak in November are now very cautious after the pull-back. For long-term investors this may be a once in a generation buying opportunity. Even though it doesn't seem like we've seen selling capitulation (total submission) in market participants, it seems like a reasonable time to continue to dollar-cost-average into this market.

Global Market Performance

Quarter Performance

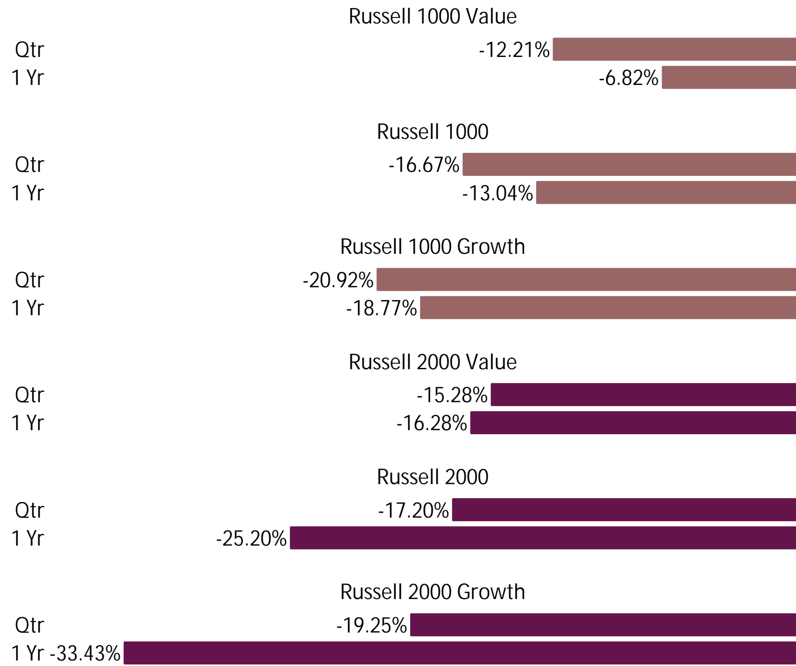


One Year Performance



U.S. Equity Markets

U.S. Equity Style Performance

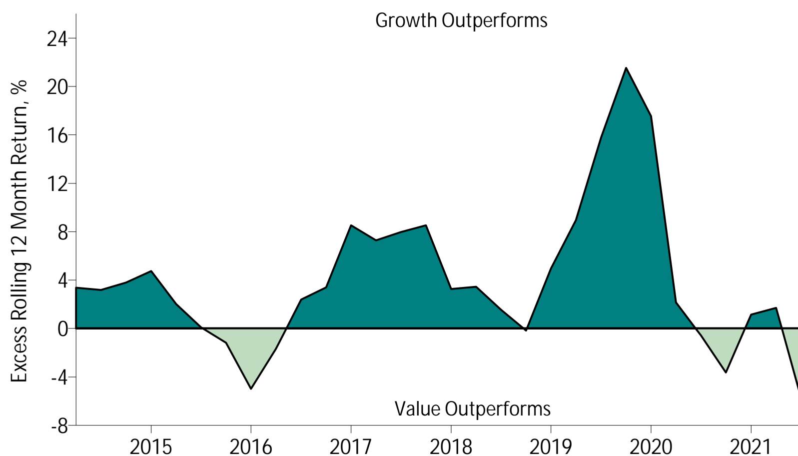


Equity markets completed the transition from a minor reset in the first quarter of 2022, to a much larger reset in the most recent quarter. The S&P 500 Index of large cap stocks decreased 16.1% during the quarter and small cap stocks as measured by the Russell 2000 Index fell even more. With the additional market drawdown in the second quarter, based on Price-to-Earnings (P/E), US stock valuations appear just below the 25 year average. So still not inexpensive and many other valuation metrics still register above their respective 25 year averages.

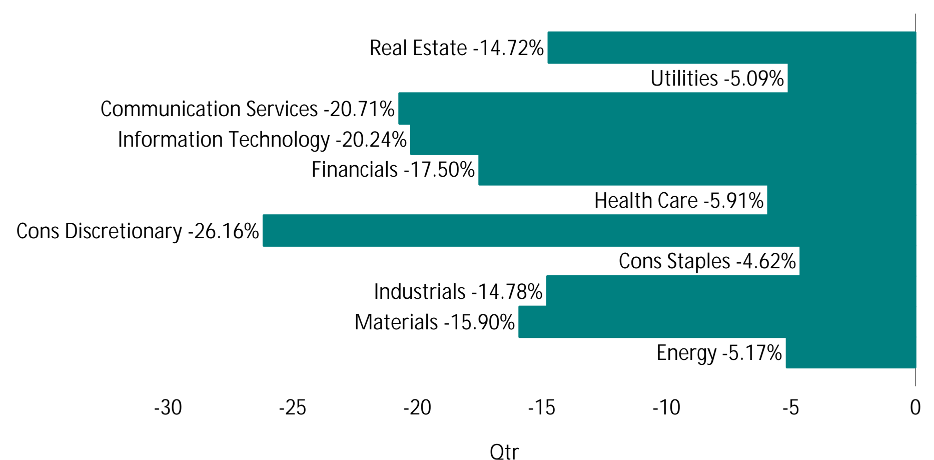
During the quarter, value stocks continued their recent outperformance relative to growth stocks, but towards the end of the quarter as recession talk increased, growth stocks found some buyers. In recessions, investors look for companies that can leverage sales and earnings growth (growth companies). Based upon a comparison of current P/E to 20-year average P/E, mid-cap and small-cap trade at a discount. Small growth in particular trades at only 65% of the 20 year average, the most reasonable valuation in recent memory.

With broad stock indices falling precipitously during the quarter, there were no sectors providing safe harbor in the storm. Defensives such as Consumer Staples, Utilities, and Health Care were the best relative performers, but still negative on an absolute basis. Just like last quarter, Communication Services, Consumer Discretionary, and Technology sectors were the worst performers.

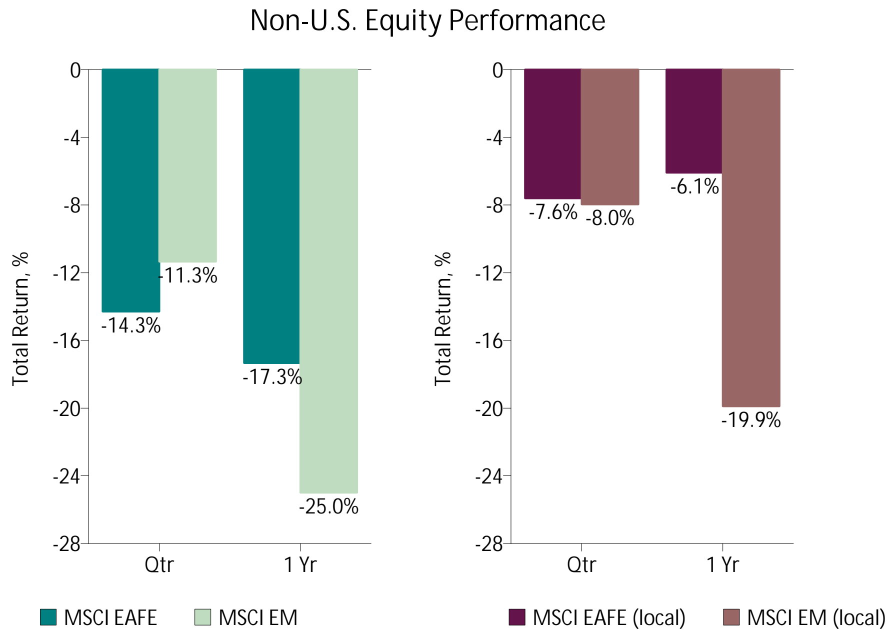
Growth Relative to Value (Russell 1000)



U.S. Equity Sector Performance (S&P 500)

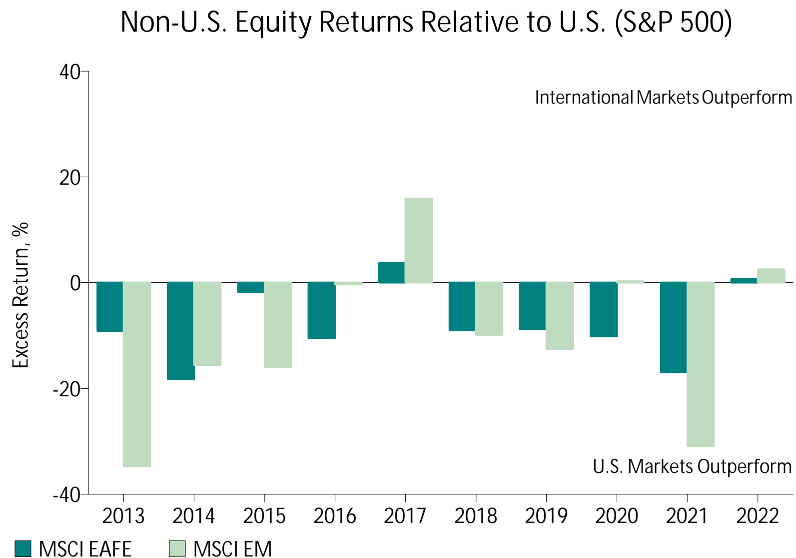


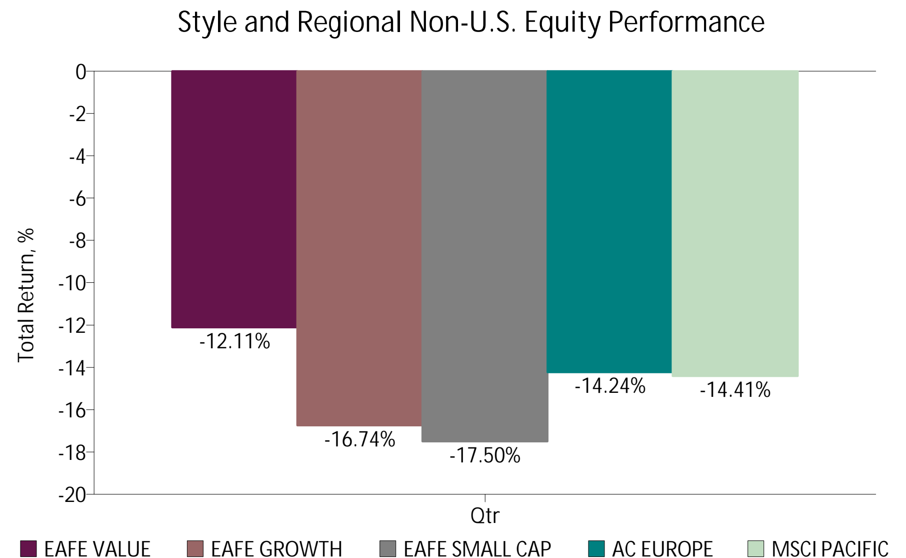
International Equity Markets



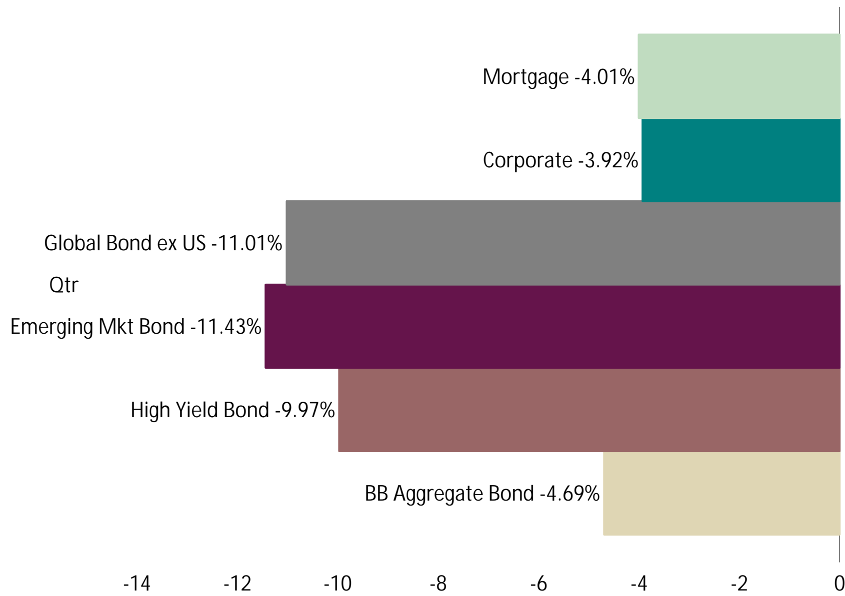
Although negative, like all other global equities, emerging markets (EM) relative returns were the best house on a blighted block. China continues to struggle with COVID, as Shanghai just exited a nine week lockdown. This led to a sharp slowdown in economic activity and exacerbated strains to supply chains. The Chinese government responded to the slowdown by announcing a wide-ranging stimulus package consisting of 33 measures in support of infrastructure, platform companies, renewable energy, autos, and appliances. Challenges aside, the Chinese stock market still produced outperformance relative to other nations.

With all the trials in the Eurozone, it's somewhat surprising the MSCI EAFE Index, a proxy for international developed equity markets, was down 14.3% during the quarter, outperforming US markets. Inflation is taking a toll across the world but especially in developed international markets. The Russia-Ukraine war continues to have wide ranging impact on energy and food prices, supply chains, inflation, and interest rates. Limitations to exports of Ukrainian grains and Russian fertilizer have significantly raised prices throughout the agricultural value chain, leading to strains in food supply, in part driving social unrest in nations such as Sri Lanka.



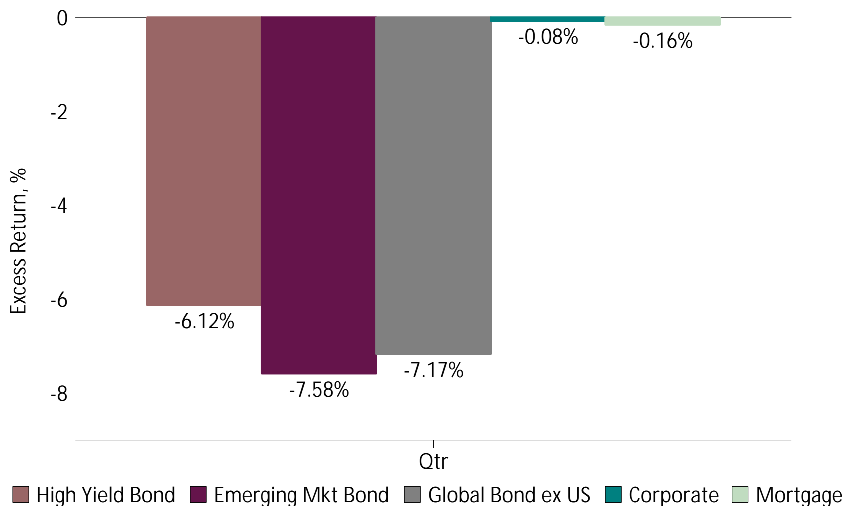


Fixed-Income Markets



The first half of 2022 was dominated by quickly rising rates. For the first time in many years, the Fed is aggressively raising rates in an effort to reduce inflation and maybe more importantly inflation expectations. Right now the Fed's tough stance on inflation is causing the dollar to strengthen even further placing additional pressure on international and emerging market's inflation. This circular challenge forces foreign central banks to tighten so that they don't lose their inflation fighting credibility. As a result, the Global Bond Ex-US and Emerging Market Bond Indices were both down over 11% for the quarter. This was much worse than the US Bloomberg Aggregate Index which was down 4.7%. As the market digests the possibility of slowing growth and possible recession, corporate credit spreads have been widening. This is most noticeably seen in the high yield market. As spreads widened, the High Yield Bond Index was down nearly 10% during the quarter.

As the Fed pushed short rates higher, it has also been a pretty bumpy ride for longer-dated maturities. The US 10-year yield started the quarter at 2.39% only to burst out to 3.49% by mid-June. Since then, as recession fears have become more prevalent, the yield fell precipitously in just a few weeks back to 2.82%. The 2-10 year yield curve now is slightly inverted with the 2-year yield slightly more the 10-year yield.



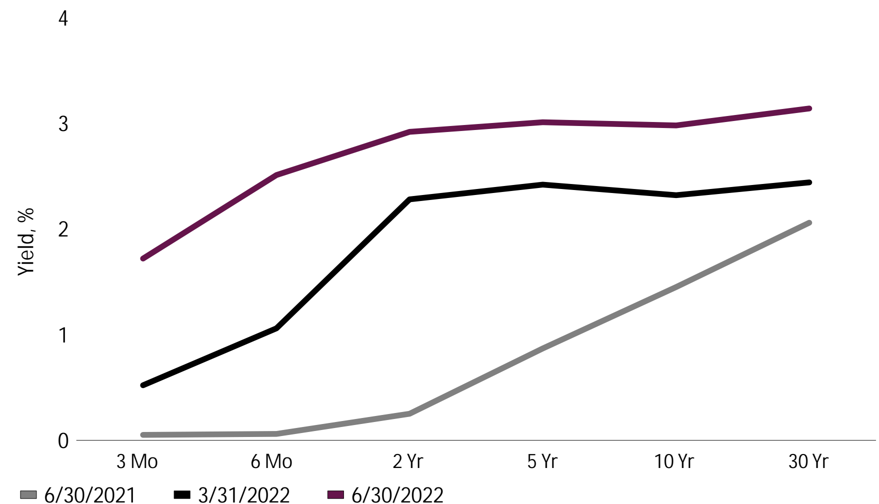
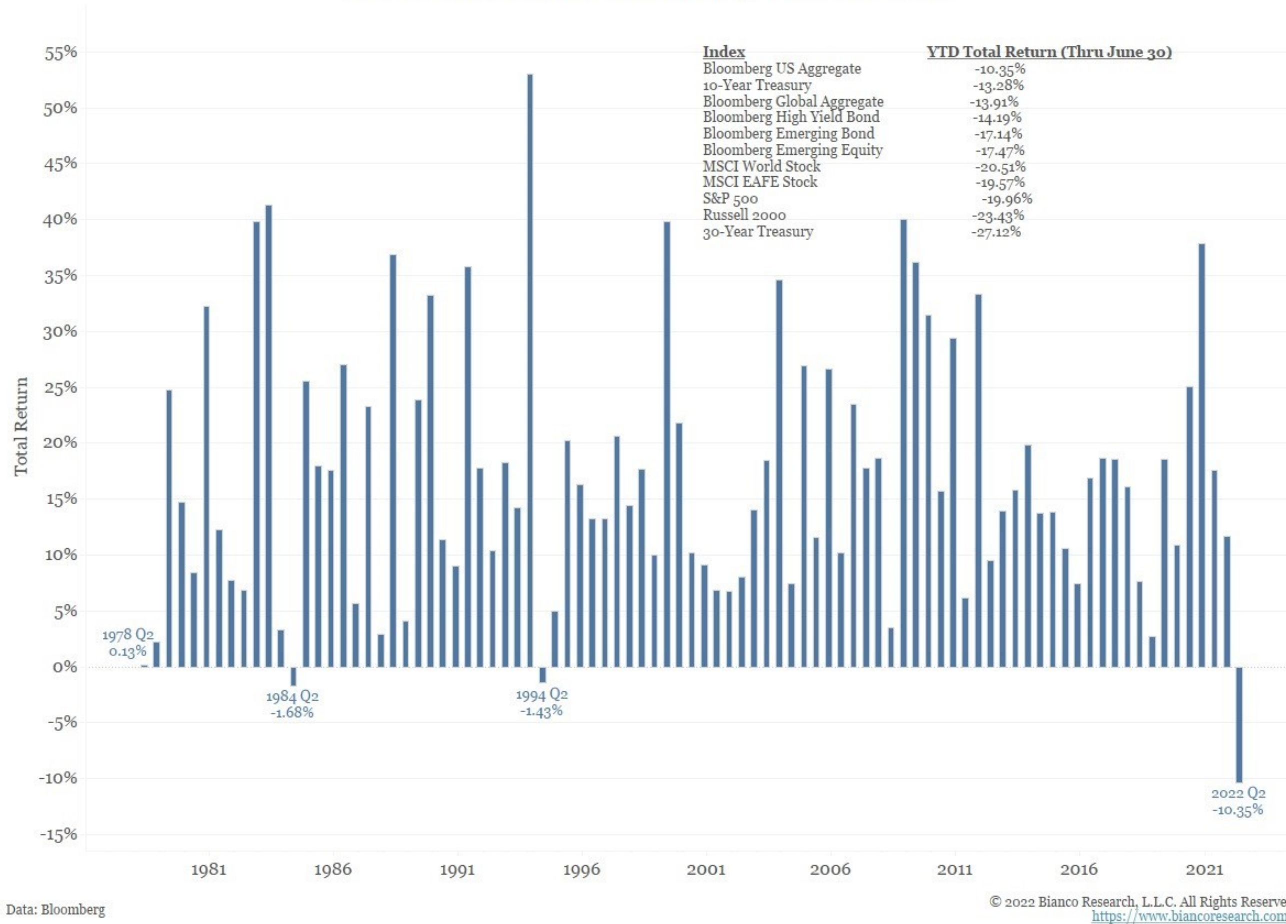


Chart of the Quarter



You Can't Be Serious - The Best Return in 2022 is -10.35%

At the halfway point of the year, 2022 continues to produce some of the most extreme returns in history. The chart above illustrates just how abnormal this year has been through June. Among financial assets (excluding commodities), there has been no shelter from the storm. Of the list of bonds and stocks, both here in the U.S. or global shown in the list above, not a single asset provided a positive return. The U.S. Aggregate Bond Index provided the smallest loss at -10.35%. Nothing like this has been seen since at least the 1970s.