Investment Newsletter

Second Quarter 2022

Stock market performance globally was exceptionally poor in the quarter. The S&P 500 Index declined -16.20%, culminating in its worst first half performance since 1970, and the MSCI All-Country World ex-U.S. Index declined -13.73%. It is, however, important to recall that the S&P 500 Index was up +28.04% last year, the sixth-best performance since 1990, as well as to note that it is still up +13% above its pre-pandemic high.

The key negative catalyst was the May report of the Consumer Price Index (CPI), which showed inflation up +8.6%, worse than expected, and the largest 12-month increase since December 1981. The heavy response to the COVID-19 pandemic – massive fiscal spending, easy monetary policies, and lockdowns – overstimulated demand while creating new global supply chain bottlenecks which jointly caused this resurgence in inflation.

The May CPI report not only caused a -12.4% decline in the S&P 500 over just seven trading days, but it also caused the Federal Reserve to accelerate the pace of its interest rate increases over the course of the year. In fact, investors are now expecting interest rates at 3.00-3.25% by year-end, up from 2.00-2.25% previously. Moreover, central banks globally are following suit by raising interest rates to ward off inflation, causing investor concern that economic growth will slow and potentially trigger a recession in many countries.

Other drivers of the stock market's poor performance include the ongoing pandemic-induced disruption in the global supply chain from Asian manufacturing, the grinding Russia-Ukraine war and the ramifications of global financial sanctions on Russia, slumping business and consumer confidence, a significant reduction in government transfer payments to consumers as pandemic restrictions ease, global geopolitical strife, a rocketing U.S. Dollar trading near a 20-year high, weakening economic and corporate earnings growth, and concern that the economy is entering a period of 'stagflation' (stagnant growth plus inflation).

For fixed income, yields rose in response to the Federal Reserve aggressively raising interest rates to combat inflation. The Bloomberg U.S. Intermediate/Government Index declined -2.37%, and the Bloomberg Municipal Bond Blend 1-5 Year Index declined -0.02%. For the second quarter in a row, returns were negative across all maturities except for short-maturity Treasury bills. Year-to-date returns have not been this low since 1980.

Longer maturities have been hit particularly hard by rising interest rates since they had fallen to historically low levels over the past two years. For example, the return on the 30-year U.S. Treasury bond has fallen over -25% year to date as yields rose to 3.12% at the end of June from 1.90% at the end of December. While this sounds shocking, bond yields in the 3.00% range are still very low on an historical basis, and since late 1979, long-maturity bond yields have averaged over 6.00%. Over the same period, 10-year U.S. Treasury note yields have averaged 5.80%. The decline in interest rates from 2008 to 2020 under the Federal Reserve's Quantitative Easing (QE) policy was unprecedented and unsustainable. We are seeing this unwind now.

While yields have risen across all maturities, they have risen more on maturities under three years, reflecting the Federal Reserve's increase in interest rates. We expect this pattern to continue as investor expectations for higher interest rates and a slowing economy and lower future inflation get priced into longer maturities. Yields on longer maturities will likely not rise as much if the economy slows or recession fears mount.

Our fixed income strategy remains conservative and defensive, focusing on shorter maturities to preserve capital. We will opportunistically purchase bonds with slightly longer maturities to lock in higher coupons and yields. Our objective is to increase the average coupon and yield of the portfolios as interest rates rise.

While the drivers of the poor performance for both equities and fixed income clearly worsened sequentially from the first quarter, there are several positive developments worth noting:

- Inflation may be peaking. The most recent report on the Personal Consumption Expenditures (PCE) Index – the Federal Reserve's main inflation gauge used for setting monetary policy – came in lower than expected. Moreover, bond yields and commodity prices both have corrected significantly. The yield on the 10-Year U.S. Treasury note has declined to 2.82% from 3.48% on June 16, and the Refinitiv/CoreCommodity CRB Index – the most widely tracked index for commodity prices – has declined -15.6% from its high in early June.

- The pace of the Federal Reserve's interest rate increases could be curtailed sooner than investors expect. This is due not only to potentially peaking inflation expectations, but also because of weakening economic growth. First-quarter real GDP growth was -1.6% and second-quarter growth is forecasted to be -1.0%, which would meet the technical definition of a recession (two consecutive quarters of negative growth).

- Corporate earnings comparisons get easier in the second half of the year. Although corporate earnings growth is expected to be challenging in the upcoming second-quarter earnings season, earnings growth in the second half of 2022 and into 2023 will be aided by easing earnings growth comparisons.

- The stock market's valuation has improved to a more reasonable level. The S&P 500 now trades at 15.9x forward earnings, a -5.7% discount to its 10-year average of 16.9x, and down from 22.5x in April 2021.

- There has been a significant reduction in speculative investing. The prices of cryptocurrencies, meme stocks and SPACs have all dropped sharply. Bitcoin has crashed -70% since its all-time high in November.

- The U.S. unemployment rate is low at 3.6% and the global economy is still in the process of fully reopening.

- The more the Federal Reserve can reduce its unsustainable easy-money policies it put in place since the Great Recession of 2008, the healthier and more self-sustaining the economy can be over the long term.

Despite these evolving positive developments, the investment environment is expected to continue to be a challenging one, characterized by uncertainty and elevated volatility. We have responded to this challenge in three ways: 1) by reinforcing our disciplined investment strategy to find companies with the right qualities to maximize investment performance – ones with good growth, reasonable valuations, low debt and superior business models tied to the most compelling long-term secular trends; 2) by structuring appropriate and forward-looking asset allocation for client portfolios; and 3) by taking advantage of higher fixed income yields to increase portfolio income.

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Sources: Federal Reserve Bank of Atlanta, Strategas, Bloomberg and FactSet