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Quarterly Commentary
July 2022

There was no rest for the weary during the second quarter of 2022. In fact, within just days of the end of the quarter, the S&P 500 was down 22.3% nearly making the start of 2022 the worst start of a year since 1932, the depths of the Great Depression. Thanks to a very small rally worth only 2 percentage points, the index dodged the Great Depression parallel and wrapped up the first half with its worst showing since 1970.

For those who have the traditional 60/40 portfolio (most American investors), the news wasn't any better. The bond market has been hammered, failing to balance portfolios while losing nearly as much as equities. According to Deutsche Bank, 10-year treasuries experienced their worst first half since 1788, losing more than 15%. That's right, the largest loss since the year the United States Constitution was ratified. Struggling to believe 10-year treasuries existed in 1788, I instinctively wanted to check the Germain Bank's data source, but no reference was listed. Treasury notes were first listed for sale in 1929. Regardless of the accuracy of Deutsch Bank's historical data, suffice it to say, the first half was brutal in a way no living money manager has experienced.

Blindfolded Fed

Some strategists are successfully building a career by pointing out the errors of the Fed and moving in a way the data support rather than simply listening to "Fed Speak." Barclays was the first to correctly call a 75-basis point hike while the Fed and everyone else was looking for a move of one-half a percent.

For the adventurous among market participants, it has become sport listening to the Chair of the Fed, Treasury Secretary, or any of the Administration's Economic Advisors and methodically moving in a direction different than where they are guiding.

At his June 15th press conference, Jerome Powell came up with several new quotes that I expect will age as poorly as "Inflation is transitory." The following came during the press conference where he raised rates by 75 basis points after saying just a week earlier, that he didn't see any need for a move of 75 basis points.

> *"There's no sign of a broader slowdown in the economy."*
>
> *"Real GDP growth has picked up this quarter."*
>
> *"It appears the US Economy is in a strong position"*

(Jerome Powell June 15, 2022)

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Meanwhile, that very week, CEO confidence declined sharply in the second quarter of the year for the fourth straight time. The Conference Board's measure has slipped to a level only seen in 1980, 1991, 2001, 2008, 2012, and 2020. Powell's "clear blue skies" press conference would be as out of place during those periods as it was last month. All but 2012 were recessionary.

Moderating Inflation, Falling Stock Prices & Soon-to-Decline Earnings

Thus far, in 2022, the markets are trading poorly. The Fed is removing liquidity, and the government is sharply reducing stimulus spending. At the same time, the prior stimulus and covid-related supply chain problems are pushing inflation to 40-year highs. The economy is slowing rapidly.

Fundamentally, the economic outlook is poor. Consumers are suffering and wages are not keeping up with inflation. Barron's reported this past weekend the default rate of auto loans is nearly three times higher for loans initiated in 2020-2021 than in prior years; a likely result of short-term extra cash flow created by government stimulus during those years, leading some to live far beyond their means. Credit card spending has ramped up sharply to fill the gaps. Mortgage refinancing, a source of consumer dollars, is out of the question as mortgage rates surpass 5%.

Despite weakening economic data, the Fed claims tackling inflation is its number one goal. Never in history has the Federal Reserve raised rates on the heels of a 1.5% negative GDP quarter (Q1 2022) while staring directly into the eye of the second quarter of negative GDP. If that second-quarter negative number materializes, a textbook definition of a recession will have arrived. Now is not the time to fight the Fed. Nor is it the time to ignore fundamentals.

Unless the Fed pivots, inflation falls sharply, or financial instability occurs, we seek to take advantage of any relief rallies by reducing exposure to investments that have proven weaker than expected under stress, or those that are beginning to show balance sheet or business stresses.

In the coming weeks, we will receive a lot of important inflation data. I will be focused not on the actual inflation number, but if inflation is continuing to rise, moderate, or even beginning to fall. Reports released this week that indicate inflation is moderating or even falling (unlikely) will be perceived by the market as an indication the Fed does not need to continue with its aggressive rate hike campaign. This would be a short-term bullish indicator and could lead to a late-summer rally similar to mid 2008. I do believe data suggests the speed at which inflation is rising has been moderating.

Clearly, 8.6% inflation, according to the government (16%+ to those of us who live in the real world and by the same calculus the government itself used back in 1980), is unsustainable. Over time, inflation and higher interest rates will largely be the cure for inflation. (This may not apply to the energy sector due to self-inflicted supply constraints). Higher inflation and cost of borrowing will

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decrease demand. Decreasing demand along with already high corporate inventories will damage earnings and create a recession. Since the middle of the first quarter, my base case has been that we are in a recession now and if we aren't now, we will be very soon. I'm going to go out on a limb and suggest the recession will cause the Fed to be discussing interest rate ***cuts*** by this time next year, if not sooner.

While I do expect the data to show inflation moderating, earnings season will be in high gear. If I was sitting in a corporate boardroom, I would want to "kitchen sink" this earnings report, which is to say throw out all negative news, both current and anticipated, and blame it on the economic conditions, setting the stage to under-promise and over-deliver in future quarters. Actual corporate earnings will be relatively strong, but weakening. Corporate guidance will be very pessimistic reflecting the CEO confidence number referenced earlier. In addition, there has been massive inventory build across industries due to supply chain issues. This is at a time when consumer demand is softening. Strong earnings but high inventories and negative outlooks could offset any potential market gains that come from inflation moderation.

In the April commentary, I discussed how investors can get trapped in bear market rallies as the market churns trying to find a bottom. Because of the lack of clarity and the coin flip as to how the market reacts to positive news of moderating inflation versus negative corporate guidance, I do not anticipate becoming significantly more involved in the market even if we experience a 10%-12% bear market rally like in 2008. We will continue to selectively add investments when we believe the price of the investment has become negatively dislocated from the value the investment offers.

So far in this cycle, the price component of the Price to Earnings (PE) ratio has fallen but most analysts still report anticipation of earnings to remain on the same trend as late 2020 – 2021. This I have found perplexing for many reasons; war, supply chain dislocations, a weakening consumer, inflation, and the biggest factor, a Federal Reserve that is no longer loose, but increasingly tight, choking off the easy money that drove the economy since COVID. I understand the hope component of the market and I understand the desire for continuing economic growth at the same pace as in the past few years. However, the foundation of the economy has experienced a paradigm shift, and it is unreasonable, if not irrational, to expect the equities market not to reprice value and risk in a changing environment.

In the first half of 2022, the price component came down and resulted in a painful loss of 22% for equity investors. Next, the earnings component is likely to come down. With a weakening consumer and margins squeezed by inflation, many corporations will not earn at the same rate of the past few years. Very few people are talking about earnings revisions or bringing down expectations for earnings over the next several quarters. I struggle to envision a scenario where earnings don't decline

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unless the Federal Reserve pivots and indicates they are no longer focused on increasing rates. Bear markets end when there is no hope left just like bull markets end when there is no fear left. I've experienced two historically significant bottoms in the market, October 2002 and March 2009. No one was sitting around on those days calmly discussing if this is the bottom or wondering if capitulation had occurred. At the bottom individual investors are panicked, frozen in fear, or selling everything they can find, and it appears the financial world is ending. We aren't there.

The fact that analysts have not even begun to guide earnings lower tells me there is still a lot of hope left in this market. For that reason, I anticipate another leg down in the coming months as the Federal Reserve continues to tighten the screws and corporate earnings begin to be repriced**. *Along the way, good opportunities will arrive, and the seeds planted over the coming 6-18 months will create the growth that powers portfolios over the next 5-10 years.*** I anticipate the bottom to be when the Fed pivots from tightening to loosening. Softening inflation numbers, rising unemployment, and weakening consumers will give the Fed the opportunity to pivot, but the market will reprice further to the downside first.

We continue to hold significant amounts of cash, defined outcome holdings, energy, and aerospace & defense. We have been and will continue to selectively add to equities when appropriate. With the recent increase in rates, individual bonds have become attractive, yielding nearly 4.5% on a 5-year bond. For some clients, I am considering building out bond ladders for fixed income exposure rather than blending the fixed income component into balanced mutual funds as we have done over the past period of years. Year to date, investors in bonds have lost money due to interest rate risk – a risk especially acute in mutual funds that hold bonds. A bond ladder allows us to nearly eliminate that risk. Adding individual bonds would allow us to control the duration and interest rate risk of individual fixed income portfolios. This significant strategic shift would result in the sale of large amounts of balanced funds and the purchase of individual bonds, as well as equities, to replace the equity exposure currently within the funds.

Clients should anticipate an increase in trading activity as we seek to defensively capture greater income while effectively managing risk. 2022 has not been an enjoyable year, but our defense has worked, and we have retained the ability to play offense where appropriate. Please don't hesitate to reach out to our office with questions, concerns, any changes in your financial situation, or to talk about portfolio strategy. It is a privilege to work for you and we sincerely appreciate your business.

Michael R. Harding, CFP®