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July 5, 2022 Dow Jones Industrial Avg: 31,097

Make the Bad Man / Woman Stop!!!

For the past decade, I have been writing a six-month outlook for the market…in good markets, bad markets, and sloppy markets. I try to produce a catchy phrase for the piece, you can see the phrase that I went with for the second half of 2022, but the other titles that stood out to me were the following:

- WTH???
- OY VEY!!!
- Cue the Rocky Music!

All these titles convey the sense that the first half of 2022 was akin to "Misery". Not quite like the Stephen King movie, but kind of!

To refresh your memory, the stock market started the year with one day of positive trading, and then simply began to sell off.

The Federal Reserve officials began the non-stop talking "UP" interest rates, which also had the opposite effect of pushing down the stock market. The 10-year Treasury started the year at 1.51% and recently topped out at 3.498% on June 14, 2022.

> "Including the latest rate hike [June 15, 2022], the Fed has already lifted rates by 1.5 percentage points this year, putting its benchmark interest rate at a range of 1.5% to 1.75%."[1]

[1] https://www.pbs.org/newshour/economy/analysis-what-the-feds-largest-interest-rate-hike-in-decades-means-for-you#:~:text=The%20Federal%20Reserve%20on%20June,inflation%20in%20over%2040%20years.

Between historically high inflation, the War in Ukraine, Oil Prices topping $120 a barrel, and the Federal Reserve doubling interest rates on the 10-year Treasury…the stock market finished the first half of 2022 having its worst start in 50 years.

Lest you think that the stock market was the only asset class that got damaged over the past 180 days, please see the following returns for fixed income indexes and Bitcoin:

U.S. Aggregate Bond Index	**- 9.81%**
U.S. Corporate Bond Index	**-13.91%**
10-yr. Municipal Bond Index	**- 7.96%**
High Yield Index	**-14.03%**
Bitcoin/ current value of $19,524	**-70.9% * Nov. 8 high of $67,130**

As a licensed Registered Representative (Financial Advisor), I cannot recommend cryptocurrencies (Bitcoin, Ethereum, Dogecoin, etc.), but where the stock market and the cryptocurrency markets overlap is through the use of "Margin". Margin investing is the concept of leveraging your investment portfolio to buy additional investments. In a good market, leverage helps to "juice" a market return. But, as the stock and cryptocurrency markets decline in value, a leveraged portfolio can act like an ANCHOR TIED TO A PERSON TRYING TO TREAD WATER…it eventually drags the investor under water and accelerates the decline. Take a look at the following:

Source: FINRA, FactSet

The reason that I bring up margin debt, the QQQ (NASDAQ 100 stocks) peaked in value during November 2021, and as the market declined- the selling of stocks (and cryptocurrencies) accelerated due to the FORCED reduction of margin balances.

Per Jason Bodner's recent research piece [2]:

> "Since the beginning of 2022, margin debt has fallen $150 billion. That is about 25% of the total margin debt heading into the pandemic market meltdown."

Given the decline in the stock valuations and sharp decline in margin debt, you can visualize the 1:1 relationship. Additionally, there are investments that give an investor up to 3x the performance (plus or minus) of certain indexes…even before the added leverage is applied to the strategy. ***So, there certainly was a snowball effect that helped to push down the market over the past 180 days.***

[2] What-Happened-to-Risk-Assets-in-2022.pdf (navellier.com)

You may be thinking to yourself:
"JP- I am aware that my account value is down, but should I get out or should I stay in???"

It certainly looks like **the Federal Reserve may have caused inflation to have peaked**…given the decline in commodity prices (including the price of oil), and the decline in interest rates. Even the Federal Reserve's preferred measure of inflation has declined in the recent period.

As noted in the recent Federated Hermes report [3]:

- **Peak inflation (for now)** Core PCE prices rose a modest and below-consensus 0.3% for a fourth straight month in May, dropping the annual rate to a 6-month low. Declines in commodity prices pushed global food prices down a third straight month, and ISM manufacturing prices (*more below*) slipped to a 4-month low. Meanwhile, with microchip shipments now at 95% of their pre-pandemic levels, auto delivery times are improving, adding to easing inflationary pressures. Regional Fed surveys also show supply-chain bottlenecks easing.

- **Peak yields?** Renaissance Macro shares three things that tend to signal peak yields: 1) cyclicals underperforming defensives (this has been happening for six months); 2) banks underperforming utilities (underperformance has been extreme); and 3) copper underperforming gold (the recent break in copper has led to outperformance in gold). All three conditions suggest deteriorating economic and credit conditions that have seen TIPS breakevens roll over—the yield on 10-year TIPS has fallen back below 2.4%, well within the 1.5% to 2.5% range of the past two decades.

Additionally, the Investor Sentiment may be a good "contrary" indicator of better times to come. In the recent Yardeni Research's Morning Briefing, Ed Yardeni pointed to the "Bull/Bear Ratio":

> "Last week, Joe and I were dumbfounded by the Investor Intelligence Bull/Bear Ratio. It fell to 0.60 during the June 21 week (*Fig. 1*). That's the lowest it's been since the March 9 week in 2009 during the Great Financial Crisis (GFC), when the ratio stood at 0.56. Back then, the S&P 500 bear market bottomed on March 9, 2009, after the index had fallen 56.8% from its October 9, 2007 peak." [4]

History points to better times ahead after the decline that we have endured:

> "Leading up to Election Day, stocks tend to experience a pronounced pullback—19% on average—before rallying afterward. This would be a dramatic change from last year, when 5% represented the maximum drawdown—ranking ninth out of the past 70 years in terms of the smallest intra-year declines. Calm markets rarely are repeated the following year. And midterm years historically have been volatile, even though equity performance for the entire year often is positive—the S&P on average has risen 32% off the midterm election-year bottom. And it has not declined in the 12 months following a midterm election since 1946." [5]

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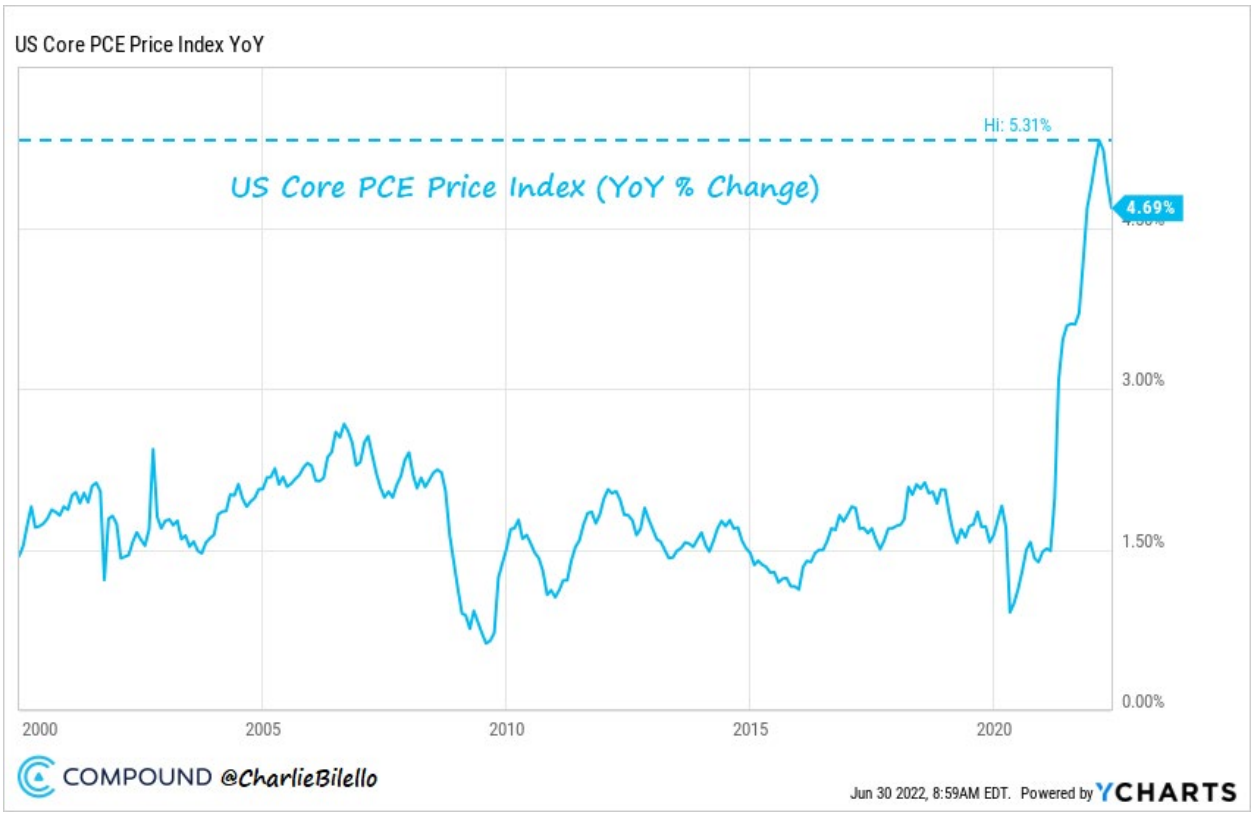
[3] The summer of our discontent . Linda Duessel. July 5, 2022.
[4] US Economy & Financial Markets: From Wrong to Right Track? . Edward Yardeni. July 1, 2022.
[5] https://www.federatedinvestors.com/insights/article/-it-s-going-to-be-a-volatile-year.do

Lastly, a picture paints a thousand words, right? To give more conviction to the mantra that "the Federal Reserve may have caused inflation to peak" take a look at the following charts, disseminated by Charlie Bilello [6]:

> "What could potentially alter the Fed's rate hiking plans? Any signs of a peak in inflation.
>
> On that front, the Fed's "preferred measure of inflation" (Core PCE Price Index, which excludes Food & Energy) has now shown a decline in the year-over-year inflation rate for 3 consecutive months, moving from a high of 5.3% down to 4.7%."



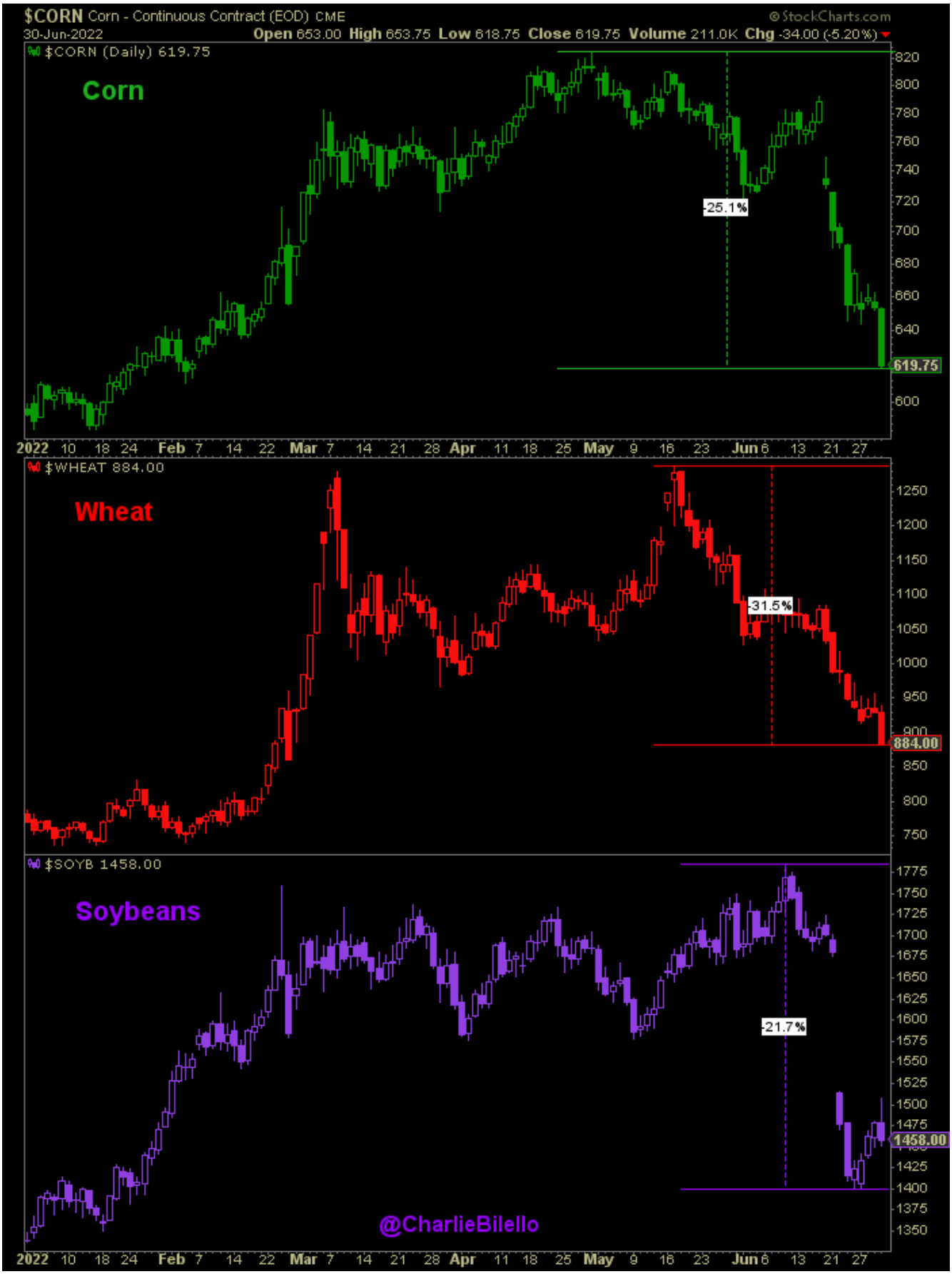
More from Charlie Bilello:

Welcomed Declines

Declines are not usually something to celebrate, but this is a notable exception that hopefully will continue.

> Corn, Wheat, and Soybeans are all down over 20% from their recent highs, providing a much-needed respite from the painful increases we've seen in the past year"

[6] https://compoundadvisors.com/2022/7-chart-thursday-6-30-22


$CORN Corn - Continuous Contract (EOD) CME
© StockCharts.com
30-Jun-2022
Open 653.00 High 653.75 Low 618.75 Close 619.75 Volume 211.0K Chg -34.00 (-5.20%)
$CORN (Daily) 619.75
Corn
-25.1%
619.75
$WHEAT 884.00
Wheat
-31.5%
884.00
$SOYB 1458.00
Soybeans
-21.7%
1458.00
@CharlieBilello
2022 10 18 24 Feb 7 14 22 Mar 7 14 21 28 Apr 11 18 25 May 9 16 23 Jun 6 13 21 27

"In addition, the price of Cotton has plummeted over 40% and is now lower on the year."

To summarize, I would encourage investors to stay the course. The stock market (and the economy) may have put in a bottom. At the very least, stock prices are much more compelling than 180 days ago- especially given the fact that corporate profits are still showing growth. ***At some point, valuations will matter, and money will come back to growth opportunities. But to be sure- volatility will remain, which will continue to test an individual investor's risk appetite.***

Have a great summer! Please call if I can be of any assistance.

Jeffrey S. Patterson
Investment Account Manager