

MARKET REVIEW

Second Quarter 2022



We are pleased to present *Market Review*, featuring a discussion of the Capital Markets during the Second Quarter 2022 and a summary of historical performance for the major asset style passive indices for the period ending June 30, 2022. We hope you find the information useful and helpful in your investment considerations.

We welcome your comments.

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Founded in 1991, Asset Strategy Consultants provides investment consulting services to institutional clients representing \$8 billion under advisement.

Asset Strategy Consultants is headquartered in Baltimore, with a consulting office in Harrisburg, PA.

THE MACROECONOMIC ENVIRONMENT

Global Challenges Mount

A dearth of good news is an apt characterization for 2022. There was no shortage of challenges facing the world: the relentless and tragic war in Ukraine, persistent and widespread inflation, a startling 75 bps hike in the Fed Funds rate, a stubborn virus, and escalating concerns over a slowing global economy.

Global bond and stock markets sank, with the S&P 500 Index officially in a bear market, defined as down 20% from the most recent peak. In mid-June, the probability of recession (conventionally defined as two consecutive quarters of negative GDP growth) within the next year was 44%, up sharply from 18% in January, according to a survey of economists conducted by *The Wall Street Journal*. The primary culprits were seen as inflation and the Fed's weapon of choice to fight it: higher interest rates. Further, a "stagflation" scenario, which describes a period of slow growth and high inflation, is an increasing source of concern.

May's CPI print wreaked havoc on the markets and spurred the Fed to raise rates by 75 bps, the largest hike since 1994, to a 1.50% - 1.75% target. Headline CPI was 8.6% year-over-year (YOY), the highest in four

decades. Stripping out Energy (+34.6%) and Food (+10.1%), the Core measure rose 6.0% YOY. The Fed's preferred measure, the Personal Consumption Expenditures (PCE) Price Index, rose 6.3% YOY with Core PCE up 4.7%,

lower than expected but well ahead of the Fed's long-term target of 2%. Price gains were broad-based and global in nature and have been amplified by the war in Ukraine. Food and energy prices have risen sharply, and supply chain issues have not been resolved, adding further pressure to prices in some sectors. "Shrinkflation"—hidden inflation in the form of tinier package sizes—delivered another blow to consumers.

In spite of these pressures, both the markets and the Fed expect inflation to fall over longer periods. The Fed projects inflation to be 5.2% in 2022 and then decline to 2.6% in 2023. Five-year breakeven spreads, which reflect the market's expectations for inflation over the next five years, were 2.6%, down from 3.3% at the end of 1Q.

Going into quarter-end, markets were expecting another 75 bps hike at the July meeting with more hikes following, bringing the year-end target to 3.5%, slightly above the median

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Fed projection of 3.4%. The Fed also began to reduce the size of its \$9 trillion balance sheet by letting as much as \$95 billion of U.S. Treasuries/mortgages mature without reinvesting the proceeds. Real GDP decreased at an annual rate of 1.6% in 1Q following a 6.9% increase in 4Q. Expectations for 2Q are mixed, but the popular Atlanta Fed's GDPNow model-based tool is predicting a decline of 2.1%, while the median expectation from the Fed is a 1.7% increase, although that is down from 2.8% in March.

While consumer balance sheets remain reasonably robust given healthy savings during the pandemic, the savings rate and real personal disposable income have dipped as inflation has taken a bite out of balance sheets.

The Conference Board's Consumer Confidence Index, which gauges consumers' six-month outlook for jobs and the economy, has fallen sharply in 2022. The June reading for the expectations component of the Index, which measures consumers' short-term outlook about the labor market, business, and income, was the lowest since 2013. Consumer sentiment as measured by the University of Michigan survey fell to an all-time low in June. The Michigan survey tends to be more sensitive to gas prices. While consumer balance sheets remain reasonably robust given healthy savings during the pandemic, the savings rate and real personal disposable income have dipped as inflation has taken a bite out of balance sheets.

Business sentiment was equally bleak. In June, the National Federation of Independent Business (NFIB) reported that small businesses continue to face acute labor shortages, with just over half stating they have job openings that they cannot fill. Labor quality remains a top-of-mind concern, followed closely by inflation. Nearly 50% reported increasing compensation and 72% reported raising prices, the highest level in the 48-year history of the index. Similarly, the NFIB Optimism Index showed that owners expecting better business

conditions over the next six months hit a record low. Importantly, small businesses account for roughly half of total employment in the U.S.

In contrast to this gloomy news, the labor market remained strong, with 11.4 million job openings on the last day of April, according to the U.S. Bureau of Labor Statistics. Job gains have averaged more than 400,000 per month in 2022, and unemployment remains low (3.6% as of May). Housing is another bright spot, unless you are a first-time buyer. Home prices remain sky-high; the S&P CoreLogic Case-Shiller U.S. National Home Price Index jumped 20.4% YOY as of April 2022 while housing inventory remained low. The median price increased to a record \$429,000, according to the U.S. Department of Housing and Urban Development. And home affordability (as measured by the National Association of Realtors' Fixed Rate Mortgage Housing Affordability Index) hit the lowest level since 2007. Rising mortgage rates have begun to impact sales, but evidence of price declines has not yet surfaced. Existing home sales have fallen sharply in 2022.

Central bank rate hikes are expected around the globe (with China and Japan being exceptions) as inflation is widespread. According to data from J.P. Morgan, inflation across developed markets is 7.6% and across emerging markets it is 6.2%. Britain has the highest inflation rate among the G7 countries with the most recent print being 9.1%.

The European Central Bank did not raise rates at its June meeting, but cited intentions to raise them by 25 bps in July; it further increased its forecast for annual inflation in the euro zone to 6.8% for 2022 and lowered its forecast for growth to 2.8%, down from 3.7% at its March meeting. The economic effects of the Russian invasion of Ukraine have been especially painful in Europe, which has relied heavily on Russia for its energy needs. Natural gas prices in Europe are more than six times higher than in early 2021. Europe is also still experiencing supply-chain bottlenecks that began in the pandemic.

China, the second-largest economy in the world, was hurt by widespread lockdowns to combat COVID, which took a toll on consumer spending and youth

unemployment (16-24 year olds), which surged to a record high of 18.4% in May. Going into quarter-end, however, data began to improve as lockdowns ended and President Xi Jinping committed to stimulus measures to achieve economic goals. ■

GLOBAL EQUITIES

The S&P 500 Index sank 16.1% in 2Q on concerns over rising rates and a slowing economy; the Index is down 20.0% YTD. All sectors posted negative returns, but the worst were Consumer Discretionary (-26%), Communication Services (-21%), and Technology (-20%). Energy, Utilities, and Consumer Staples each lost roughly 5%. Value outperformed growth by a substantial margin (Russell 1000 Value: -12.2%; Russell 1000 Growth: -20.9%) and the YTD differential is more than 15 percentage points.

The MSCI ACWI ex USA Index sank 13.7% (Local: -8.3%), bringing its YTD loss to 18.4% (Local: -11.9%). The U.S. dollar continued to strengthen, benefiting from its “safe haven” status as well as attractive interest rates relative to other developed markets. The yen lost 11% versus the greenback, the euro 6%, and the British pound 8%. Across developed market countries, losses were broad-based, with nearly all posting double-digit declines. As in the U.S., Value (MSCI ACWI ex USA Value: -11.9%) outperformed Growth (MSCI ACWI ex USA Growth: -15.7%). Technology (MSCI ACWI ex USA Technology: -23%) fared the worst with Energy (MSCI ACWI ex USA Energy: -5%) being the relative outperformer. Emerging markets (MSCI Emerging Markets: -11.4%; Local: -8.1%) outperformed developed markets for the quarter, led by China (MSCI China: +3%), which was helped by improving data as lockdowns ended as well as promises of government stimulus. Returns were mixed but negative across regions: Latin America (-22%), Emerging Europe (-21%), and Emerging Asia (-9%). ■

GLOBAL FIXED INCOME

The Bloomberg US Aggregate Bond Index fell 4.7% in 2Q, bringing its YTD loss to 10.3%. Mortgages and corporates underperformed U.S. Treasuries, and the yield-to-worst of the Aggregate Index climbed to 3.7%. High yield corporates (Bloomberg High Yield: -9.8%) underperformed investment grade, and the Index is down 14.2% YTD. Rates were volatile during the quarter; the 10-year U.S. Treasury hit an intra-quarter high of 3.49% in June, the highest since 2011, before closing the quarter at 2.98%. TIPS (Bloomberg TIPS: -6.1%; -8.9% YTD) sharply underperformed nominal U.S. Treasuries for the quarter as longer-term inflation expectations declined. The 10-year breakeven spread was 2.3% at the end of the quarter, down from 2.8% on 3/31/22.

Interest rates also rose overseas and the U.S. dollar continued to strengthen, hurting unhedged fixed income returns. The Bloomberg Global Aggregate ex USD fell 11.0% (hedged: -4.0%). Losses were broad-based with double-digit declines across Europe, in Japan, and the U.K. Emerging markets performed similarly with the JPM EMBI Global Diversified down 11.4% and the local currency JPM GBI-EM Global Diversified off 8.6%.

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The Bloomberg Municipal Bond Index fell 2.9% for the quarter and is down 9.0% YTD. The shorter duration 1-10 Year Blend fell 0.8% for the quarter and 5.6% YTD. The ratio of AAA Municipal yields to the 10-year U.S. Treasury increased to 92%, up from 69% as of year-end. Outflows continued (25 consecutive weeks) and reached \$76 billion, the largest drop since data was first collected (1992). Municipal credit fundamentals remained sound with state and local revenues benefiting from strong employment and property taxes. ■

REAL ASSETS

Following very strong 1Q results, real assets as a group posted negative returns in 2Q as concerns over slowing global growth mounted. A lone exception was the energy-heavy S&P GSCI Index, which eked out a 2.0% gain during the quarter while the Bloomberg Commodity TR Index fell 5.7%. WTI Crude closed the quarter at \$106/barrel, up from \$100 on 3/31/22 and \$76 at year-end. Gold (S&P Gold Spot Price Index: -7.5%), listed infrastructure (DJB Global Infrastructure: -7.1%), REITs (MSCI US REIT: -16.9%), and TIPS (Bloomberg TIPS: -6.1%) declined. ■

CLOSING THOUGHTS

The ability of central banks to dampen high and widespread inflation without causing recessions remains a key question for investors. The war in Ukraine and its ultimate implications also weighs heavily. Stock and bond markets have undergone significant corrections, but we expect volatility to continue to be a key theme given significant tail risks. As such, we continue to advise adherence to a disciplined investment process that includes a well-defined long-term asset allocation policy. ■

Source: Asset Strategy Consultants and Callan Associates

Important Disclosure Information

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PRELIMINARY RETURNS FOR VARIOUS PERIODS: 2Q22

| | April | May | June | Last Quarter | Year to Date | Last Year | Last 3 Years | Last 5 Years | Last 10 Years | Last 15 Years |
|------------------------------|---------|--------|---------|--------------|--------------|-----------|--------------|--------------|---------------|---------------|
| EQUITY | | | | | | | | | | |
| 1 Russell:3000 Index | (8.97) | (0.13) | (8.37) | (16.70) | (21.10) | (13.87) | 9.77 | 10.60 | 12.57 | 8.36 |
| 2 Russell:1000 Index | (8.91) | (0.15) | (8.38) | (16.67) | (20.94) | (13.04) | 10.17 | 11.00 | 12.82 | 8.51 |
| 3 Russell:1000 Growth | (12.08) | (2.32) | (7.92) | (20.92) | (28.07) | (18.77) | 12.58 | 14.29 | 14.80 | 10.67 |
| 4 Russell:1000 Value | (5.64) | 1.94 | (8.74) | (12.21) | (12.86) | (6.82) | 6.87 | 7.17 | 10.50 | 6.10 |
| 5 Russell:Midcap Index | (7.70) | 0.08 | (9.98) | (16.85) | (21.57) | (17.30) | 6.59 | 7.96 | 11.29 | 7.77 |
| 6 Russell:Midcap Growth | (11.26) | (3.87) | (7.48) | (21.07) | (31.00) | (29.57) | 4.25 | 8.88 | 11.50 | 8.21 |
| 7 Russell:Midcap Value | (5.94) | 1.92 | (10.99) | (14.68) | (16.23) | (10.00) | 6.70 | 6.27 | 10.62 | 6.91 |
| 8 Russell:2500 Index | (8.52) | 0.34 | (9.55) | (16.98) | (21.81) | (21.00) | 5.91 | 7.04 | 10.49 | 7.29 |
| 9 Russell:2500 Growth | (11.42) | (2.43) | (6.92) | (19.55) | (29.45) | (31.81) | 3.68 | 7.53 | 10.88 | 7.96 |
| 10 Russell:2500 Value | (6.78) | 1.91 | (10.95) | (15.39) | (16.66) | (13.19) | 6.19 | 5.54 | 9.54 | 6.19 |
| 11 Russell:2000 Index | (9.91) | 0.15 | (8.22) | (17.20) | (23.43) | (25.20) | 4.21 | 5.17 | 9.35 | 6.33 |
| 12 Russell:2000 Growth | (12.27) | (1.89) | (6.19) | (19.25) | (29.45) | (33.43) | 1.40 | 4.80 | 9.30 | 6.80 |
| 13 Russell:2000 Value | (7.76) | 1.92 | (9.88) | (15.28) | (17.31) | (16.28) | 6.18 | 4.89 | 9.05 | 5.58 |
| 14 S&P:500 | (8.72) | 0.18 | (8.25) | (16.10) | (19.96) | (10.62) | 10.60 | 11.31 | 12.96 | 8.54 |
| 15 S&P:400 Mid Cap | (7.11) | 0.75 | (9.62) | (15.42) | (19.54) | (14.64) | 6.87 | 7.02 | 10.90 | 8.05 |
| 16 S&P:600 Small Cap | (7.81) | 1.86 | (8.55) | (14.11) | (18.94) | (16.81) | 7.30 | 7.20 | 11.26 | 8.03 |
| 17 MSCI:ACWI ex US | (6.28) | 0.72 | (8.60) | (13.73) | (18.42) | (19.42) | 1.35 | 2.50 | 4.83 | 1.58 |
| 18 MSCI:EAFE | (6.47) | 0.75 | (9.28) | (14.51) | (19.57) | (17.77) | 1.07 | 2.20 | 5.40 | 1.42 |
| 19 MSCI:EM | (5.56) | 0.44 | (6.64) | (11.45) | (17.63) | (25.28) | 0.57 | 2.18 | 3.07 | 2.00 |
| 20 MSCI:ACWI | (8.00) | 0.12 | (8.43) | (15.66) | (20.18) | (15.75) | 6.21 | 7.00 | 8.76 | 4.80 |
| FIXED INCOME | | | | | | | | | | |
| 21 Blmbg:Aggregate | (3.79) | 0.64 | (1.57) | (4.69) | (10.35) | (10.29) | (0.93) | 0.88 | 1.54 | 3.26 |
| 22 Blmbg:Gov/Credit | (3.96) | 0.48 | (1.58) | (5.03) | (11.05) | (10.85) | (0.77) | 1.05 | 1.67 | 3.38 |
| 23 Blmbg:Credit | (5.24) | 0.89 | (2.61) | (6.90) | (13.81) | (13.64) | (1.00) | 1.24 | 2.45 | 4.14 |
| 24 Blmbg:Corporate High Yld | (3.56) | 0.25 | (6.73) | (9.83) | (14.19) | (12.81) | 0.21 | 2.10 | 4.47 | 5.78 |
| 25 Blmbg:Municipal Bond | (2.77) | 1.49 | (1.64) | (2.94) | (8.98) | (8.57) | (0.18) | 1.51 | 2.38 | 3.56 |
| 26 Blmbg:US TIPS | (2.04) | (0.99) | (3.16) | (6.08) | (8.92) | (5.14) | 3.04 | 3.21 | 1.73 | 3.92 |
| 27 Blmbg:Glob Agg ex USD | (6.83) | 0.01 | (4.50) | (11.01) | (16.49) | (18.78) | (5.07) | (1.75) | (1.06) | 1.42 |
| 28 S&P:LASTA Levlg Loan | 0.22 | (2.56) | (2.16) | (4.45) | (4.55) | (2.78) | 2.09 | 2.91 | 3.74 | 3.95 |
| 29 ML:US Treasuries 1-3 Yrs | (0.48) | 0.55 | (0.58) | (0.50) | (2.84) | (3.30) | 0.24 | 0.94 | 0.79 | 1.61 |
| 30 LIBOR - 3 Month | 0.11 | 0.14 | 0.19 | 0.43 | 0.59 | 0.66 | 0.81 | 1.35 | 0.91 | 1.11 |
| 31 3 Month T-Bill | 0.01 | 0.07 | 0.02 | 0.10 | 0.14 | 0.17 | 0.63 | 1.11 | 0.64 | 0.75 |
| 33 S&P GSCI | 4.14 | 1.52 | (10.77) | (5.66) | 18.44 | 24.27 | 14.34 | 8.39 | (0.82) | (1.77) |
| 34 MSCI:US REIT Index | 5.12 | 5.07 | (7.64) | 2.01 | 35.80 | 45.05 | 14.69 | 11.67 | (1.83) | (3.05) |
| 35 Alerian:MLP Index | (4.46) | (6.15) | (7.37) | (16.95) | (20.32) | (6.41) | 4.03 | 5.30 | 7.32 | 5.73 |
| 36 DJB:Gbl Infrastructure | (0.09) | 7.73 | (13.95) | (7.38) | 10.04 | 4.33 | 0.07 | (0.29) | 0.74 | 3.69 |
| 37 US DOL:CPI All Urban Cons | (2.83) | 3.23 | (7.41) | (7.11) | (4.14) | 2.07 | 4.45 | 5.65 | 7.59 | 6.54 |

Source: Callan Associates