Q2 2022 Commentary

July 2022

"Many receive advice, only the wise profit from it."
Harper Lee

Q2 MARKET RECAP

Global equities and fixed income returns continued to be challenged in the first half of 2022 as "sticky" inflation, rising interest rates, the ongoing war in Ukraine, continued COVID-19 lockdowns in China, and slowing global growth weighed on investors' minds. Several key indices officially entered a bear market (defined as a 20% price decline from highs) during the quarter, dragging consumer confidence down. Fixed income's historically poor performance to start the year resulted in losses for risky and risk averse investors alike. Large cap stocks outperformed small cap, value outperformed growth, and foreign outperformed U.S. equities. Investment grade corporate bonds, long dated U.S. Treasuries, and foreign sovereign bonds were notable underperformers within fixed income. Sharply rising rates have increased return expectations for all fixed income asset classes, with investment grade credit now yielding approximately 4.6%, more than double the level where it started the year.[1]

Asset Class	Benchmark	June	Q2 2022	YTD
U.S. Large Cap Stocks	S&P 500 TR USD	-8.3	-16.1	-20.0
U.S. Small & Micro Cap	Russell 2000 TR USD	-8.2	-17.2	-23.4
Intl Dev Stocks	MSCI EAFE NR USD	-9.3	-14.5	-19.6
Emerging & Frontier Mkt Stocks	MSCI EM NR USD	-6.7	-11.5	-17.6
Global Stocks	MSCI ACWI NR USD	-8.4	-15.7	-20.2
U.S. Municipal Bonds	Bloomberg Municipal TR USD	-1.6	-2.9	-9.0
U.S. Taxable Bonds	BBgBarc US Agg Bond TR USD	-1.6	-4.7	-10.4
U.S. High Yield Bonds	BBgBarc US Corporate High Yield TR USD	-6.7	-9.8	-14.2
Intl Dev Bonds	S&P International Sov Ex-US Bond TR USD	-5.1	-12.5	-18.7
U.S. REITs	MSCI US REIT NR USD	-7.5	-17.2	-20.7
Broad Commodity Futures	Bloomberg Commodity TR USD	-10.8	-5.7	18.4
Energy Partnerships	Alerian MLP TR USD	-14.0	-7.4	10.0
Gold	DJ Cmmdty Gold TR USD	-2.1	-7.6	-1.5

Data from Morningstar as of 6/30/22

Two dominant themes to watch over the remainder of the year are changing inflation and growth expectations. The Federal Reserve's hawkish stance has made it clear they will raise rates and tighten financial conditions as much as needed to reduce inflation. Conversely, many economic indicators are already pointing to a slowing economy which should relieve some inflationary pressure and require less central bank tightening. This 'bad news is good news' perspective has produced significant asset volatility which we expect will continue for some time. Recessions and expansions are a fact of business cycles. Rather than focusing on recession timing, we continue to focus on investing over complete market cycles favoring assets that we think will generate attractive risk-adjusted returns.

[1] iShares iBoxx Investment Grade Corp Bond ETF yield to maturity. Data as of 7/1/2022 from ishares.com

SLOWING ECONOMY AHEAD?

Many economic and leading indicators started to show decelerating growth or outright contraction throughout the second quarter. Higher than expected year-over-year inflation data in Q2 surprised investors, causing considerable volatility in interest rates and inflation sensitive assets. Market participants believe peak inflation is close and will moderate soon. Despite a brief rise last month, investors expect inflation to be approximately 2.6% five years from now.[2]

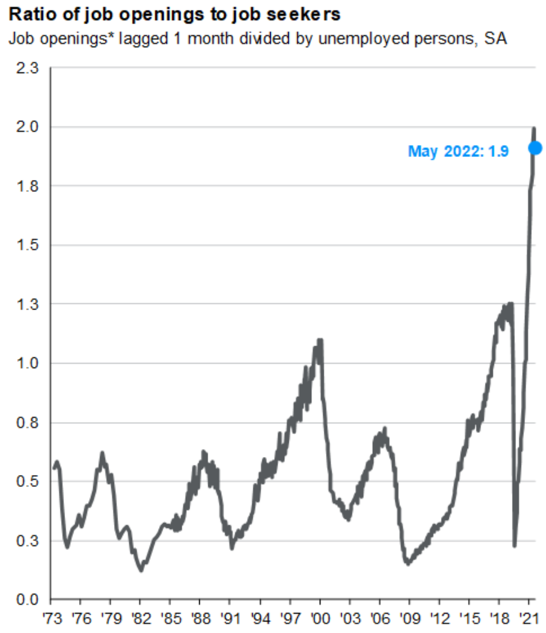

Figure 1. Source: U.S. Department of Labor, J.P. Morgan Asset Management. Data as of 6/30/2022

Higher mortgage rates are expected to act as a major headwind to the housing sector. Building permits and housing starts declined in Q2.[3] Low inventory and falling prices for construction materials (mostly driven by lumber) should act as price stabilizers to offset demand weakness driven by higher rates. The Conference Board Leading Economic Index for the U.S. declined again in May reflecting falling stock prices and a general slowdown in business activity.[4] Consumer sentiment hit an all-time low (index level 50) as measured by the University of Michigan Consumer Sentiment Index in June with respondents citing inflation as their primary concern.[5] Industrial metals including copper fell over 10% in June.[6] Copper prices are widely used to interpret economic growth because it is heavily utilized in industrial applications. In June, and for a second time this year, the 10-year U.S. Treasury yield minus the 2-year U.S. Treasury yield went negative, suggesting investors are positioning for further economic slowdowns ahead.

There remain several key positive economic indicators that should not be overlooked: Labor demand continues to be very strong and the ratio of job openings to job seekers is still near an all-time high of 1.9x (see Figure 1). Typically, this ratio peaks before recessions, but the current strength of the labor market portends a potentially shallower recession relative to those with larger GDP declines. Researchers at Blackstone quantified this by looking back at the previous 11 recessions and found a strong correlation between rising unemployment and severity of economic recessions (see Figure 2).

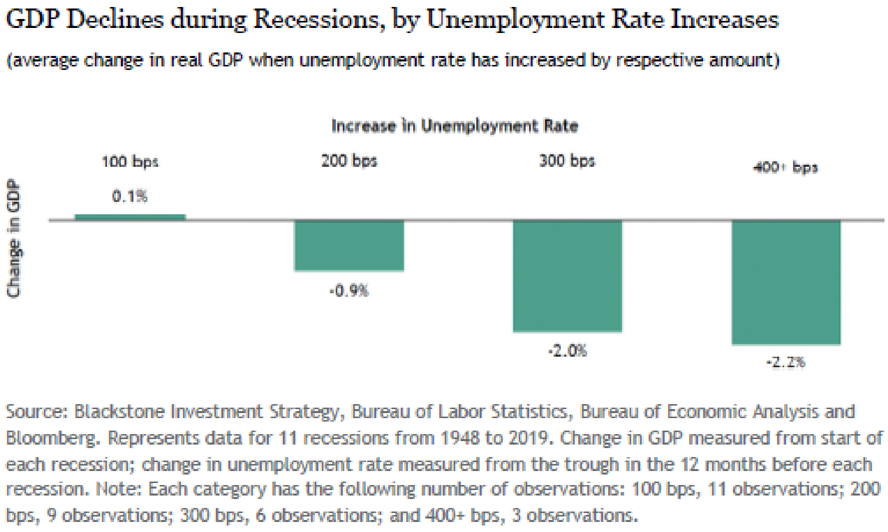

Figure 2.

[2] Federal Reserve Bank of St. Louis, 5-Year Breakeven Inflation Rate [T5YIE], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/T5YIE, July 6, 2022.

[3] https://www.census.gov/construction/nrc/pdf/newresconst.pdf. Monthly New Residential Construction, May 2022

[4] The Conference Board Leading Economic Index, retrieved from https://www.conference-board.org/topics/us-leading-indictors, July 6, 2022

[5] Surveys of Consumers, Index of Consumer Sentiment. University of Michigan, retrieved from http://www.sca.isr.umich.edu/, July 6, 2022

[6] https://www.marketwatch.com/investing/future/hg00, July 6, 2022

Unemployment data typically lags other indicators, but the labor market has not shown signs of considerable weakening ending the quarter.

Secondly, the consumer balance sheet is still in relatively good shape. The household debt service ratio of 9.5% is far below the 40-year average of 11%.[7] Despite the pullback in equities and bonds year-to-date, consumers' net worth remains near an all-time high. Consumer preferences have shifted in the last 6 months to spending on services and experiences over goods, with hospitality, leisure, and travel sectors anticipating strong revenues this summer.

Some economists and market observers believe the U.S. may already be in a recession. It is widely assumed that two sequential quarters of negative GDP growth defines a recession, but the call is ultimately made by the National Business of Economic Research, often well after the economy has contracted. If we are currently in a recession, it is very different than the previous two (2020 and 2008-2009).

CORPORATE EARNINGS REMAIN ROBUST

At odds with those calling for an imminent recession, analysts have not significantly lowered earnings estimates for U.S. companies in Q2. In fact, analysts revised full year 2022 earnings estimates higher as compared to Q1 2022 estimates. These estimates have trended downward since last month and earnings guidance issued over the next few weeks will be watched closely. Companies have largely preserved margins and top line revenue growth by raising prices to offset higher costs of goods and labor costs. Falling equity prices paired with stable earnings has the S&P 500 trading at a forward price to earnings ratio of 15.8x, which is lower than the 5-year (18.6x) and 10-year (16.9x) averages.[8]

IS ASSET ALLOCATION BROKEN?

U.S. focused 60% equity / 40% fixed income portfolios suffered the second worst start to a year since 1926 (see Figure 3). For the past several decades, stocks and bonds have been negatively correlated to each other. High quality bonds have provided diversification, and positive returns, when equity markets sold off. Interestingly, this has not always been the case. U.S. equities and 10-Year Treasuries displayed positive correlation for most of the 1970s – 1990s (see Figure 4). Why was this? Researchers at AQR note that equities tend to do better in high and rising growth environments as investors rightfully expect higher future cash flows.[9] Higher growth prospects naturally increase interest rate expectations, which negatively impacts bonds. High and rising inflation expectations also negatively impact bonds. From the 1970s to 1990s, inflation shocks resulted in negative stock returns over the short-term. During this current market cycle, we've seen stocks and bonds display similar sensitivity to positive inflation surprises.

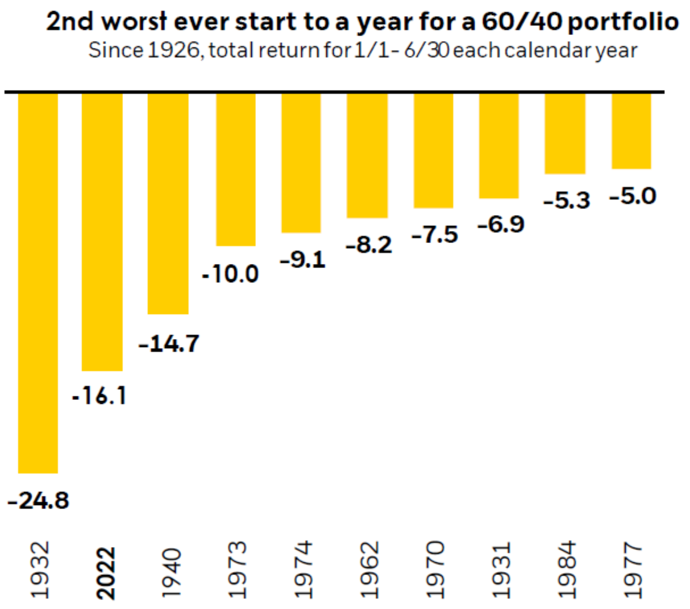

Figure 3. Source: Morningstar as of 6/30/22. U.S. bonds represented by the IA SBBI US Gov IT Index from 1/1/26 to 1/3/89 and the Bloomberg U.S. Agg Bond TR Index from 1/3/89 to 6/30/22. U.S. stocks are represented by the S&P 500 Index from 3/4/57 to 6/30/22 and the IA SBBI U.S. Lrg Stock Tr USD Index from 1/1/26 to 3/4/57.

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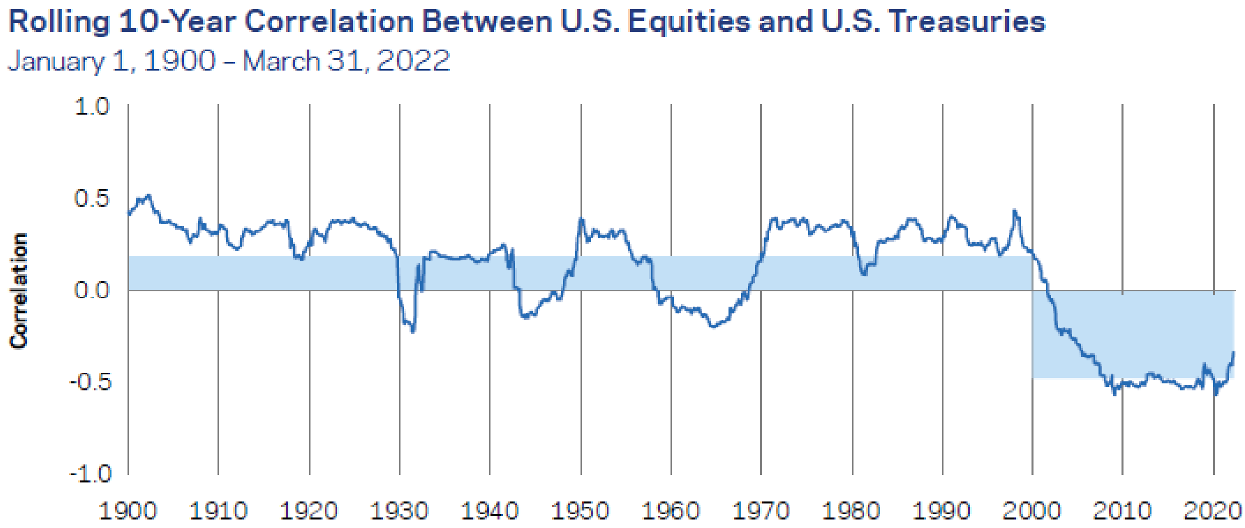
[7]Board of Governors of the Federal Reserve System (US), Household Debt Service Payments as a Percent of Disposable Personal Income [TDSP], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/TDSP, July 7, 2022
[8] Earnings Insight, Factset, https://advantage.factset.com/hubfs/Website/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_070122.pdf, July 7, 2022
[9] The Stock/Bond Correlation Q2 2022, https://www.aqr.com/Insights/Research/Alternative-Thinking/The-Stock-Bond-Correlation, July 10, 2022

Figure 4.



Sources: Bloomberg, Global Financial Data, AQR. Based on overlapping 3-month returns at monthly frequency. Shading shows average correlations in 20th and 21st Centuries.

In a market with rising stock-bond correlations, investments in hedged strategies and private investments, such as private credit, private equity, and direct real estate, may be beneficial when deployed as part of a comprehensive investment approach (and where appropriate for the investor). We anticipate these strategies will help offset rising portfolio volatility, reduce maximum drawdowns, and potentially increase overall returns.

PARTING THOUGHTS

Time will tell if central banks can engineer a "soft landing" or if ongoing monetary tightening will lead to a deeper recession. We remain cautiously optimistic that today's strong consumer paired with a robust labor market will reduce the odds of a severe recession and moderate additional significant market declines, at least in the U.S.

Nearly all U.S. equities are now trading below their previous 20-year average forward price-to-earnings ratio with small capitalization stocks offering the most compelling discount.[10] Valuations look even more attractive for overseas investments. Expected returns from fixed income appear significantly better than anytime over the last 10 years. Improving valuations point to a brighter future for those who remain diversely invested in the markets. We encourage our clients to stay disciplined and focus on what you can control: Take a long-term perspective, rely on asset allocation to manage risk, and thoughtfully implement active, passive, and alternative strategies.

Your PCM advisor is here to help you navigate these challenging times. Thank you for your continued trust.

Sincerely,
The Private Capital Management Team

[10] JPM Guide to the Markets. Data as of 6/30/2022. Small cap stocks trading at 17.1x forward P/E versus 20-year average of 21.4x.