Market Review and Outlook

Index		YTD	Q2	1Y
S&P 500	US Large Cap	–19.96	–16.10	–10.62
DJIA	US Large Cap	–14.44	–10.78	–9.05
Russell 3000	US All Cap	–21.10	–16.70	–13.87
Russell 2000	US Small Cap	–23.43	–17.20	–25.20
MSCI EAFE	Developed International	–19.57	–14.51	–17.77
MSCI EM	Emerging Markets	–17.63	–11.45	–25.28
Bloomberg Barclays US HY	US High Yield	–14.19	–9.83	–13.63
Bloomberg Barclays US Agg	US Core Bond	–10.35	–4.69	–10.29
Bloomberg Barclays Muni	US Muni Bond	–8.98	–2.94	–8.57
MSCI US REIT	US Real Estate	–20.32	–16.95	–6.41

Source: Bloomberg

There was little respite for financial markets this past quarter from the many factors that continue to dog the economy and financial markets: COVID, supply chain constraints, high inflation, rising interest rates, recession fears, and geopolitical tensions.

COVID seemed to be less front and center in the West—in the sense that although it was still very prevalent and at the end of the quarter there was yet another wave of it, with mortality rates now low and the economy suffering from restrictions, the population has generally chosen to ignore it (e.g., being encouraged not to report it, and few are even still obliged to quarantine if they actually have it). Crucially, however, this was not the case in China, where the government imposed some of the strictest measures on residents we have seen so far. Many residents were locked in their homes for at least a month, and some were also suffering from severe food and water shortages, as the Chinese authorities desperately tried to stamp it out completely. These shutdowns only helped to further exacerbate the supply chain issues that continued to plague the global economy over the last quarter.

Sadly, the war in Ukraine has also continued and is seemingly turning into a war of attrition: allies have been able to provide enough intelligence and technical support to halt Russian progress, but not enough for Ukrainians to regain much ground (or enough that might lead to allegations of Western involvement and escalation in the conflict). The result is that it remains difficult to see an obvious exit route from the situation. These developments were a prominent driver of the steady increase in global commodity prices throughout most of the quarter.

Inflation was, therefore, generally higher than expected through the quarter, reaching 8.6% in May, and is expected to hit 8.8% in June. The scale and stickiness of the price increases shocked the Fed and other central banks into becoming much more aggressive in tightening monetary policy, forcing the Fed into yet another pivot on both the scale and timing of expected rate increases. It resulted in the fed funds rate rising by 25 basis points in May, followed by a surprise 75-basis-point rate increase in June. The Fed also intimated that another 75-basis-point increase was likely in July. The response from the long end of the yield curve was for 10-year T-note yields to increase from 2.3% at the start of the quarter to 3.5% by June 14.

Just as the quarter came to a close, however, the combination of sustained higher inflation and much tighter financial conditions has seemingly led to a broader consensus among financial market participants that a recession would be

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harder to avoid; as a result, we saw a sharp pullback in both commodity prices and Treasury yields. This included a previous expected peak in the fed funds rate of 4.0% slipping to 3.3% in the final two weeks of the quarter; 10-year yields dipping from 3.5% to 3.0%; and most major commodity prices falling by around 15%-20% from their recent highs.

Meanwhile, the impact from tightening financial conditions and the COVID-induced liquidity tide turning could perhaps be no more strongly felt than in the performance of the various cryptocurrencies, SPACs (special purpose acquisition companies), and meme and negative profit stocks, which all experienced precipitous declines in the quarter. Incredibly, the CEO of one crypto-finance company—an industry that has sold itself as being entirely decentralized—without a hint of irony, boldly suggested that the industry should be receiving government liquidity support. Higher quality companies were also not immune from the tumult, with the stock market finally entering a bear market (defined as a decline of more than 20% from its peak), and the S&P 500 yielding its worst half-year performance in 50 years. The high inflation, meanwhile, meant that the Treasury market fared little better, with the total return on long-term T-bonds falling by 20% during the first half of the year, and thereby eliminating what over the last several decades has been a dependable source of ballast for equity investors.

These developments only enhanced the enthusiasm for the dollar and for higher yields and a safe haven for investors. This resulted in a 5.3% decline in the euro over the quarter, the renminbi falling by 5.4%, sterling down by 7.3%, and the yen falling by a whopping 10.3%—all substantial moves for major global currencies.

The weakness in the euro was accelerated by the fact that Italian bond yields were once again in the spotlight when BPT yields hit a high of 4.16% mid-June, a level that prompted an emergency ECB meeting and the promise of some kind of new—as yet to be determined—lending facility to smooth over these troubles. The actions were successful in calming the market, but at some point in the coming quarter, investors will be demanding that the ECB "show me the money."

Perhaps surprisingly, despite the deterioration in the financial markets, actual evidence of a sharp slowing in the real economy over the past quarter was not as easy to spot as the market would have us believe. While consumer confidence plummeted (the result of the high inflation) and there was also a large decline in housing-related activity (the result of mortgage rates hitting 6%), employment growth was still very strong, consumer spending was also generally solid, and businesses continued to complain about too much demand, with not enough supply to satiate it. Furthermore, the very clear message from the vast majority of the 320-odd companies presenting at William Blair's 42nd Annual Growth Stock Conference was: "If there's any weakness out there—we're not seeing it yet."

Nor, it seems, were financial analysts, given that their S&P 500 EPS estimates barely budged over the quarter, despite the growing recession fears: earnings are still expected to increase by 10% in 2022 and another 10% in 2023 as well. This has meant that while the market's 12-month forward P/E multiple has fallen from 19.9x at the start of the quarter to 15.8x at the end, just about all of that work was achieved through price, and none through earnings. Yet, if the economy really is entering a recession, these estimates will likely need some adjustments, and therefore represent further downside risk for the market.

When it comes to the potential for a recession, what is also important to note is that this economic weakness is being driven by the combination of high inflation (the result of strong demand against limited supply) and central bank interest rate increases (in order to quell that inflation). In short, this is what might be viewed as more of a classic cyclical economic slowdown. This is a completely different animal from one being driven by the collapse of a major systemically important economic sector, which is often then followed by a sustained period of major debt deleveraging, market malfunctioning, and the Fed having to drop rates to zero and undertake quantitative easing. Today's consumer, for example, is in much better shape than was the case heading into the 2008-2009 financial crisis.

What this means for longer-term investors is that while volatility will likely remain high in the very near term, valuations across many asset classes are now starting to look more compelling than they have done in years. For example, the relative P/E of the S&P 600 small-cap index against the S&P 500 is now the cheapest it has been since at least 1995. In such markets, it also means that active management is essential given such volatility can often represent key market entry points for quality growth equities.

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Wealth Management Tip

Consider reviewing your investment portfolio to take advantage of tax-savings opportunities and to avoid potential tax traps. You may think about selling stocks that are declining in your portfolio to offset capital gains from sales of winners. Beware, however, of the wash-sale rule. If you purchase substantially identical securities up to 30 days before or after the sale, the capital loss is not deductible. Any suspended loss is added to the tax basis of the replacement securities.

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