INVESTMENT STRATEGY UPDATE

MARKET REPORT
QUARTER 3 - 2022

INFLATION & RECESSION FEARS BRING OUT THE BEAR

It was a difficult first half of the year for a diversified portfolio with stocks and bonds both posting double-digit losses.The S&P 500 fell into bear market territory, touching a low of -24% before recovering slightly by the end of June to close right at the bear market level of -20%. This represents the worst first half year performance for the S&P 500 index since 1970.

The growth-oriented NASDAQ fared worse, losing -30% in the first six months of 2022, -22% of that in the second quarter alone, with the prospect of higher interest rates discounting the future earnings growth priced into these stocks. Losses were not unique to US markets, with foreign markets down significantly as well. Emerging markets were slightly better than developed markets, with the MSCI Emerging Markets Index down -17.6% year-to-date. Energy and commodities were the only sectors to post positive year-to-date returns, benefitting from inflation and supply constraints.

Bonds had the worst start to a year on record, posting double-digit losses through the end of June.The yield on the 10-year US Treasury moved from 1.5% at the end of 2021 to a high of 3.5% on June 14, before falling back to 3% to close the quarter. The Federal Reserve has raised rates three times in the first six months of the year, effectively increasing the Fed Funds rate by 1.5%. The most recent increase in June of 75 basis points is the largest single rate hike the Fed has made since 1994.

Raising interest rates is intended to take demand out of the economy, which should reduce inflation but could also slow growth enough to cause a recession. In general, rising interest rates hurt bonds as higher rates offered on new bonds force prices of existing bonds lower to provide a comparable return to maturity.

Index	*2022 (through 6/30)*
S&P 500	-20.0
DJIA	-14.4
EAFE (Int'l)	-19.6
BC Ttl Bond	-10.4

Dow Jones Relative Risk Benchmarks	
Conservative	-12.3
Moderate	-15.8
Aggressive	-19.7

A recession is damaging for stocks as slower economic activity and earnings decline and reduce their value. Investors are weighing these risks, and it is unclear whether higher rates will tip the economy into a recession, or how much of the risk is already priced into markets given the losses they have already incurred.

MARKETS & RECESSIONS

The economy and the financial markets are not one and the same, and they do not usually move in tandem. Looking back at historical data, the market commonly declines in advance of an economic slowdown and recovers before the economy rebounds. The markets are forward-looking and attempting to project what will happen in the future, rather than what is happening today. The current market downturn may foreshadow an impending recession, and it is difficult to know how much of a potential recession is already reflected at this point.

History also tells us that when markets bottom the recovery can come very quickly, and it is important to remain invested to capture that bounce. Historically, the S&P 500 has gained 15% in the first 30 days out of bear markets. (RJ Investment Strategy Quarterly, June 2022). Missing out on just a handful of the best days can have a meaningful impact on long-term returns. Although staying invested in times of high uncertainty can be difficult, investors that do so should be rewarded in the end.

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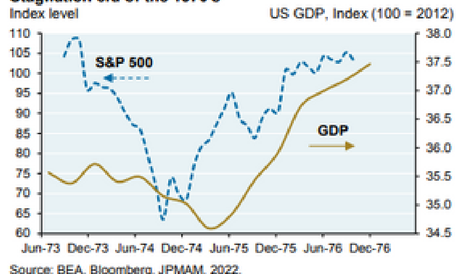
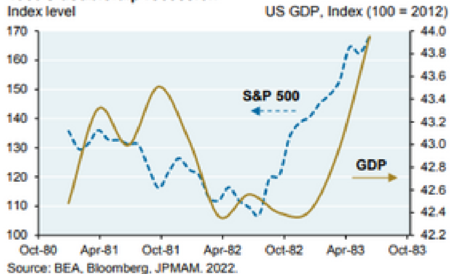
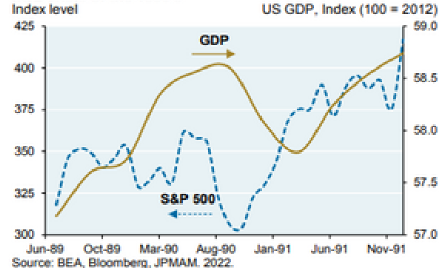
Markets & Recessions (continued) - Previous market corrections & recessions







Source: J.P. Morgan, Eye on the Market, June 6, 2022

OUR VIEW

FIXED INCOME:
Bonds have been a disappointing diversifier so far in 2022 as they have not offered their typical counterbalance to falling equities. However, we feel that the majority of the downside in bonds is behind us. Absent another unexpected inflation or interest rate shock, going forward bonds should offer better risk management should stocks continue to falter. At this point, bonds are more attractive than they have been in a long time, with yields now near the highs from the past decade. We continue to recommend slightly lower traditional fixed income exposure, and a combination of bonds and alternative strategies to help manage both equity and interest rate risks.

US EQUITY:
The S&P 500 is now trading at 15.9 times forward earnings, below its 25-year average price to earnings ratio of 16.9. Although earnings are still growing and profit margins remain high, they are at risk if the economy slows. Should a recession occur, the US economy is in a fairly good position to withstand it with unemployment very low and almost two job openings for each unemployed person. We feel a recession would likely be relatively mild, and are focused on the long-term prospects in US stocks. While there may be some additional downside, we believe there are buying opportunities at this juncture, particularly in large growth companies which have declined the most this year. Generally, we are biased to large, quality US companies and favor a balance in growth and value.

INTERNATIONAL EQUITY:
The European economy is under pressure from record high energy prices, with Russian imports accounting for one-third of its energy consumption (Raymond James, Investment Strategy Quarterly, June 2022). It will take time for Europe to adjust its consumption or obtain oil and gas from other sources. Absent an end to the war, European energy prices are likely to remain high, increasing the odds of a recession. Foreign stocks remain relatively cheaper, however given the high degree of unpredictability, we are recommending less European exposure for the near term. We are neutral on emerging markets for the short-term, and recommend no change in exposure at this time.

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