MARKET REVIEW & OUTLOOK

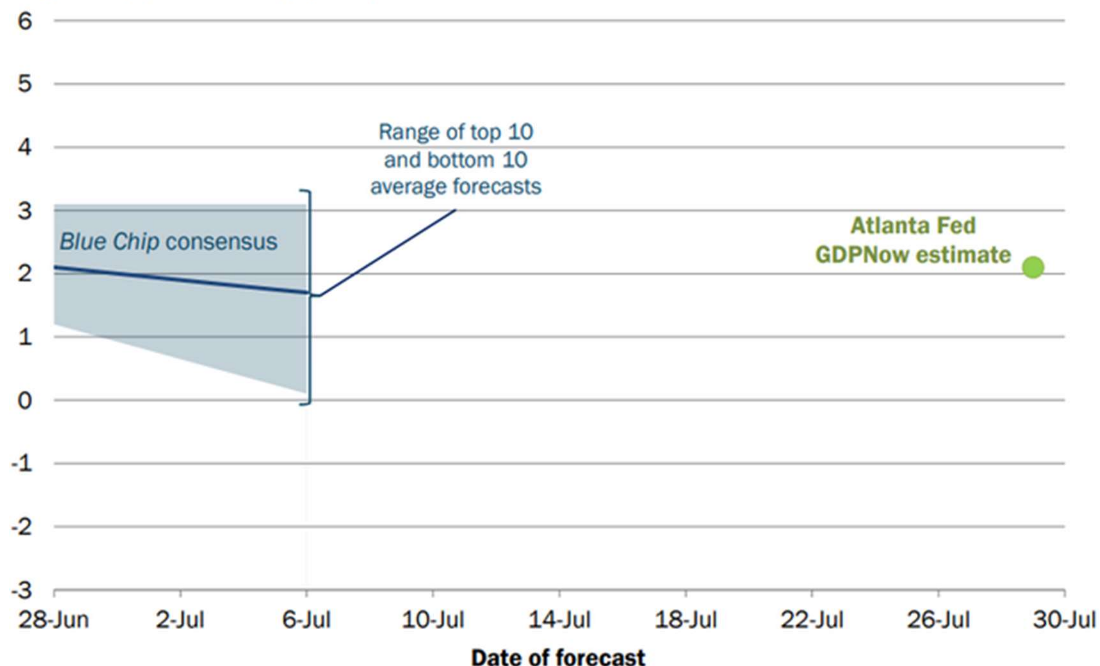
JULY 2022

KEY TAKEAWAYS

- In a flash the June swoon was swiftly reversed in a ferocious rally. The stock markets take is that the Fed will pause interest rate hikes shortly and look to cut interest rates in early 2023.
- Interest rates spent most of the month hugging 3.00% on the 10-year Treasury Bond, but the last few days of the month saw a significant drop in rates on the premise that the recession will come sooner, and Fed interest rate hikes will quell inflation.
- The Russia/Ukraine conflict still shows no signs of ending, but the market put more focus on a potential recession which led to a second monthly decline in oil prices.

The U.S. Economy

The first look at 2nd quarter GDP came in at -0.9%, what commonly is viewed as a recession given the second consecutive quarter of negative GDP. The market still seems to be viewing this merrily as a "technical" issue, given the large reduction in fiscal stimulus on a year over year basis. The consensus is still not expecting a recession to hit until 2023. The 3rd quarter estimate for the Blue-Chip consensus is almost identical to 2nd quarter, at +2% and similar for the GDPNow estimate. Again, other than higher interest rates, I am not sure what makes this quarter look any different than the last two. We will continue to monitor incoming data for signs that the negative growth is the removal of fiscal stimulus vs. a broader weaking in the economy.



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

Stocks and Bonds

Interest rates spent the first 3 weeks traversing 3.00% on the 10-year Treasury Bond. However, the last few days of the month saw a large drop in yields on fears that the economy is moving closer to recession. Further, the Fed did raise interest rates another 75 bps in July, giving the fixed income markets some comfort that the Fed may quell inflation and drove rates to close at the low yields of the month. The Fed removed “forward” guidance and stated they will be data dependent. The long end of the Treasury curve interpreted that to mean continuing to fight inflation. The Fed funds market is pricing in smaller rate hikes going forward; 50 bps in September and November and 25 bps to close out the year in December followed with cuts for interest rates in early 2023, i.e., the result of a recession. The drop in yields provided a much-needed tailwind for High Quality fixed income, which as measured by the iShares US Aggregate Bond ETF, gained +2.42% for the month. The U.S. 10-year Treasury bond yield ended the month at 2.64% closing at the low yields of the month and down significantly from June’s close of 2.97%.

The Dow Jones Industrial Average rallied +6.73%, the S&P 500 jumped +9.11%, and the small cap Russell 2000 soared +10.38%. The international markets traded in a more muted fashion relative to the U.S. The MSCI EAFE iShares Core International Developed Markets ETF Index gained +5.41%, and the MSCI Emerging Markets iShares Core ETF Index eased -0.15%, hurt by the strong US Dollar.

July was a sharp contrast to the ugliness of June in the market, with every sector green.

The great performers were…

- Consumer Discretionary: +16.70%
- Technology: +11.94%

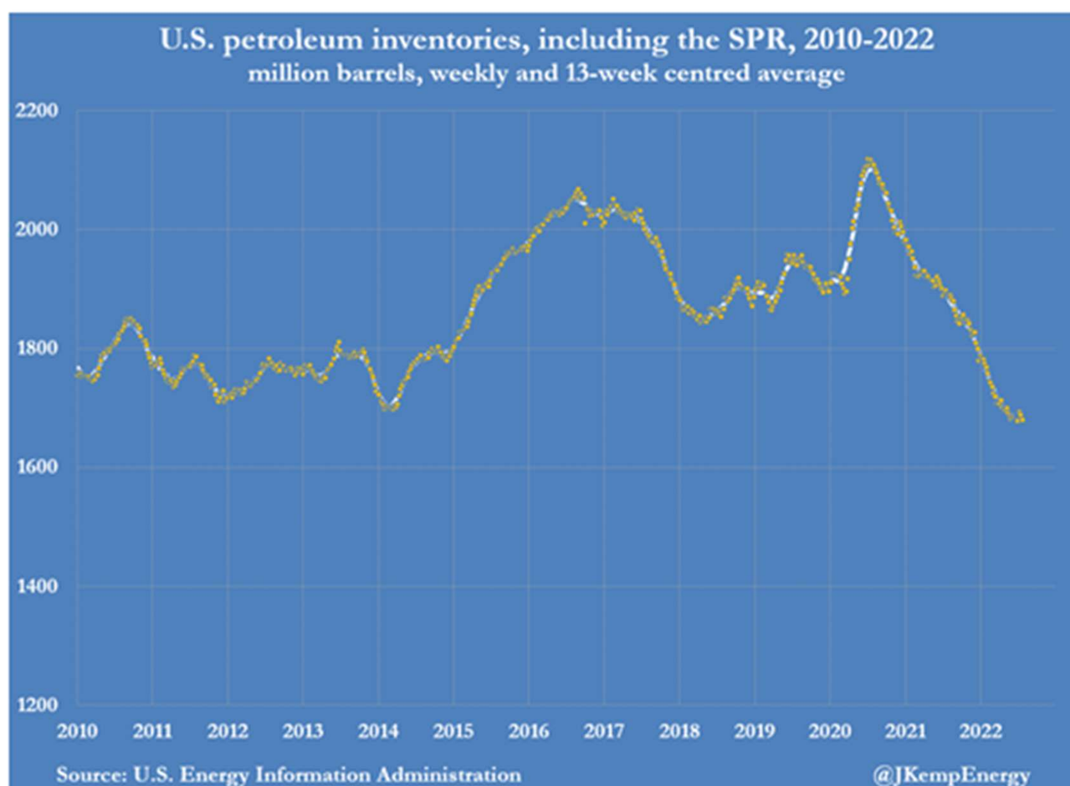
The lesser performers were…

- Communication Services: +2.62%
- Health Care: +3.01%
- Consumer Staples: +3.27%

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

Oil Report

The oil market dropped 10% on the first day of the month and spent a lot of time under the $100 mark and continued to experience strong selling pressure each time it poked above the $100 mark. As the chart below illustrates, crude oil inventories remain near decade lows, which long-term is a tailwind for higher oil prices. However, in the short-term, demand destruction from high gas prices and concerns of recession globally are exerting more force on the price of oil. The current NYMEX WTI Crude Oil futures settled at $98.30 and posted a loss of over 7% from the prior month close of $105.76 a barrel. The weakness in oil spilled over to RBOB gasoline, which dropped over 12% vs June's close and off approximately $0.43 from June's close. The reality of these comments rings truer today as Europe is now in a winter energy crisis even though it is still the middle of summer. "Economic slowing may put a band aid on high prices for the time being, but the issues of shutting off Russian energy as well as the West's war on fossil fuels does not appear to be going away. Once growth resumes, without major technological advances, energy costs will be poised to quickly regain losses."



Source: https://www.zerohedge.com/markets/plunging-us-oil-inventories-imply-deeper-slowdown-will-be-needed

The Rest of the Data

The June ISM Manufacturing Index decreased 3.1 points to 53.0 from May's reading of 56.1. Further, the ISM Services Index decreased to 55.3 in June from May's print of 55.9. The prices paid component for both the Manufacturing and Services surveys again eased modestly but remain at very elevated levels. Any reading above 50 generally indicates improving conditions. Consumer confidence declined to 95.7 in July, which compares to a downwardly revised figure of 98.4 in June. The unemployment rate again

held steady at 3.6% and the economy added a decent 372,000 jobs in June, which was the 2nd month of less than 400k+ of job adds in a year, but still respectable. The Consumer Price Index for All Urban Consumers (CPI-U) was up +1.3% in June, on a seasonally adjusted basis, as inflation reaccelerated. Over the last 12 months, the All-Items Index increased to +9.1% on a non-seasonally adjusted basis, now at 41-year highs. The CPI ex Food and Energy, decreased again to 5.9% from last month's 6.0%. The Fed continues to discuss the strong labor market and the need to reduce demand to rein in inflationary pressures, which seems to be code for recession, though we don't seem to know what that definition is anymore. 😊 The above data indicates the economy is still on good footing, though continues to miss expectations. The Fed has raised rates faster than any time in the last 40 years, though inflation is still significantly above the Fed Funds rate, i.e., we still have accommodative monetary policy. Thus, the Fed's actions seem to suggest they expect an economic contraction to bring down inflation to the point they end up raising interest rates. For once, let's hope the Fed has this one right. Otherwise, the Fed has likely created the blunder of Fed Head Burns in the early 70's of prematurely declaring victory over inflation. We will continue to monitor economic activity in concert with Fed policy.

Summary

The equity market, read the Fed is now data dependent, as the rate hikes are almost over and soon, we will see interest rate cuts, which means a renewal of economic growth, buy with both hands. Equity does seem to have ignored the ramifications, i.e., recession, earnings contraction, perhaps expecting the rate cuts to boost the economy so quickly as to not have a material impact on earnings. Or perhaps this is a sign of the moral hazard that the Fed was concerned about in 2008 when this all began, i.e., the Fed has our back and losses are always only a temporary condition. The bond market is pricing in concerns that economic growth is in fact slowing and that a recession is becoming highly probable, isn't that the usual outcome of interest rate hikes? Some in the Fed Funds market have argued the Fed has removed forward guidance for one of two reasons. 1) They have no idea what is next and don't want to even hazard a guess or 2) they fear inflation is going to continue to be too strong and will necessitate rate hikes greater than 75 bps, neither option seems very appealing, but again most of the blame rests with themselves. The oil market continues to be placing more weight in the short term on recession fears, notwithstanding the secular tail winds of tight supplies against future high demand. The Fed doesn't meet again until September, though if history repeats, we will get more insight into their thinking at the end of August Jackson Hole meeting. The Fed has given up on guidance and is focusing on the data, so too shall we.

However, given the above crosscurrents, 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 and Mid-Cap, 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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