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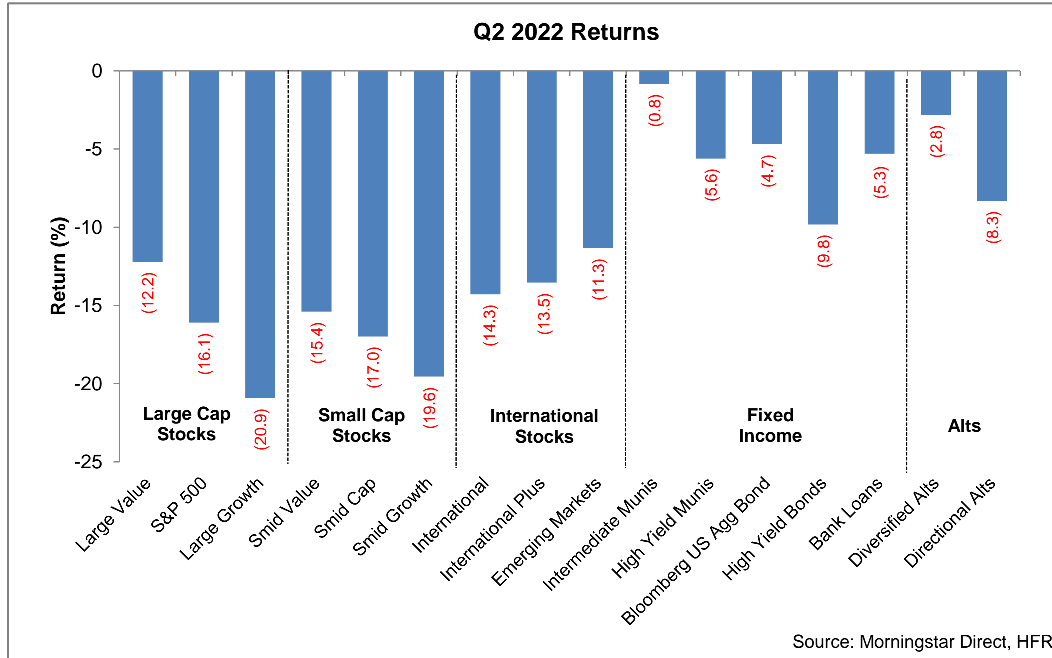
Second Quarter 2022 Investment Review & Outlook



EXECUTIVE SUMMARY

Q2 2022 Recap:

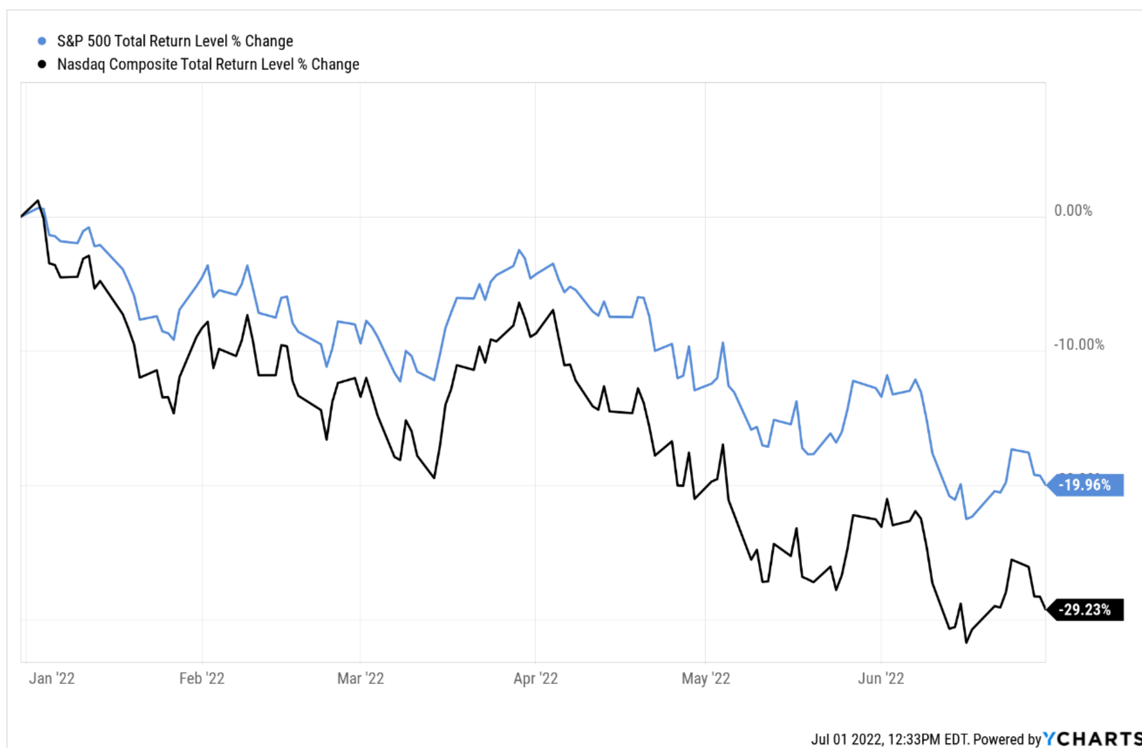
- Stocks were significantly negative in the quarter, officially entering a bear market.
- Inflation surged through quarter end, forcing the Federal Reserve to shift to a much more aggressive posture.
- Both high quality and non-investment grade bonds sank in the quarter as interest rates and credit spreads increased sharply.

NEXT Outlook:

- The Federal Reserve is now battling an inflation narrative, which will require an aggressive policy response that will likely tip us into a recession.
- This slowdown in economic growth will affect corporate earnings, although that has yet to be significantly reflected in analyst estimates.
- Financial assets do not yet appear cheap enough in the face of these headwinds. However, investor sentiment is reaching extreme levels of negativity that could position it for a swift recovery if and when the fundamental environment improves.

Dear Clients & Friends,

Financial markets finished the second quarter down more than 16%, capping off one of the worst starts to a year in recent memory. Despite a modest rally near quarter end, the index ended the 2022 midpoint in a bear market: down 20% from its highs.



Negative stock market performance was widespread, with virtually every market and sector in the red for the quarter. Even energy stocks, which turned in a stunning 39% gain in the first quarter, turned lower as investors broadly cut risk. The traditional FANG sectors which have dominated performance in recent years – technology, consumer discretionary, and communication services – all lost more than 20% in the year's second stanza.

Little reprieve was found in the fixed income markets. Despite a late decline in interest rates, the yield on the 10-year Treasury rose nearly 70bps in the quarter. This translated into an additional 4.7% loss in the quarter for high quality bond portfolios, pushing year to date losses to more than 10%. It is not hyperbole to say this is the worst stretch of performance for the bond market in more than 40 years (during the last inflationary crisis in this country).

Non-investment grade bonds, too, turned lower after holding up reasonably well at the start of the year. High yield bonds lost nearly 10% in the second quarter alone. Bank loans, which are the beneficiaries of floating rate coupons, declined by 5%. Despite historically low defaults, healthy balance sheets, and lack of a near term maturity wall, credit markets were punished as investors began to price in the risk of an economic downturn.

Market Review…

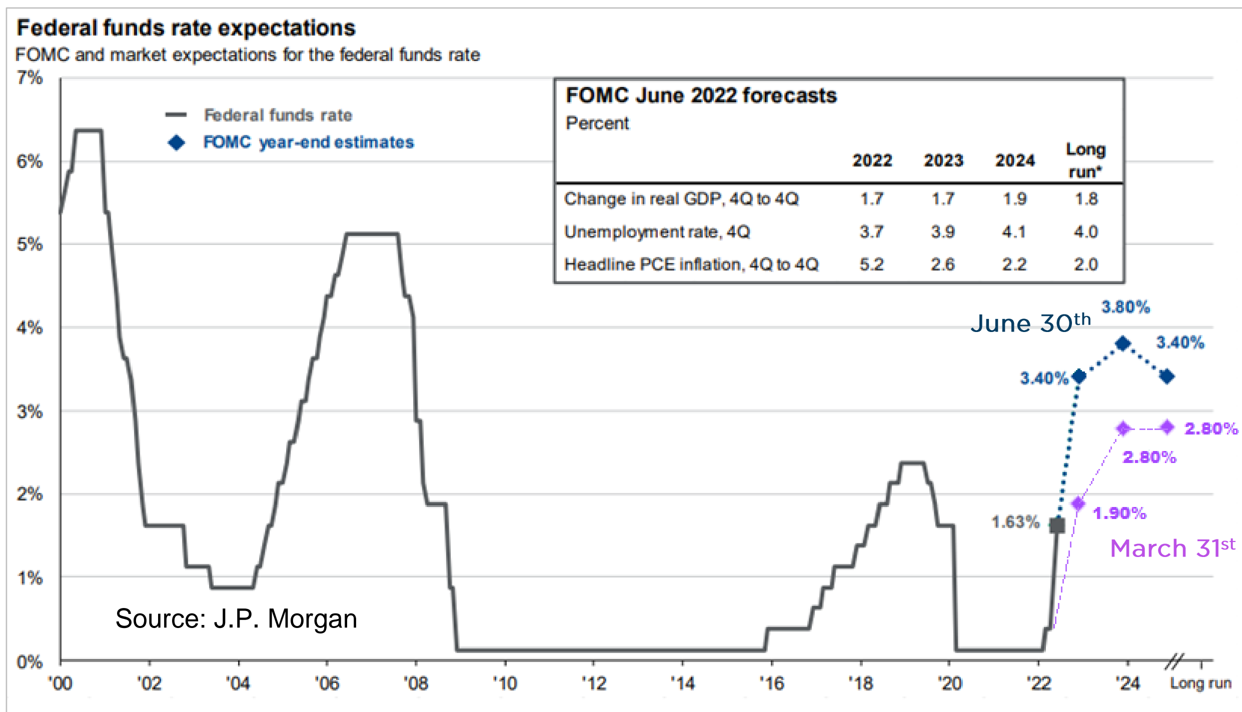
As we have noted in our recent market communiqués (for those who may have missed these, please feel free to find them here and here), the Federal Reserve and inflation serve as the main characters in this year's story. At this point, the *causes* of recent inflation – the war in Ukraine, supply chain disruptions, or post-covid stimulus packages – are less important than its *effects*. Inflation's persistence has raised fears that it could translate into a shift in inflation expectations. If those expectations become embedded into the economy, they become very difficult to reverse and inflation can become self-fulfilling. The think tank Brookings Institution explains this phenomenon:

> *As a result of the persistently high inflation in the 1970s and 1980s, inflation expectations became unanchored and rose with actual inflation—a phenomenon known at the time as a wage-price spiral. This cycle plays out as follows: high inflation drives up inflation expectations, causing workers to demand wage increases to make up for the expected loss of purchasing power. When workers win wage increases, businesses raise their prices to accommodate the increase in wage costs, driving up inflation. The wage-price spiral means that when inflation expectations rise, it is difficult to bring down inflation, even if unemployment is high.*[1]

The Federal Reserve is, therefore, not just working to impact inflation data; they are also attempting to change the *narrative* regarding inflation. Until May's consumer inflation report, the Fed was relatively content to take a measured approach to normalizing monetary policy. Their own projections, back in March, suggested they would increase the Federal Funds rate to 1.90% by year end.

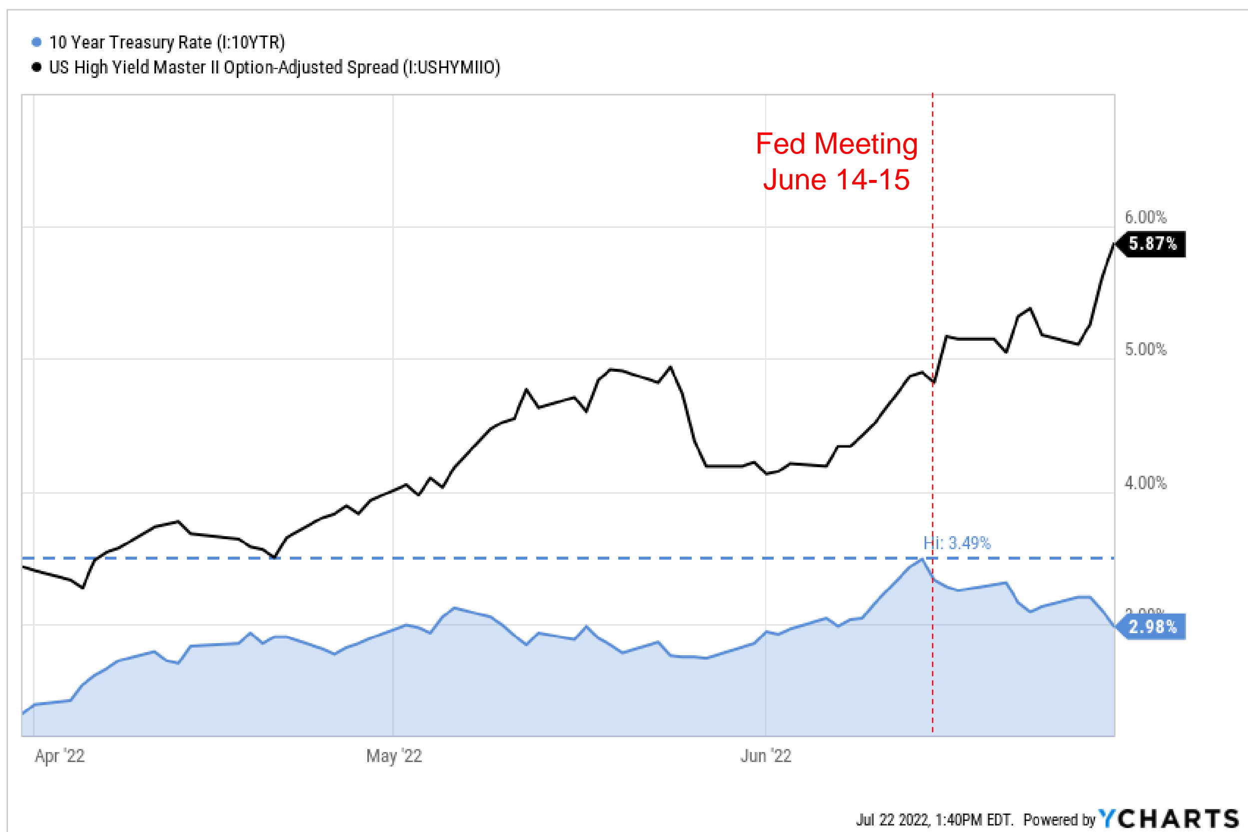
May's Consumer Price Index (CPI), released on June 10th, dramatically altered both the Fed's plans and the market's perception of the inflation problem. Largely expected to decline, year-over-year CPI instead hit its highest level since 1981. The report came in significantly above economists' estimates and served as a wakeup call that inflation may not resolve itself in the near term. The Fed responded aggressively, hiking rates by 0.75% in its June meeting (the largest such hike since 1994) and signaling it would increase rates to 3.40% by year end.

[1] Source: https://www.brookings.edu/blog/up-front/2020/11/30/what-are-inflation-expectations-why-do-they-matter/



The Federal Reserve's potential success in stamping out rising prices, unfortunately, comes at the expense of economic growth. Increasing interest rates is explicitly designed to restrain the economy, reducing demand and thereby undermining inflation. Initially, the hope was that the Fed could normalize monetary policy in a way that could be absorbed by an otherwise healthy consumer and corporate America. The Fed's change in tactics, however, is now clearly prioritizing inflation over any near-term damage to the economy. The Fed would rather cause a recession now, in a bid to successfully defeat the inflation problem, than allow a much more costly inflationary spiral to take root.

The shift in market sentiment has been clear. After reaching a decade high of 3.49%, the yield on 10-year Treasury bonds has declined by more than 0.50% since the start of the Fed's June policy meeting. Credit spreads for non-investment grade bonds – a strong barometer of investor risk appetites – widened by nearly 150 bps in the aftermath of the Fed's decision. Both metrics are signaling the probability of recession has increased significantly.



Equity markets have thus far not shared these concerns. Performance has largely stabilized since the Fed's June policy meeting: after dropping 3% the day after the Fed's announcement, the S&P 500 has gone on to rally more than 8% midway through July.

One might infer that equity markets have already reflected the bad news and are now cheering the potential resolution of the inflation issue. We think that is a somewhat optimistic view. If we are truly headed for a recession, it portends some level of retrenchment in corporate earnings. Yet, analysts' earnings estimates for 2022 are little changed. This means that market valuations that have just fallen to more "average" levels may be much higher than they currently appear. Stocks will likely be swimming upstream against this phenomenon through the balance of the year.

Outlook…

We concede that the fact pattern presented above paints a less constructive picture for financial markets – at least in the short term. Many of us have been conditioned over the last decade to expect rapid market recoveries – the so called "buy the dip" phenomenon. Prior market declines have been met with swift responses by central banks both here and abroad. Those actions fostered an environment of risk taking and moral hazard[2] that reduced both the magnitude and duration of prior market declines.

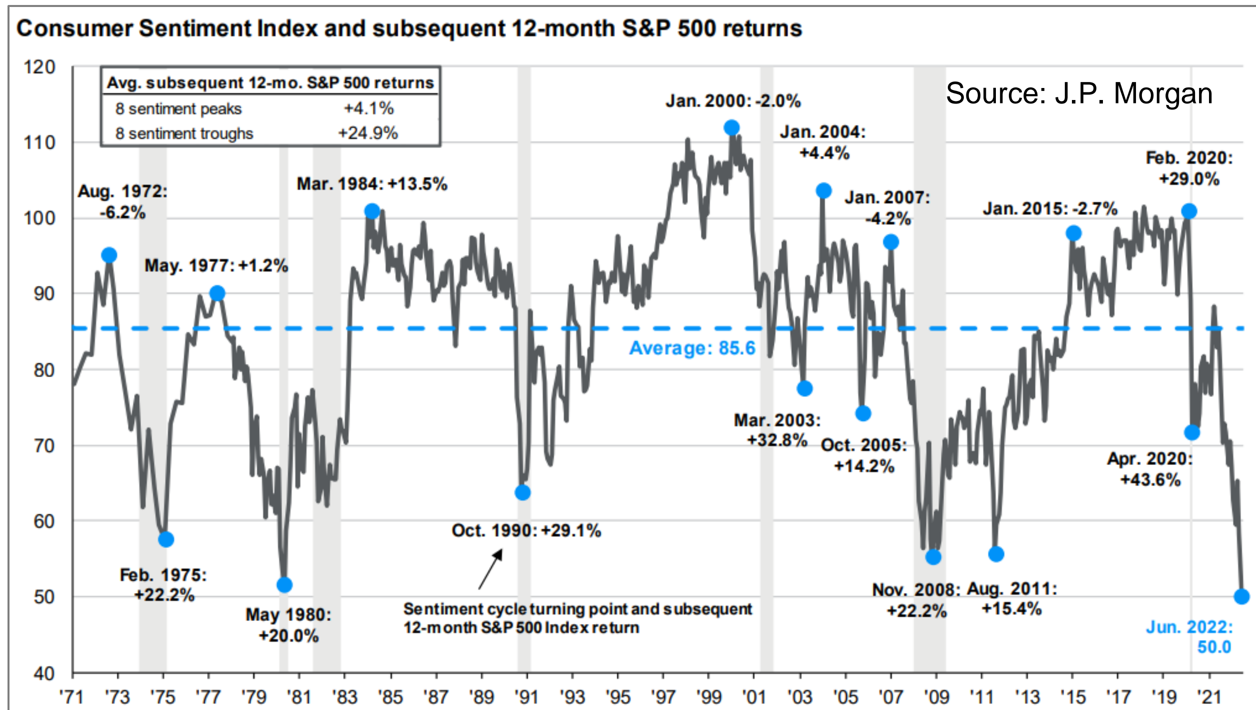
Yet, this time, with the Federal Reserve no longer supporting financial markets, a more extended, frustrating stretch could be in store for markets. Until inflation stabilizes, the Fed is, by their mandate, required to act in a manner at odds with the interests of investors. This makes the forward path of financial markets extremely data dependent. The trajectory of inflation and earnings reports will be paramount in the months ahead.

For those with a long-term perspective, however, public markets are becoming an increasingly fertile environment for investment. Wider spreads, lower valuations, and dispersion across markets is increasing the future return potential across a range of securities. While equity securities are not quite at levels we would prefer, credit markets are getting closer to levels that we find attractive.

We would also note that we are witnessing an extreme level of pessimism from investors. A variety of measures, ranging from sentiment surveys to cash levels in portfolios, reflect an

[2] Moral hazard is defined as a lack of incentive to guard against risk where one is protected from its consequences

investor that is the most cynical they have been in modern history. It's hard to imagine that someone could be more negative today than they were in the global financial crisis – when the structural underpinnings of our economy were in question – but that is indeed the case. Historically, these "contrarian" signals have been a positive signal for market performance.



Any morsel of good news in the future, therefore, could serve as a catalyst for a shift in market performance. Inflation data coming down more quickly than expected, for example, would provide cover for the Federal Reserve to tap the brakes on their aggressive interest rate campaign. Additionally, while we are concerned about some cyclical impact to earnings, the reality is that corporate America and the consumer entered this episode on much firmer footing than in past cycles. With labor markets historically strong and balance sheets relatively healthy, we expect any downturn to be shallower in nature.

In the interim, we encourage you to remain patient as we navigate what has been a very challenging market environment. We understand that the pervasive nature of this year's market declines has been frustrating. However, history has shown us time and again that long-term investors are rewarded for maintaining a disciplined approach. Rebalancing, tax loss harvesting, and opportunistic allocations are all strategies that can ultimately benefit portfolios as we look toward an eventual recovery.

If you would like to discuss financial markets or your portfolio further, or if you feel like your personal circumstances have changed, please do not hesitate to contact us.

Sincerely,

Your Next Capital Team

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