Investment Update

Second Quarter 2022

The first half of 2022 has not been a good one in the investing world to say the least, with essentially everything down except cash, and shares of energy and large pharmaceutical companies. Both the first and second quarters saw volatile trading in stocks, and a steady increase in interest rates depress the value of bonds. The S&P 500 was off 13% from its January 3rd all-time high when Russia invaded Ukraine in February but rebounded somewhat and was only down 5% by the end of the first quarter. As you can see from the returns table on this page, most of damage in the stock market was done in the second quarter. Even sectors and stocks that had held up well, like consumer staples and Apple, eventually weakened, and at its lowest point the S&P 500 was 24% off its high in mid-June.

The Federal Reserve Board has embarked on an aggressive monetary tightening campaign this year, raising the Fed Funds Rate three times, by 25, 50 and 75 basis points. Market-based rates have increased further due to the Fed's transparent forecasting of the tightening to date, and to come, as well as the gradual shrinking of its balance sheet. The 10-year Treasury yield was 1.52% at the end of 2021 and reached 3.49% by mid-June. The 2-year yield increased more over the same period, from 0.73% to 3.45%. Increases of this magnitude might normally be expected to occur over a year or more, and these higher rates are starting to have the intended effect on economic activity.

Equity Markets (Total Return)	**2Q'22**	**1-Year**
Dow Jones Industrials	-10.8%	-14.4%
S&P 500	-16.1%	-20.0%
S&P Mid-Cap	-15.4%	-19.5%
S&P Small-Cap	-14.1%	-18.9%
MSCI All-Country World	-15.5%	-20.0%
MSCI Foreign Developed Markets	-14.3%	-19.3%
MSCI Foreign Emerging Markets	-11.3%	-17.5%
US Bond Markets (Total Return)	**2Q'22**	**1-Year**
Bloomberg US Treasury	-3.8%	-9.1%
Bloomberg US Municipal	-2.9%	-9.0%
Bloomberg US Corporate Investment Grade	-7.3%	-14.4%

Mortgages rates have risen even more than Treasury yields, sharply increasing monthly payments for prospective buyers. Mortgage applications, new home construction, and other secondary measures of activity in the rate-sensitive real estate market have slowed as a result. We expect home prices to remain elevated for the time being because of tight supply in many markets, and remaining buyers in a rush to bid for fear of missing out before rates potentially go higher. Nonetheless, housing costs are a large component of inflation measures, so a return to subdued inflation is unlikely without a cooling off in real estate.

The primary question on investors' minds at this point is if the Fed's inflation-fighting interest rate increases will cause a recession. Industry analysts' estimates of S&P 500 forward earnings- whether for next quarter or next year- have not come down to reflect this concern. To be fair, they tend to do "bottom's up" analysis and forecast a company's earnings in a continuation of the current macro environment, rather than guess what the economy will look like in the future. Based on current estimates the overall stock market is not particularly expensive, but many think stock prices will need to go lower if estimates are revised downward once the environment has changed materially.

Although 10% corrections in the stock market are usually caused by fears (frequently erroneous) of a looming recession, one usually needs to occur to result in a 20% pullback. Hindsight might prove that we are already in a recession, but the stock market has placed its vote so to speak with investor sentiment extremely bearish. Investors collectively are not always right about what is about to happen, but by the time something foreseeable does happen, the market has typically already discounted it. In short, it is possible that the bad news is largely priced in, even without clarity on the downside to forward earnings.

Recently markets appear to be trading from one day to the next in a "bad-news-is-good-news" pattern, where signs of economic weakness are welcomed because they might mean a quicker end to Fed rate increases, and a reduced chance that they will overdo it and send the economy in to recession. Household balance sheets are still bolstered by the pandemic stimulus, bank balance sheets are in very good shape so a contraction in credit is not forthcoming, and the job market is extremely strong, all providing support for a short and shallow recession. That said, Europe seems destined for a recession due to collateral economic damage from the war in Ukraine, and thus will have reduced demand for US goods. The biggest fear really should be if there is a significant lag in inflation's response to monetary policy because of all the exogenous factors propelling it aside from basic demand (i.e., continued supply disruptions caused by China's covid lockdowns and the Ukraine war's effect on commodity prices), at the same time that monetary policy is otherwise pressuring the economy. Even in the midst of a slowdown or recession, a durable rally could occur once there are signs the Fed has been able to bring inflation under control, because the market will start to look forward to an eventual return to growth.

The S&P 500 is 16% higher than it was at the end of 2019, and we need not remind you of all the unforeseen events in the interim that raised doubts about the stock market's future path. Market observers have been scrutinizing past recessions for hints of what is to come. As uncertain an environment as we might seem to be in, we are largely dealing with a combination of the standard variables that drive the normal ups and downs of the business cycle, not "black swan" events like 9/11, the pandemic or the global financial crisis.

	12/31/2019	**12/31/2021**	**6/30/2022**
2-Year US Treasury yield	1.58%	0.73%	2.96%
10-Year US Treasury yield	1.92%	1.52%	2.98%
30-Year Mortgage	3.74%	3.11%	5.70%
Year-over-year Inflation Rate (CPI)	2.3%	7.1%	8.5%
S&P 500	3,244.67	4,766.18	3,785.38
S&P P/E Ratio	24	30	19
MegaCap-8 % of S&P 500 Market Cap	16.8%	25.7%	23.0%
Crude Oil (WTI)	$61.14	$75.33	$111.44

*The MegaCap-8 is a term coined by Yardeni Research, Inc. to refer to both share classes of Alphabet (parent company of Google), Amazon, Apple, Meta (parent company of Facebook), Microsoft, Netflix, NVIDIA, and Tesla.