Market Review & Outlook

July 2022

2022 is proving to be one of the more challenging years in financial market history. Over the first six months of 2022, the S&P 500 index tumbled almost 20% amid high inflation expectations and a hawkish Federal Reserve, whose rate-hike plans could push the U.S. economy into recession. According to Dow Jones markets data, it was the worst first half performance for the senior index since all the way back in 1970 when it lost 21%.

Investor sentiment has suffered along with stock prices, and many market analysts expect more downside for stocks. The 12 bear markets since World War II (not including the current one) lasted an average of 10 months from market peak to trough, with an average drop of 34%. Assuming the current bear turns out to be "average," that means stocks could bottom later this year in October. Of course, there is much variability in the data, and given that each bear market has unique characteristics, comparisons to previous episodes don't always provide investors with a useful roadmap.

Index	June 2022	2nd Qtr. Perfomance	YTD Performance	One Year	Description (what the index is comprised of)
S&P 500	-8.25%	-16.10%	-19.96%	-10.62%	Large cap stocks
DJ Industrial Average	-6.56%	-10.78%	-14.44%	-9.05%	Large cap stocks
NASDAQ Composite	-8.65%	-22.28%	-29.23%	-23.43%	Large & mid cap tech stocks
Russell 1000 Growth	-7.92%	-20.92%	-28.07%	-18.77%	Large cap growth stocks
Russell 1000 Value	-8.74%	-12.21%	-12.86%	-6.82%	Large cap value stocks
Russell 2000 Growth	-6.19%	-19.25%	-29.45%	-33.43%	Small cap growth stocks
Russell 2000 Value	-9.88%	-15.28%	-17.31%	-16.28%	Small cap value stocks
MSCI EAFE	-9.28%	-14.51%	-19.57%	-17.77%	International stocks
MSCI EM	-6.65%	-11.45%	-17.63%	-25.28%	U.S. Government bonds
Credit Suisse High Yield	-6.60%	-9.66%	-13.42%	-12.09%	High yield corporate bonds
Bloomberg Agg. Bond Index	-1.57%	-4.69%	-10.35%	-10.29%	Primarily US Gov't Bonds + Inv. Grade Corporates

A particularly painful part of the current bear has been the dismal performance of bonds, which are supposed to be the "conservative" asset class you include in a portfolio for income and to balance the volatility and risk inherent in stocks. For much of the past 20 years, bonds have been inversely correlated with stocks, meaning that when stocks were performing poorly, bonds were generally doing well or at least not going down.

This relationship has changed recently. 1994 used to be held out as the "worst year ever for bonds" (at least in the US), when the aggregate bond index lost slightly less than 3%. Since its peak at the beginning of 2021, the Bloomberg Global Aggregate Bond Index has lost nearly 18%. Even with US Treasury bonds performing better the past couple of weeks, the US Aggregate Bond Index is still down 10.35% year to date through June, resulting in the traditional 60% stock-40% bond "balanced" portfolio recording its worst first half performance ever. Looking back at history, investors have never seen both stocks and bonds decline so quickly at the same time.

However, with global growth slowing, there are some signs that interest rates are peaking, meaning the pain in the bond market could be ending, at least for US Treasuries and other "safe" sovereign bonds. Even if bonds do well over the remainder of the year, 2022 will almost certainly finish as the worst year for bond investors in the modern era. In an investment note released last week, Deutsche Bank said one must look back to 1788 to see first half global bond losses worse than what we have experienced this year. For a more detailed look at how various asset classes performed in recent periods, please refer to the table.

Coming off a two-year global pandemic when governments forced widespread economic shutdowns, the current setup is unlike anything we've seen in the past. The modern global economy is a complex system comprised of countless interconnected parts developed over many decades. Given the unknown potential cost in human lives and suffering, global political leaders felt the economic shutdowns were a necessary precaution. The obvious downside is that it was also unknown how the global economy might recover from being locked down. Turning it back on is not like turning on a light switch, and 18 months on from when vaccines became available, supply chains are still a mess.

The lockdowns meant less people working and less production, which constrained supply. On the demand side, you had governments sending stimulus checks to people who would normally be working but instead were home ordering products from Amazon. In the US alone, $5 trillion in fiscal stimulus was passed by Congress during 2020-2021. Economist Milton Friedman famously said: "Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." Not only did the global money supply grow rapidly during the pandemic, but the output of goods also slowed dramatically, and the result has been increasingly higher inflation since the first few months of 2021.

The Russia-Ukraine war has been another factor as both countries are major sources of important commodities and food products. In addition, with Russia being the world's largest exporter of natural gas and second largest of oil, the conflict contributes to inflation because of the sanctions levied against Russia and halted production in Ukraine. As the sanctions remove key supplies from the global economy, it keeps upward pressure on the prices of those supplies.

For much of last year, the Federal Reserve had maintained that inflation was "transitory" because of pandemic-related factors. Higher and more persistent inflation finally forced it to hike interest rates after many years of loose monetary policy. At its June 15 meeting, it announced an interest rate hike of 0.75% in an attempt to cool the economy and slow inflation. This was the largest interest rate hike since 1994 and comes on the heels of a 0.50% hike in May and a 0.25% increase in March.

A major challenge is the Fed had never in history raised rates with the economy at stall speed and a stock market already headed for a bear market, defined as being down 20% from an all-time high, which the S&P 500 hit on January 3. Indeed, according to the Bureau of Economic Analysis (BEA), the economy had already slowed at a 1.6% annual rate during the 1st quarter of this year. Moreover, as of July 1, the Atlanta Fed's GDPNow model was predicting the economy declined at a 2.1% annual rate during the 2nd quarter.

This model has never been off by more than 0.30% in a quarter, meaning we were likely already in a recession when the Fed hiked rates the first time in March. As interest rates are a blunt tool, many economists have accused the Fed of causing recessions in the past by raising rates too much. Heading into a recession is normally when the Fed would be lowering rates. Given the lagging effects of monetary policy, it will be interesting to see how things unfold over the next 6-9 months. The futures market is already starting to price in interest rate cuts next year, which contrasts sharply with the Fed's hawkish public posture about higher rates.

What does this mean for investors? With growth slowing and costs rising, corporate earnings forecasts are almost certainly too optimistic and will need to be revised lower. Retailers like Wal Mart and Target have already lowered guidance, as have many consumer discretionary companies. Also, 40% of the S&P 500 earnings come from overseas and converting those earnings back into dollars means lower profits with the dollar up almost 10% this year against a basket of foreign currencies. The stock market is a forward discounting mechanism. It's possible lower margins and earnings have already been priced into stocks, but that is predicated on how severe the growth slowdown turns out to be.

Already, inflation expectations have begun to come down as recession fears have grown. Commodity prices have started to fall and oil prices have dropped 20% since earlier this year. If growth continues to slow and recent disinflationary trends persist, the Fed could turn dovish and back off its rate hike plans, but this is not the most likely outcome given official pronouncements. The last time it had to deal with inflation near current levels, then Fed-chairman Paul Volcker raised interest rates so much it caused a double dip recession in the early 1980s. Currently, recession is not the consensus forecast, and most economists who are forecasting one believe it will be mild.

In behavioral economics, the "wealth effect" is a theory which suggests people spend more as the value of their assets rise. The idea is that consumers feel more financially secure and confident about their wealth when their homes or investment portfolios increase in value. However, the wealth effect can work in reverse too and we have yet to fully see how the wealth destruction in the stock, bond, and cryptocurrency markets will affect consumption, which accounts for 70% of GDP. Sharply higher mortgage rates have already cooled an overheated housing market, and some are even predicting outright price declines given the eye-popping price increases the past two years. Ultimately, consumer behavior is going to determine how severe the slowdown is, and we believe risks remain to the upside if the Fed stays on course with rate hikes.

Back in 1970 when the market fell 21% during the first half, it gained 26.5% in the second half to eke out a gain for the year. However, that is just one data point and with the unprecedented nature of everything that's happened since February 2020, comparing then to now isn't particularly useful. While stock prices have already come down a lot, the valuation (P/E ratio) of the S&P 500 is still ~40% higher than the average since 1950 and history suggests the market could drop further if this turns out to be an "average" bear market. Still, for long-term investors, making a big change to their investment strategy in reaction to what's already happened is almost certainly a mistake unless personal facts and circumstances have changed.

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