Client Note

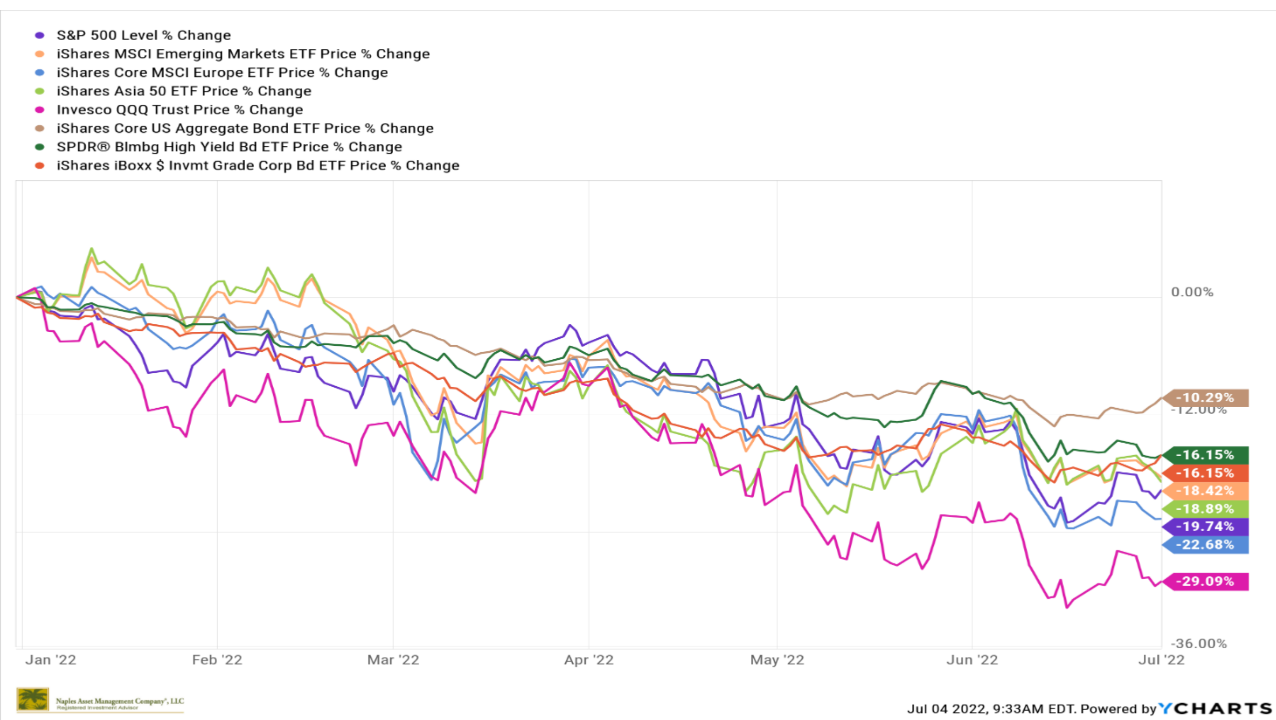
July 3, 2022

Wow, what an end to the second quarter/first half of 2022! Is that a light at the end of the tunnel or an oncoming train?? With this dismal end to a very difficult half and an abysmal quarter, the S&P500 finds itself -20% year to date. From March 31 to June 30 the SP500 was down, from 4533 to 3785, about 16%. The low so far this year was on June 17, where the S&P500 was down more than 23% for the year at one point. There are numerous 'worst X since Y' stories one can find. One of the more startling factoids is that through June 17, **the previous 10 out of 11 weeks** saw declines. The worst set of weekly declines since 1932 AND now we have the worst first half of a year also since 1970.

When markets are down, everyone piles on to forecast lower lows. The same happens when the markets are hitting highs. Its human behavior. This is called 'herding.' In general people often join a trend once its well underway. Unfortunately, we know that people tend to buy high, and sell low. After a 20% market decline, "everyone knows" it's going to continue, with pundits tripping over themselves to put out lower and lower targets. As investors, we need to focus more on what is actually happening as opposed to simple extrapolations.

Before I get too much further along, let's look at other markets and asset classes' returns for the quarter and year to date. **The NASDAQ 100**, the large-cap tech index has fallen almost 30% on the year; down almost 25% for this quarter. The Dow is off 16% (held up by energy-which has faded fast). **Emerging markets (EEM**) is down 18% on the year, 13% on the quarter. While **Chinese large cap stocks** are down a mere 10% on the year. **European stocks** are down 20% on the year and quarter.

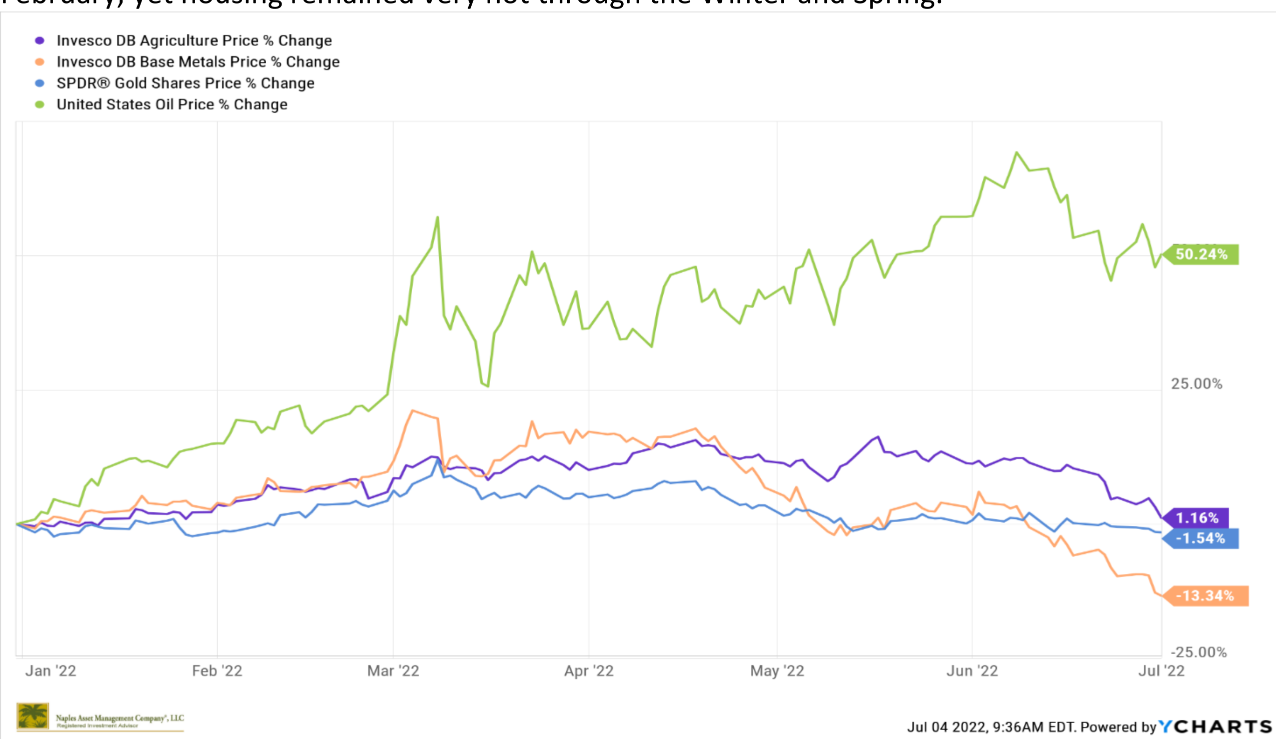
For **bonds**, only a bit better. **The Aggregate bond index** (AGG) is down almost 11% year to date and about 5.5% on the quarter**. Junk bonds** (JNK) are down almost 17% for the year and down 12% for the quarter**. Investment grade bonds** are down about 15% year to date and off about 9% for the quarter. Notice how bonds' quarter isn't as shocking at stocks? **There has been a nascent turn down in interest rates and expectations.**



The selling pressure in the stock market, as seen by the opening down gaps in the market in mid-June, was among the worst in 60 years. A cluster of down gaps like this has only happened 16 times in the past 90 years. 14 of those times saw significant gains 6 and 12 months later. The selling pressure on the New York Stock Exchange one of those days was such that 93% of all NYSE stocks were down on the day. While this makes us feel 'bad,' or nervous; we also have to ask, **"was that the 'capitulation' we've been looking for?".**

For **commodities**, it's a lot better. However, prices have been in decline since May for agricultural items, early June for industrial metals and mid-June for oil. Oil is down 15% from its highs two weeks ago, and 20% off the high hit after the Russia/Ukraine war began. Another 10% and oil will be at its lowest price since the war began. Year to date, oil is up more than 40% year to date, but has **fallen almost 15%** over the past few weeks. **Agricultural commodities** are up 3% year to date, but 10% below highs in May. **Industrial or base metals** are down 12% on the year, having declined some 25% since March. **With gold's** recent weakness, prices are down 1% year to date and down some 17% from its high in March. A lot of this decline is attributed to China's lockdowns/slow economy.

An interesting and unique thing about consumable commodities like oil, food, metals is that when the price goes up, production increases. As production increases, prices fall. Lumber was in all the news in 2021 and early 2022. Futures prices for **lumber have fallen by more than 50%** since February, yet housing remained very hot through the Winter and Spring.



There you have it for 2022 so far. Stocks are down 20-30%, bonds are down 10-15%, oil is up a lot but is declining and gold is near flat on the year. A portfolio 60% stocks and 40% bonds would be down approximately 20%. Fortunately, we are doing much better than this.

The Economy

With those kinds of market headlines, one would think we are in a severe recession. "Officially," or rather, technically **we are not**. It takes two consecutive negative growth quarters to meet the modern definition of a recession**. Initial results from the second quarter won't come out until late July**. If that GDP is negative, then we will meet the technical definition of a recession. Economic slowdown has been my expectation for the past few quarters. Given the upheavals seen in the Covid lockdowns, the massive stimulus spending and early income tax refunds, it came at no surprise to see massive growth in late 2020 and into 2021 followed by slowing. Our mature economy isn't capable of running at >7% growth—we have near 0% population growth!

We all know that **economic data lags market performance**, or rather, to put it another way, the market forecasts, or 'prices in' real time economic activity while we get the official data months later**. Now the question is, if we are in a recession, will it continue and get worse? Or is this more of a statistical recession?** With incongruent metrics resulting from economic contraction in Covid, massive fiscal stimulus and Fed intervention in financial markets, high energy prices resulting from first a massive decrease in global output (drilling and refining) during Covid lockdowns, then huge demand increase post-Covid while the energy industry has its own bottlenecks still being sorted, alongside the Russian Ukraine conflict. There is so much in flux its difficult to know which metrics are correct.

My **current read on the economy** is that, since job creation remains robust, layoffs near non-existent, and wages rising; is that we **may not even see the two consecutive negative GDP** quarters. The 'slowing' has occurred and Fed tightening (or really expectations thereof) is mostly done (you heard it hear first, one more increase and then the Fed 'pause').

We are seeing **energy and commodity prices begin to decline**. **Interest rates have declined** noticeably in recent weeks (after hitting highs not seen since 2018). Areas like housing which have been 'frothy' to say the least, are cooling. These are good developments that had been running well ahead of sustainable rates. Company earnings are forecast to increase almost 10% for 2022, and estimates ***were raised*** during the first quarter. Corporations appear to be able to pass along **price increases and consumers are paying them** with their higher wages and healthy household balance sheets. Home equity is at all-time highs. The US has more people employed today than in July 2019, and 'help wanted' signs abound.

Looking Ahead

Its these factors that have me **more optimistic than pessimistic** for the economy and financial markets. Mid to late June saw the recent peak in interest rates and oil, and a low in stock markets. If these can trend just a bit further in the right direction, **it increases the likelihood that the worst is behind us**. **July's market behavior and economic data from June may contradict** each other, as markets price in recovery/expansion and slow economic data comes in weeks after the fact.

One can look across the data and see either a glass half full or half empty. Slowdown in housing is seen as a sign of recession; or it can be welcome relief that its stabilizing. Retail inventories are on the rise. Is this a lack of purchasing power, or a replenishment that will keep prices in check. Job and wage growth, a sign of inflation to come, or the ability for people to pay higher prices is another example.

We have seen a major reset post Covid-crash. Interest rates are back to historical averages, stock valuations (due to lower prices and better earnings) have come back to merely 'elevated' levels. **The size and duration of the market decline** indicates this pullback in prices is the post-Covid boom's correction. The S&P500 has given up 44% of its price gains. All the money thrown into the economy and consumers pockets caused prices of everything to launch. Now we are going to see how things settle out as that stimulus fades in the rearview mirror.

I believe what we are seeing now are **markets and the economy finding a new equilibrium** amongst wages/employment, inflation/interest rates, and stock valuations. Year over year inflation rates will decline simply on base effects. If month to month inflation goes flat or even declines, headline inflation rates will come down quickly.

We have ALREADY seen a significant decline. The adage of buy low, sell high needs to be top of mind. History shows us that after steep declines, the average one-year gain is 55%. During expansions, the median decline has been 21%, over a 6-month period. **The decline we have seen is exactly average**. Add all this up and we have a **good case for a solid second half of 2022**, and perhaps even further. **On the other hand, a break of recent market lows would indicate were not out of the woods yet and a more defensive posture is required**.

In the immediate term, I am still looking for my indicators to show a 'good low' is in place in order to more confidently add exposure to risk assets.   In the meantime, the mid-June lows are important to hold.

Adam Waszkowski CFA