MARKET REVIEW & OUTLOOK

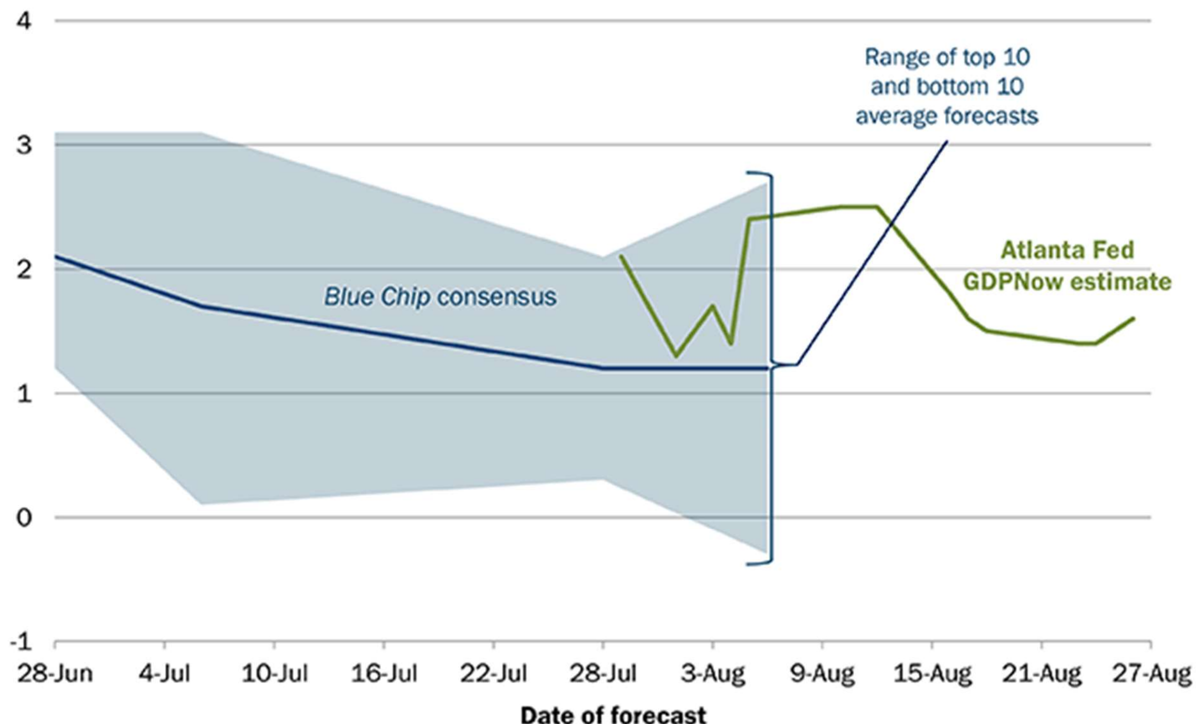
AUGUST 2022

KEY TAKEAWAYS

- The perceived "Fed pivot" that continued driving the equity market rally into late August was kiboshed by Fed head Powell at the Jackson Hole symposium.
- Interest rates spent the month reversing the late July plunge in the 10-year Treasury Bond yield, with yields rallying back to two-month highs on inflation concerns and Fed hawks.
- The Russia/Ukraine conflict still shows no signs of ending, but the deal no deal saga with Iran continues and with-it oil prices seemingly moving $5 on each change in headline.

The U.S. Economy

The second look at 2nd quarter GDP came in at -0.6%, which was better than the originally reported -0.9%, though still negative GDP. The 3rd quarter estimate from the Blue-Chip consensus and the GDPNow estimate continue to be relatively low, but still positive around 1.5%. The incoming data has been modest, but generally less negative than we were seeing in the first half. Inflation pressures and continued interest rate hikes from the Fed likely continue to weigh against robust GDP growth.



Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

Source: https://www.frbatlanta.org/cqer/research/gdpnow

Stocks and Bonds

Interest rates were pretty much a one-way trade for the month, ending at the high yield of the month and closed back over the 3.00% mark on the 10-year Treasury Bond. The bond market continued pricing in likely continued hawkish Fed policy as equities continued to hope for a dovish pivot. The other Fed governors continued speaking hawkishly as reflected in the continued march higher in bond yields. As seen in the chart below, the 5-year Treasury had its second largest yield increase since 2009 and is at levels last seen in 2008. At the July Fed meeting, Powell said they were data dependent, which equities took to mean leaning dovish. However, the bond markets said that could be hawkish to not limit them to "forward" guidance. At the Jackson Hole symposium, Powell leaned into the accuracy of the bond market read and very succinctly stated in 9 minutes, that the Fed was very focused on getting inflation back down to the 2% target, i.e., not dovish at all. The run up in yields created a strong headwind for High Quality fixed income, which as measured by the iShares US Aggregate Bond ETF, lost -2.42% for the month. The U.S. 10-year Treasury bond yield ended the month at 3.13% closing at the high yields of the month and up significantly from July's close of 2.64%, basically the mirror opposite of last month.

Source: https://www.zerohedge.com/markets/august-hawk-nado-hammers-stocks-bonds-commodities-crypto

The Dow Jones Industrial Average lost -3.21%, the S&P 500 fell -4.24%, and the small cap Russell 2000 eased -2.18%. The international markets traded in a similar fashion to the U.S. The MSCI EAFE iShares Core International Developed Markets ETF Index dropped -5.18%, and the MSCI Emerging Markets iShares Core ETF Index slipped -0.26%.

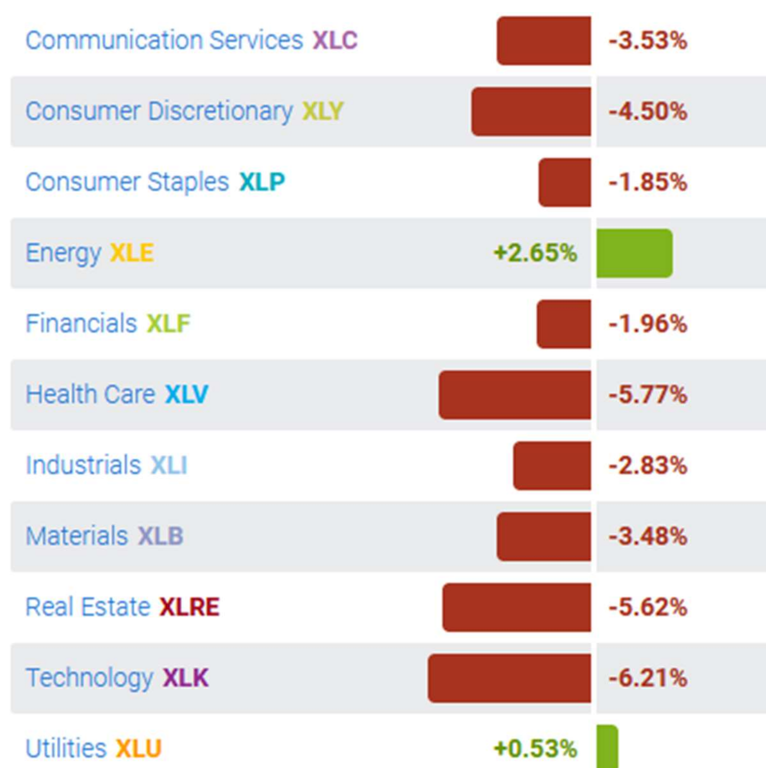
August was relatively tame compared to the last 2 months, though most sectors finished in the red.

The best performers were…

- Energy: +2.65%
- Utilities: +0.53%

The worst performers were…

- Technology: -6.21%
- Health Care: -5.77%
- Real Estate: -5.62%



Source: https://www.sectorspdr.com/sectorspdr/tools/sector-tracker

Oil Report

The oil market dropped hard on the first day of the month again, this time nearing the $90 mark. Fears of demand destruction from high prices and potential economic slowing pulled prices lower. However, the "almost" done deal with Iran, which I think has been in the same place all year, gave crude a bid when it was off again. The current NYMEX WTI Crude Oil futures settled at $88.85 and posted a loss of almost 10% from the prior month close of $98.62 a barrel. The weakness in oil continued to bring down RBOB gasoline, which dropped over 22% vs July's close and is off approximately $1.86 (43%) from June's high. The tug of war between the near-term potential demand destruction against the fact that globally capex for the oil complex is still relatively low, i.e., new supplies are not being brought online, continues the wide swings in the oil markets.

The Rest of the Data

The July ISM Manufacturing Index eased 0.2 points to 52.8 from June's reading of 53.0. Conversely, the ISM Services Index increased to 56.7 in July from June's print of 55.3. The prices paid component for Manufacturing plunged and for Services prices dropped meaningfully and are now at high and elevated levels, respectively. Any reading above 50 generally indicates improving conditions. Consumer confidence jumped to 103.2 in August, which compares to a downwardly revised figure of 95.3 in July. The unemployment rate eased down to 3.5% and the economy added an eye popping 528,000 jobs in July, which smashed expectations of 250,000 jobs, nothing telling the Fed to slow down on rate hikes with this report. The Consumer Price Index for All Urban Consumers (CPI-U) was flat at +0.0% in July, on

a seasonally adjusted basis, as inflation disappeared. ☺ Over the last 12 months, the All-Items Index eased to +8.5% on a non-seasonally adjusted basis. The CPI ex Food and Energy, held at 5.9% over the last year. This data, granted only one month, suggests the Fed may finally be getting an easing of inflationary pressures. The above data indicates the economy is generally on good footing. The Fed has raised rates faster than any time in the last 40 years and continues to be firm in the stance that interest rates will be higher for longer. So, the opposite of the last 10+ years of policy, the equity market continued to call the Fed's bluff until the Fed head Powell pushed "all in" saying this time is different with inflation significantly above the Fed target of 2%. At least for a few days the equity markets are taking the Fed more seriously. We will continue to monitor economic activity in concert with inflation reports and how that may impact Fed policy.

Summary

The equity market learned the hard way that the Fed's data dependence was not actually a dovish pivot. The buyers of that perception, quickly disposed of positions as most of the loss for the month occurred in the last 4 days. The bond markets continued to price in additional rate hikes and pushed out the timing of future rate cuts. There is a saying, that the adults trade bonds and the kids play in equities, i.e., equities drift off into LaLa land only to be rudely awakened. If the Fed continues to raise rates and then holds rates higher for longer, then seemingly the economy and earnings will be hampered by this continuing and increasing headwind. Short term the energy markets are suggesting that demand destruction is occurring, which will help bring down inflation. However, without new supplies or significant advances in alternative sources of energy, the economic recovery likely let's the inflation genie back out of the bottle.

As always, the markets can be emotional, so we retain our focus on what we can control, which is the amount of equity risk that is taken in a clients' portfolio in concert with the clients' risk tolerance and long-term goals. The markets will always face different "worries", today it is inflation/war vs. waning growth expectations, tomorrow it will be something else. We have built our asset allocation models with dynamic features and quarterly rebalancing, both in fixed income and equities. If the markets continue to decline, we will reallocate the overweight that occurs in Fixed Income back into equities. The decline in equity markets has triggered the rules-based defense mechanisms to reduce the risk of the portfolio via the dynamic investment vehicles that have been deployed. Further, if the equity markets get too extended on the downside, some of the vehicles will reallocate some capital back into their respective equity exposures.

These dynamic tools have been engaged, a couple of times during the increase in volatility. At month end a portion of equity has shifted to Treasury Bills for U.S. Large, as well as Developed International.

If you have specific questions about your portfolio or financial situation, we are here to help. Long-term financial planning is designed to deal with uncertainty like those we discussed above. Our portfolio management process is to design a prudent allocation across many asset classes. Equities are for long-term growth and several vehicles that we utilize offer defensive mechanisms to mitigate equity market declines.

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