

Fed Continues Fighting Stubborn Inflation July 2022

My Dear Client:



The end of the second quarter of 2022 saw consumer sentiment at record lows, inflation measures at 40-year highs and markets in free fall as the S&P 500 had its worst first half (-20%) since 1970. This has been a painful year for investors, with most U.S. equity benchmarks down 20% to 35% from their 52-week highs. Stocks, bonds, commodities, crypto currencies, and IPOs all took big hits as they responded to rising inflation, rising rates, global oil price shocks, the war in Ukraine, China lockdowns, food and energy shortages and the possibility of a recession. These factors reversed the course of surging post-COVID equity market.

To fight inflation, the Federal Reserve has started hiking rates and unwinding its gargantuan balance sheet, replacing quantitative easing with quantitative tightening via reducing its Treasury and mortgage bond holdings.

At the start of the year, markets were pricing in three 25bp rate hikes by the Fed for all of 2022. Instead, the markets have seen the Fed lead all central banks in hawkish behavior: At the last three Federal Open Market Committee (FOMC) meetings, the Fed hiked three times in increasing increments of 25bps (March), 50bps (May) and 75bps (June). That marked the first 75 bps rate hike since 1994.

Markets were pricing in a 50bps hike until three days before the June rate change, which occurred when the monthly CPI (May) and consumer sentiment (June) data came in much worse than expected, raising fears that inflation was becoming more entrenched. That same week, the Swiss National Bank surprised global markets with a 50bps rate hike, its first hike in 15 years. Brazil's central bank raised its lending rate 50bps and the Bank of England raised its by 25bps while cutting its Q2 GDP outlook to -0.3%. Many global central banks are playing catch up on inflation by rapidly tightening interest rates and liquidity, which negatively impacts global economies and capital markets, reducing the odds of a soft landing and increasing chances of a recession.

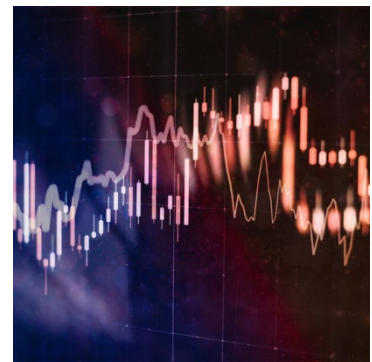
The second quarter of 2022 had negative returns across all major market segments. The U.S. equity market posted negative returns for the quarter and underperformed both non-U.S. developed and emerging markets. Value outperformed growth; small caps underperformed large caps. The U.S. stock market as measured by the Russell 3000 was down (-16.7%) for the quarter and is now down (-13.87%) for the trailing year. Large growth stocks as measured by the Russell 1000 growth index were down (-20.92%) for the quarter, pulling the Standard & Poor's solidly into bear market territory. Large value stocks as measured by this Russell 1000 value Index were down (-12.21%) for the quarter and were the best-performing domestic equity class for the quarter. Rising interest rates continue to put pressure on growth stocks as P/Es contract.

Economic measures of inflation remain elevated, with the most recent core CPI (May) excluding food and energy coming in at 6% year over year (YoY), down slightly from the peak of 6.5% YoY in March. Headline CPI (May) reached a new 40-year high of 8.6% YoY. Core PPI (May) was 8.3% (YoY), down from its recent peak of 9.6% YoY in March, while headline PPI came in at 10.8%, down from its recent peak of 11.5% in March. The PCE deflator (May) was 6.3% YoY, down from a high of 6.6% in March. Core PCE (May) came in at 4.7% YoY, down from the recent high of 5.3% in February.

We are starting to see some wobbling in the labor market, as CEO confidence has plunged and job cuts have picked up noticeably YoY. Though the unemployment rate still ebbs near all-time lows and “Help Wanted” signs, especially in the service economy, are everywhere, this is likely peak employment.

Domestic equity market

In terms of size in the second quarter of 2022 in U.S. markets, small stocks as categorized by the Russell 2000 underperformed large caps and were down (-17.2%) for the quarter and down (-23.43%) for the trailing year. Large stocks as measured by the Russell 1000 were down (-16.67%) for the quarter and (-20.94%) for the year. Value stocks significantly outperformed growth stocks with large value stocks falling (-12.21%) for the quarter while large growth fell (-20.92%). The worst-performing asset class for the trailing year is small growth, at (-29.45%), closely followed by large growth at (-28.07%).



Confirmation of the breadth and scope of the recent market decline is seen in that 10 of 11 S&P sectors are in the red YTD. Energy is the lone sector in the green +32% despite declining nearly (-5.3%) in Q2. All 11 sectors were lower in both June and Q2. Notable plunges include Consumer Discretionary, with a 25.5% decline in Q2, its worst quarter since its inception in 1989, while Communication Services and Technology each declined (-21%) and (-19.7%) in Q2. Financials fell (-17.5%) and Materials declined nearly (-16%), followed by Industrials (-14.8%) and Real Estate (-14.7%) as the biggest laggards. Consumer Staples (-4%), Utilities (-5.1) and Health (-5.9%) had the smallest drops for the period.

Q2 earnings season is on the horizon; reported earnings and management guidance are likely to have a significant impact on the stock market. According to Factset, 103 S&P 500 companies have provided guidance for Q2, of which 70% have been negative. This compares with the 5- average of 60% and the 10-year average of 67%.

The earnings growth rate is expected to be 4.3% which would mark the lowest since 4Q20 3.8%. Revenue growth is expected to be 10.2%, which would mark the sixth consecutive quarter above 10%. Earnings growth rates for the third and fourth quarters are both expected to be above 10%.

Though the move in Energy and Utilities can be correlated to the spike in oil and natural gas prices that were further inflamed by Russian aggression, long-term trends are also at work. Oil and other environmentally unfriendly assets have been under pressure to reduce their expansive footprint for nearly a decade, and now that the idea has taken hold, the global system experiences a removal of

additional needed supply. The past dozen years of floundering stock prices also forced much of the energy complex to become efficient managers of their businesses. This discipline, combined with favorable macro dynamics, is a good backdrop for outperformance.

New York Fed's monthly survey of consumer expectations (SCE) covers topics ranging from inflation and the labor market to household finances. Though started only in 2013, it provides a great look at where U.S. consumers see the state of the economy and financial markets. Most recently, its measure of sentiment towards stock prices was at all-time low of 33.8% – meaning that some two-thirds of U.S. consumers expect stock prices to *remain flat or decline* over the next 12 months.

The market historically climbs a wall of worry. Just remember that the optimum word is “climb”, which implies moving from a lower state to a higher one.

International markets



International equities had a common theme this past quarter. Both Developed and Emerging Markets posted negative returns while still outperforming the U.S. markets. Value style outperformed growth style and Small Caps underperformed Large Caps in both international equity asset classes this quarter. The international developed markets saw the MSCI EAFA down (-14.8%) for the quarter.

Returns in the international markets were negatively impacted by the strong rise in the dollar over the quarter. Emerging markets as measured by the MSCI emerging markets index fell (-11.45%) and are now down 25.28% for the trailing year. The continued price increase in commodities benefited resource-related countries in Emerging Markets, limiting the sting from slowing economic growth in China, the world's second-largest economy.

The U.S. dollar has rallied to 20-year highs mainly due to weakness in the euro (which has a substantial weight in the Dollar Index) and the yen as the Fed tightens aggressively. The U.S. and UK central banks have led the charge in raising interest rates. A drawdown in their balance sheets will further increase the tightening of financial conditions. The European Central Bank is just getting started and the Bank of Japan has abstained from shifting its policy.

Global trade seems intact so far, though clearly geopolitical tensions are at heightened levels. The numerous significant sanctions placed on Russia and according penalties for countries that choose to do business with Moscow are at the early stages of impacting global economic activity.

Concerns mounted over potential gas shortages. Continued disruption to gas supplies due to the war in Ukraine saw Germany move to phase two of its emergency energy plans; the next phase would involve rationing gas to industrial users, and potentially to households as well. UK chancellor Rishi Sunak unveiled additional measures to help households facing higher energy bills this autumn.

A flash estimate from Eurostat signaled inflation at 8.6% in June, up from 8.1% in May, with energy the biggest contributor to the rise. Higher inflation is also depressing consumer confidence, with the European Central Bank (ECB) poised to follow the FED raising interest rates to fight inflation – which the ECB did on July 21st by 50bps, instead of by the 25bps markets expected, with a signal for another raise in September. The central banks of Poland and Hungary – nations deeply feeling the inflationary economic impact of the invasion of the neighbor by the Russians – quickly followed the ECB.

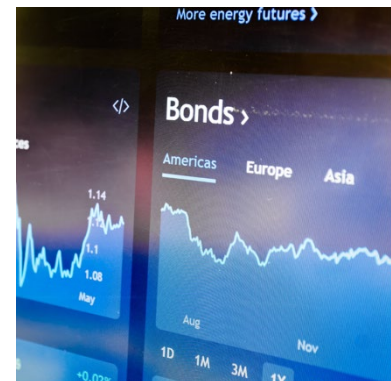
Key emerging market countries such as Colombia, Peru and Brazil, as well as South Korea and Taiwan, all lagged from a combination of rising concern over a global recession and deterioration of global trade.

Surprisingly, China was the only emerging market to generate a positive return over the quarter. Lockdown measures in certain cities were eased and macroeconomic indicators began to pick up. A significant reduction in quarantine for close contacts and visitors to China, which should help to ease supply chain issues even if the zero-Covid policy remains, was unveiled by Beijing.

Bond markets

International bonds fell due to the combination of the strong dollar and rising global bond yields as U.S. bond yields surged due to inflation that accelerated Federal Reserve rate hikes.

Interest rates increased across all maturities in the U.S. Treasury market for the quarter. The bond market as measured by the Bloomberg U.S. Aggregate bond index fell 4.69% for the quarter, about a percentage point better than its worst quarter ever (1Q22). It is now down (-10.35%) YTD.



The first half of the year was a very bad start for bond markets as the Federal Reserve embarked on a tightening regime. The U.S. consumer price index increased 8.6% YoY in May, accelerating unexpectedly, and showed price rises broadening across sectors.

The Fed implemented a series of hikes, raising the policy rate by 75 basis points (bps) in June for the first time since 1994. At the same time, Fed officials cut 2022 growth forecasts. The U.S. 10-year bond yield rose from 2.35% to 2.97% and the two-year yield from 2.33% to 2.92%.

The yield on the 5-Year U.S. Treasury Note increased 59 basis points (bps) to 3.01%, the yield on the 10-Year U.S. Treasury Note 66 bps to 2.98% and the yield on the 30-Year U.S. Treasury Bond 70 bps to 3.14%. On the short end of the yield curve, the 1-Month U.S. Treasury Bill yield increased 111 bps to 1.28%, while the 1-Year U.S. Treasury Bill yield increased 117 bps to 2.80%. The yield on the 2-Year U.S. Treasury Note increased 64 bps to 2.92%.

In terms of total returns, short-term corporate bonds (-1.94%) and intermediate term corporate bonds (-3.92%) both declined. The total return for short-term municipal bonds was 0.08% and (-1.30%) for intermediate-term municipal bonds.

Our colleagues at Strategas recently wrote:

“In most cycles, the market bottoms before the Fed finishes raising interest rates. In fact, on average, a market low is about halfway through a tightening cycle. This helps explain why stocks have averaged 7% annually across tightening cycles since 1970 despite the negative connotations associated with higher interest rates. However, during when the market is dealing with significant overvaluation (1973-74, 1999-2000) the market low often occurs only after the Fed stops tightening.”

U.S. housing has remained solid and steady, which is a key area that the Federal Reserve wants to see slow down as the Fed dampens inflation throughout the economy. According to Bank rate.com, nationwide 30-year fixed mortgage refinance rates moved from 3.1% in the beginning of January to 5.78% at the end of June.

Real estate markets are starting to see significant signs of cooling down, particularly in new home sales. Housing prices remain strong and seem unaffected yet by the rate hikes and the slowdown, but ultimately the higher mortgage rates should reduce the pace of housing construction and prices. “We began to see a moderation in demand and an increase in cancellations due to the rapid rise in mortgage rate and continued inflationary pressures across most of the economy,” said D.R. Horton CEO David Auld in a recent earnings call.

The 2-year treasury note ended the quarter at 2.92%, up from 0.75% at the beginning of the year – a massive move in a short period. Yet the biggest surprise continues to be the Bloomberg U.S. Agg Index, down (-10.35%). In its history dating back to 1980, its worst year (-2.92%) was in 1994.

Seems taming inflation is a lot harder than we were led to believe.

A Look Ahead



Inflation hovering at 40-year highs plus U.S. equity markets sliding into bear territory creates a great deal of uncertainty for the rest of 2022. Questions abound about economic and earnings growth, inflation, rate hikes, quantitative tightening, the Russian war, food and energy prices and supply chains. The labor market and unemployment are still positive, but consumer sentiment reached a record low in June. The steep selling initially of sky-high multiple growth stocks has rotated into the value, defensive and commodity sectors, too.

A mild recession appears already priced into financial markets with the odds of it occurring increasing monthly. The bond market is currently pricing the FED funds rate in a range of 3% - 3.25% by the end of 2022, yet also pricing a 50bps rate cut in 2023, which implies the increasing risk of recession and then a dovish pivot by the Fed.



“When the Fed is not worried about inflation, the market should be worried.” The Fed is now worried – and we better pay attention.” Yet, the most difficult thing for investors is resisting the urge to do something on impulse and off plan.

My portfolio recommendations for your asset allocation reflect additional modifications to last quarter. Maintain a risk-balanced focus and multi-asset class approach, evaluate opportunities and be ready to invest when larger short-term declines occur. Declines are occurring as are asset allocation adjustments.

Consider:

- Rebalancing overall asset allocation to target ranges – and when assets aren’t cheap, cash inside your portfolio is still a good idea until assets get cheap;
- Reducing overall U.S. equity allocation to mid-range of portfolio targets; tilt towards Value over Growth and Small over Large.
- Increasing cash by reducing U.S. Large Cap growth stocks and keep Private Equity distributions on hand.
- Continuing to increase allocations to Small Cap value, core and Mid Cap value, core, emerging and international stocks to the bottom range of portfolio targets.
- Maintaining high quality fixed-income holdings with short-duration (1-year to 5-year), paired with proven opportunistic private credit strategies for yield; reduce high-yield bonds.
- Patiently reviewing niche alternatives, including early-stage venture capital and co-investments, as well as opportunistic strategies and secondary private investments (don’t pay premium prices).
- Use cash to invest in cashflow generating Real Estate and Real Asset investments, both equity and debt, in private and public space (logistics, warehouses, data centers, infrastructure, commodities/natural resources, multi-family and farmland).

It is important that you maintain a disciplined focus with your investment strategies – especially during volatile periods. Many investors’ interests in the “E” for environment (as well as in “S” for social and “G” for governance) of ESG continues to grow. Please know that this has and always will be a deeply imbedded part of our firm’s philosophy that we can happily talk about at length.

It is a pleasure to serve you, and I look forward to continuing our work together. Stay safe and healthy.

With appreciation,

Walid L. Petiri

Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor’s, Federal Reserve Board, Strategas Quarterly Market Update July 2022.