Investment and Economic Update
Second Quarter 2022

The bad news in the investment markets continues. U.S. stocks entered true bear market territory in the middle of the second quarter and finished with the worst first six months' return since 1970. Meanwhile, bond rates rose, causing bond investors to suffer paper losses as well.

Losses were spread across the full investment spectrum. The widely quoted S&P 500 index of large company stocks lost 16.45% in the second quarter and is down 20.58% so far this year. The Russell 2000 Small-Cap Index is down 23.93% in the year's first six months, and the technology-heavy Nasdaq Composite Index is showing a 29.51% loss so far this year, as tech stocks continue to experience greater downdrafts than the market as a whole.

International investors are sharing our pain. The broad-based EAFE index of companies in developed foreign economies lost 15.37% in the second quarter, to finish down 20.97% for the first half of the year.

In the bond markets, we are experiencing a significant rise in yields at the short end of the curve, but yield rises on longer bonds have slowed down a bit. Coupon rates on 10-year Treasury bonds have climbed incrementally to a 2.88% rate. Three month, 6-month and 12-month bonds are offering returns of 1.65%, 2.46% and 2.67% respectively--taking the bond market, once again, close to the inverted yield curve which, in the past, has signaled an oncoming recession. Five-year municipal bonds are yielding, on average, 2.23%, while 30-year municipal bonds are yielding 3.22% in aggregate.

The market analysts who are widely quoted in the press and on TV have offered a number of explanations for the sell-off. The inflation rate remains high, with core personal consumption expenditures (this is the index that the Federal Reserve economists watch most closely) rising by 4.7% over last year. Estimates of the Consumer Price Index increase in May came in closer to 6.5%. Oil prices are moderating a bit, but from high levels, causing higher costs for consumers and corporations alike.

The most often-cited trigger for falling stocks is Fed policy. Fed Chair Jerome Powell has publicly stated that his biggest concern is bringing down inflation, and the Fed's policy tool to accomplish that is the opposite of what would raise stock prices: aggressively raising the Fed Funds Rate. A higher Fed Funds Rate drives up short-term interest rates which, in turn, reduces liquidity in the economy, depressing corporate investment and consumer borrowing. Directly related to consumer borrowing, inflation is outpacing wage increases, making people feel less flush than they have felt in the recent past, which is certain to depress consumer spending.

All of this is a reversal of a long-term trend where Fed policies provided a fairly strong wind at the back of the investment markets. We are seeing bond rates going up and liquidity going down, the reverse of the conditions that began with the economic bailout

of the Great Recession and accelerated with the stimulus package following the Covid outbreak. One of the clichés about rate hikes is that the Fed is 'taking away the punchbowl,' which is another way of saying that the party--at least the fun part--is over.

But for how long? The economic community seems to think that the U.S. will meet the technical definition of a recession sometime next year, but we could actually be there now. That's one of the key questions that investors and economists are asking, and there is no easy answer.

In the past, the market returns have anticipated economic slowdowns with more accuracy than the experts, and market recoveries have also tended to start before the slowdown had ended--as people intuited a light at the end of the tunnel.

A recession is a period of time when the economy stops its usual long-term growth pattern and starts shrinking. The technical definition is a drop in the value of goods and services produced (the gross domestic product) for two consecutive quarters. This is often associated with declining incomes, employment, industrial production and retail sales. The numbers aren't in yet for the second quarter, but the U.S. suffered an economic decline in the first three months of 2022 and continued negative growth is not off the table.

The U.S. experienced a shrinking GDP in the first three months of the year, down at an annual pace of 1.6%. What's unusual for this "recession" is that employment is strong, incomes were rising, and prices of goods and services were going up rather than down. Corporate profits are expected to rise for the remainder of the year. And that dismal first quarter follows a robust 6.9% increase in the previous quarter.

The conclusion is that if we are, indeed, experiencing a recession, it is an unusual one, triggered not by the usual decline in corporate activity and job losses, but by a unique combination of supply chain disruptions, a war in Europe, rising energy prices, and the persistence of Covid. In what other recession in history could we say (as we can today) that the economy added 372,000 new jobs in June, the 18th straight monthly gain, and the unemployment rate is at 3.6%—the lowest in a half century?

Unusual recessions are actually not that unusual. As recently as 2020, the U.S. economy experienced a sharp two-month downturn, the shortest ever. The Great Recession, on the other hand, lasted for 18 months, and was triggered not by the usual economic factors, but by reckless Wall Street sales of sketchy bundles of mortgages with little underwriting—followed by a housing collapse.

Often, recessions are brought to heel by a Central Bank stimulus. In the case of the Great Recession and the more recent Covid downturn in 2020, the U.S. Fed flooded the economy with money at zero or near-zero interest rates and made itself a significant buyer of government and mortgage bonds. Both times, the medicine worked. We cannot expect the Fed to ride to the rescue while the inflation rate is as high as it has been, but eventually an economic downturn will depress prices, and stimulus will once again be possible—assuming that an economy with robust employment and corporate profits will actually need it.

There are no guarantees in the investment world, of course, but history suggests that market downturns represent a buying opportunity for the long-term, and that markets tend to overshoot the actual underlying conditions on the upside and (alas) also on the downside. One of the reasons for a downside overshoot is that human psychology seems to be inverted when it comes to our investments. In the general marketplace, when something goes on sale, people flock to buy. But when stocks and other investments go on sale, people seem to regard it as a selling opportunity.

You would be hard-pressed to find an analyst who thinks that individual stocks, or stocks in aggregate, are actually worth 20% less than they were six months ago. In fact, profit expectations for 2022, for the companies that make up the S&P 500 index, have risen this year. In years when the S&P 500 falls by at least 10% in the first half, the second half has averaged a 4.3% gain.

Negative market returns mean that investors have been flocking to sell in the first half of this year, and many of them will lock in real, permanent losses. More patient investors will accept the paper losses as a temporary blip in a long-term uptrend and, if history holds, will ultimately experience a recovery and no diminishment of their portfolios' buying power.

We can only hope this happen sooner rather than later.

Below, we've summarized some of the widely quoted indexes for your reference. As a reminder the challenge is, the DJIA is not the same as the S&P 500, which is not the same as the NASDAQ – and none of these indexes perfectly match your own distinct mix of assets and their expected returns, especially if you own a globally diversified portfolio with exposure to stocks and bonds, large and small companies, value and growth companies, and U.S. and non-U.S. based companies. The following returns are quarter, year-to-date and the rolling 1-year; respectively:

S&P 500: -16.45%, -20.58%, 12.37%
Dow Jones: -11.25%, -15.31%, -11.14
NASDAQ Composite: -22.44%, -29.51%, -24.06
Russell 2000 (Small-Cap): -17.49%, -23.93%, -26.68
MSCI EAFE (International): -15.37%, -20.97%, -19.90%
Barclay's Capital US Aggregate Bond: -4.69%, -10.35%, -10.25%

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