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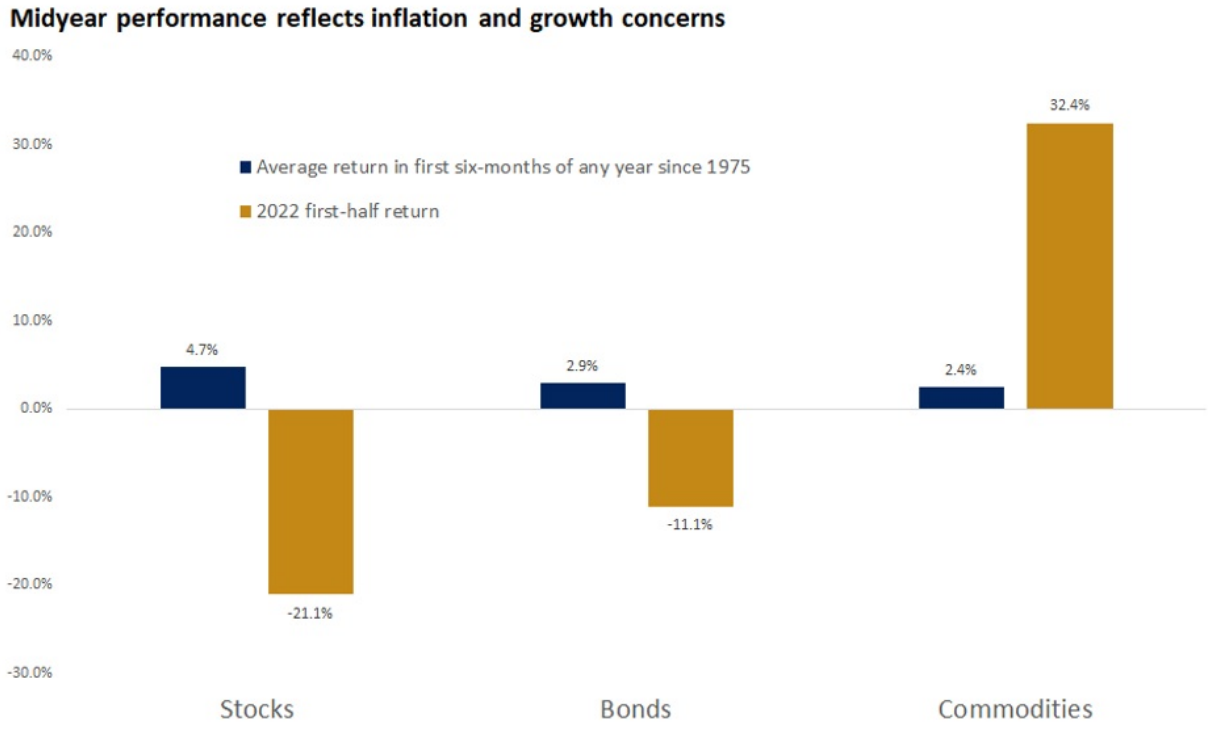
Weekly Market Commentary
June 27th, 2022

Mid-Year Market Recap: Where Do We Go From Here?

With just a few days away from the end of June, stocks gained some ground last week but remain down nearly 20%, their worst first six months of any year since 1970. Aggressive central-bank tightening, concerns around inflation, and the effect of these two factors on growth have led to a rapid adjustment in interest rates, valuations, and sentiment. The economy will likely continue to slow in the quarters ahead, reflecting the lagged impact of policy tightening. However, the year-to-date sell-off in both stocks and bonds has improved future returns for long-term investors. Here is a perspective on how the economy, stocks, and bonds are shaping up at the midyear point and what could be in store for the second half.



The graph shows returns for stocks, bonds, and commodities through the first half of this year, and how they compare with the returns of an average year.

The Economy

First-Half Assessment:

- After having grown by 5.7% in 2021, the U.S. economy entered the year from a position of strength. A positive outlook was supported by pent-up consumer

demand because the pandemic headwinds had started to fade, the labor market was robust and corporate and household finances were solid. Yet, lingering inflation pressures, which worsened following the invasion of Ukraine and lockdowns in China, started taking a bite out of personal disposable income and savings and forced the Fed to signal an aggressive rate-hike path.

- First-quarter GDP unexpectedly contracted, driven by a drag from exports and a decline in inventory spending. But consumer spending, which accounts for nearly 70% of U.S. GDP, continued to grow at a solid pace. A real-time estimate of second-quarter GDP from the Atlanta Fed is currently showing 0% growth. While there is a risk of another quarter of negative growth that would meet the definition of a "technical" recession (two consecutive quarters of negative GDP growth), an "official" recession as designated by the NBER Business Cycle Dating Committee is not in the cards in the first half. There are no signs of a widespread downturn in activity or in the labor market.

Second-Half Prognosis:

- As we move into the second half of the year, demand will likely decelerate further as consumers and businesses react to the sharp rise in borrowing costs. Typically, changes in Fed policy impact the broader economy with a lag, but the interest-rate-sensitive sectors, such as housing and autos, are already slowing. Mortgage applications are in a downtrend, and existing home sales have been lower for the last four months[1].
- The labor market remains tight, which, along with household savings, will continue to support growth. However, applications for unemployment benefits (initial jobless claims) have been slowly rising over the past two months, as companies are taking a more cautious approach to hiring amid elevated costs and slowing demand. Even as conditions shift, it will probably take a while to clear the imbalance between labor supply and demand and for unemployment to rise meaningfully. Job openings are still twice the number of unemployed workers.
- Inflation has broadened and proven stickier, which means that the Fed's foot will remain firmly on the brakes for the economy this year. While a lot of the factors that are driving inflation are outside of the Fed's control, the sharp rise in rates will have an impact on demand, economic activity and eventually inflation. Last week's drop in commodities and pullback in bond yields was a reminder that prices respond to the changing conditions, and that there is still a path for the Fed to move more gradually in the back half of the year.

Equity Markets

First-Half Assessment:

- The first half of the year contained an all-time high for stocks early on, then the longest losing streak since 2001 followed, and now we are seeing an ensuing bear market, the second 20%+ drawdown in three years. With oil prices up 40% this year, energy was the only sector to post gains. Utilities and consumer staples outperformed, as investors sought the safety of companies that are less sensitive to the business cycle. On the other hand, growth-style investments lagged the most as bond yields rose, with the technology, communication services and consumer discretionary sectors all down more than 25%.
- A breakdown of the market return into two components -- 1) change in valuations, and 2) change in corporate earnings -- reveals that this year's decline in stocks has so far been exclusively driven by a decline in valuations,

with corporate earnings growth acting as a partial offset. Specifically, the S&P 500 price-to-earnings ratio has fallen 26% (from 21.3 to 15.7), while forward earnings have risen by 6%. For perspective, in the past five Fed-tightening cycles since 1985, valuations declined 20%.

Second-Half Prognosis:

- Expect more volatility because uncertainty remains as to how restrictive the Fed policy needs to be to break the back of inflation. As GDP growth slows and likely falls below 2% this year and next, earnings expectations will probably move lower (analysts expect S&P 500 earnings to grow 10% this year and 9% in 2023). While valuations have already corrected, the likely necessary process of revising earnings expectations could weigh on sentiment in the months ahead. The kickoff of the second-quarter earnings season in three weeks will provide some clarity on how resilient the outlook for corporate profits is. Our sense is that current estimates will be clipped, but this year's earnings will still be able to rise from last year.
- Without the benefit of Fed support, the bottoming process will likely be bumpy and prolonged. And for stocks to stage a durable rebound it will likely require several months of moderating inflation. Given the unpredictable nature of geopolitical events that affect commodity prices, the range of outcomes is wide. However, the markets are already pricing in some type of a recessionary outcome, and the pullback is creating compelling opportunities for those with a broader time horizon.

Fixed-Income Markets

First-Half Assessment:

- A key reason why performance for balanced portfolios has suffered more this year than past equity-market pullbacks of this magnitude is that bonds have not provided their typical diversification benefit (bond prices tend to rise when stocks decline, and vice versa). Instead, bonds sold off along with stocks in the first half, as the Fed's signaling of an aggressive tightening policy triggered a major reset in yields. The 10-year Treasury yield doubled in six months and hit a new cycle high at about 3.5% before falling sharply last week, as recession worries weighed on commodity prices.
- The bond market priced in the fastest hiking cycle since the 1990s, with the fed funds rate expected to settle in the 3.50% - 3.75%% range by the end of the year from 1.75% currently, indicating a mildly restrictive policy. For perspective, Fed officials estimate that the neutral rate (where policy is neither accommodative nor restrictive) is about 2.5%[1].

Second-Half Prognosis:

- Bonds are down, but they're not out. With interest rates having reset higher, we expect better returns in the second half of the year, and we see an opportunity emerging to put some cash to work. Investors can now find attractive yields in higher-credit-quality bonds. The additional income earned from intermediate- and long-term bonds can help compensate for the increased interest-rate risk relative to cash or other cash instruments, in our view.
- Without attempting to predict the exact peak in yields, the 10-year at around 3.5% or slightly higher is consistent with the market pricing and the Fed's projection of what the peak policy rate will be. As shown in the graph below,

long-term government bond yields in the past have tended to converge near the peak of the fed funds rate for the cycle. Historically, the 10-year has peaked about two months before the last Fed hike, on average. While it is still possibly a year away from that point, markets have front-run the Fed faster than in the past and are already pricing in an aggressive rate-hiking cycle.

(Source: oXYGen & Jones)

Markets For The Week

INDEX	CLOSE	WEEK
Dow Jones Industrial Average	31,501	5.4%
S&P 500 Index	3,912	6.4%
NASDAQ	11,608	7.5%
MSCI EAFE	1,837	.8%
10-yr Treasury Yield	3.13%	-.1%
Gold	$1,828	-1.03%
Bonds	$101.04	.7%

Source: Reuters/Wall Street Journal

Earnings Highlights This Week

Darden Restaurants: Darden Restaurants on Thursday reported quarterly earnings and revenue that beat analysts' expectations. The company's combined same-store sales climbed 11.7%, fueled in part by the rebound of its fine-dining business. In the face of inflation and other economic uncertainty, Olive Garden's parent company issued a mixed forecast for fiscal 2023.

News and Notes

What Did the Kardashians Finale Teach Us About Money?

Repeated Infidelity Takes A Toll On (Financial) Relationships

- We need to be able to trust our partners to feel safe in any type of relationship.
- 53% of Americans in a recent study said Financial Infidelity is WORSE than regular cheating.
- Keep your eyes open for red flags such as lots of cash withdrawals, lots of credit cards being opened, and now side crypto accounts.

Boundaries are healthy for (Financial) Relationships

- Living with the decision to completely combine finances when you get married is not easy. Many people don't.
- It's important to have at least one account where you have some financial freedom and independence.
- You should set common financial goals and have complete transparency over your family finances.

Giving Second Chances Isn't Weak…But Could Be (Financially) Risky?

- Is past behavior the best predictor of future behavior?
- If you have loaned money one time to someone, should you loan them money again? (friend or family)
- But remember, famous people like Milton Hershey went bankrupt twice before he became a huge success.

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