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Market Newsletter
June 30, 2022

EXECUTIVE SUMMARY

- Global stocks, bonds and commodities fell in the second quarter of 2022. The US dollar appreciated versus a basket of other currencies of developed countries.

- Record high inflation and the Federal Reserve's attempts to curb it by raising interest rates have caused recession worries.

- Supply chain constraints are easing, and manufacturing demand is dropping suggesting inflation may have peaked.

- Stocks and bonds which have moved in opposite direction in past years, have moved together this year reducing the diversification benefit of having both in a portfolio. However, bonds still provide ballast and are a source of income in a portfolio.

- US corporate earnings are expected to have grown by 4.3% in the second quarter. Current 12-month forward price earnings ratio of US stocks are lower than their 25-year average.

- Reducing exposure to stocks when a recession is called would lead to missing future performance because stocks usually bottom out well before a recession is called.

- Since there is no proven way to consistently invest during the best periods or avoid the worst, the best course of action is to invest for the long term. Missing a short period of market performance can have a significant impact on portfolios.

Table 1: Market indices

(Returns include dividends)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	-16.10%	-19.96%	-10.62%	10.60%	11.31%
S&P Mid Cap 400	-15.42%	-19.54%	-14.64%	6.87%	7.02%
S&P Small Cap 600	-14.95%	-18.94%	-16.81%	7.30%	7.21%
MSCI Emerging Markets	-11.34%	-17.47%	-24.99%	0.92%	2.55%
MSCI EAFE	-14.29%	-19.25%	-17.33%	1.54%	2.69%
Vanguard Total Bond Market Index (VBMFX)	-4.74%	-10.46%	-10.48%	-1.04%	0.75%
Investment Grade Credit (C0A0)	-6.53%	-13.76%	-13.66%	-0.74%	1.43%
Non-Investment Grade Credit (H0A0)	-9.97%	-14.04%	-12.66%	-0.03%	1.95%
Bloomberg Commodity Index Total Return	-5.66%	18.44%	24.26%	14.34%	8.39%
Dollar Index (DXY)	6.48%	9.42%	13.26%	2.88%	1.83%
10 Yr Rate	2.97% 06/30/2022	1.51% 12/31/2021	1.44% 06/30/2021	2.0% 06/30/2019	2.3% 06/30/2017

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg, Yahoo Finance

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 07/07/2022			
	Latest Release	Recent Trend	Notes
Non Farm Employment	372,000	Positive	The employment situation was better than expected which is bittersweet news because it reflects a strong economy but elevates the risk of continuing inflation, making the Federal Reserve's job difficult. The unemployment rate is a low 3.6% and average hourly earnings grew 5.1% from a year ago- a bit faster than expected.
Weekly Claims for Unemployment Insurance	235,000	Negative	Initial claims is at the highest level since January, reflecting a moderating jobs market. However, claims numbers are still at historically low levels.
ISM Manufacturing Index (over 50 indicates growth)	53	Negative	Manufacturing is still growing as indicated by a value higher than 50, but at a lower rate, held back by supply chain constraints. The recent peak in the index was 63.7 in April.
ISM Non Manufacturing Index (Over 50 indicates growth)	55.3	Negative	The latest index value was better than expected but has been sliding since the beginning of the year. However, the services sector is still growing as indicated by a value higher than 50.

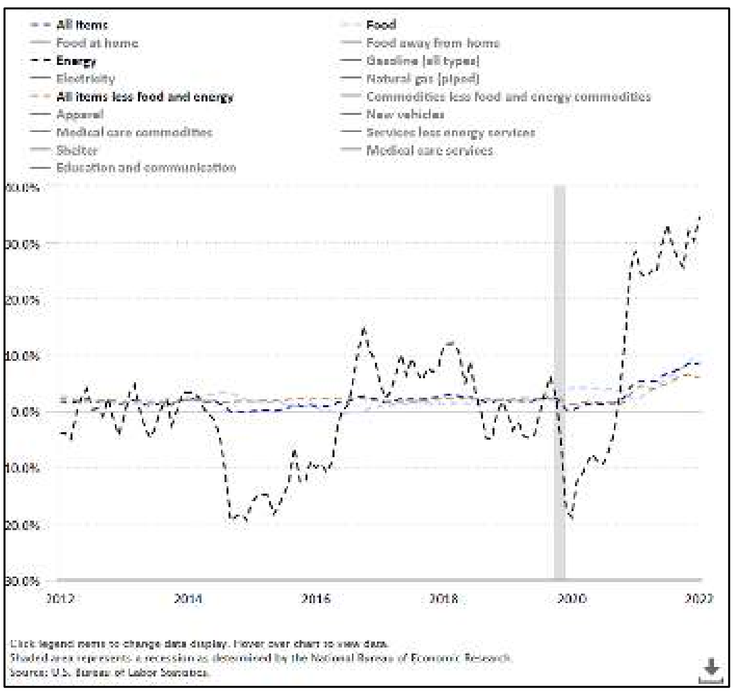
	Latest Release	Recent Trend	Notes
Consumer Prices (Month over month change)	0.6%	Negative	May consumer price index released in June showed that inflation is at a 40-year high- 8.6% year over year. This spurred the Federal Reserve to take action by raising rates by 0.75%. There are signs that inflation is cooling off.
Producer Prices (Month over month change)	0.8%	Negative	Like consumer prices, producer prices are elevated at historically high levels. The year over year increase was 10.8%
Retail Sales (Month over month change)	- 0.3%	Negative	Inflation took a bite out of retail sales as consumer cust back on spending to make up for higher gas prices among other things. Motor vehicle sales declined amidst shortages.
Consumer Confidence (Conference Board)	98.7	Negative	Consumer confidence fell to its lowest level since February 2021. Consumers signaled a grim outlook on concerns about inflation, especially gas and food prices.
Durable Goods Orders (Month over month change)	0.7%	Positive	Durable goods orders held up for a second month indicating that business investments remained firm despite increasing rates and inflation. Core capital goods shipments, a figure used in the calculation of GDP, rose a healthy 0.8%.
Industrial Production (Month over month change)	0.2%	Positive	Industrial production, which measures factory, mining and utility output, increased in May but fell sharply from the previous month. Manufacturing output dragged down the number as it declined for the first time since January. Mining and utilities grew.
Capacity Utilization	79%	Positive	Capacity utilization continued to inch up to the highest value this year and is reducing slack in the economy.
Housing Starts	1.549 million	Negative	Housing starts plunged 14.4% from the previous month suggesting that higher mortgage rates are beginning to cool a hot housing market. Home loans have almost doubled from recent lows.
Home Prices (Case-Shiller Home Price Index- Year over Year)	21.2%	Positive	Despite higher mortgage rates and falling housing activity, home buyers remained resilient. The increase in prices was the highest since the beginning of the index in 2013. There are early signs of prices cooling, as the monthly price increase fell marginally.
GDP (Real, Annualized)	-1.6%	Negative	US GDP shrank in the first quarter of 2022, a sharp drop from the 6.9% annualized increase recorded in the fourth quarter of 2021. Rise in imports skewed the number downwards but inflation and supply chain issues were also to blame.

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ism.ws, www.nahb.org

Stocks and bonds fell in the second quarter of 2022 in a continuation of the events of the first quarter. Even commodities, which had appreciated earlier in the year, fell despite being up in the first two months of the quarter. Stocks officially went into a 'bear market' i.e., they dropped over 20% from their recent peak before rallying to end the quarter with a drop just a touch below 20%. Interest rates continued their ascent and at one point, the 10-year US treasury rate was as high as 3.48%, the highest level since 2011. Bond prices, which move inversely to interest rates fell, leading to one of the worst ever performance for the asset class. The US dollar appreciated during the quarter as overseas money flowed into US assets in a flight to quality and in search of higher yields.

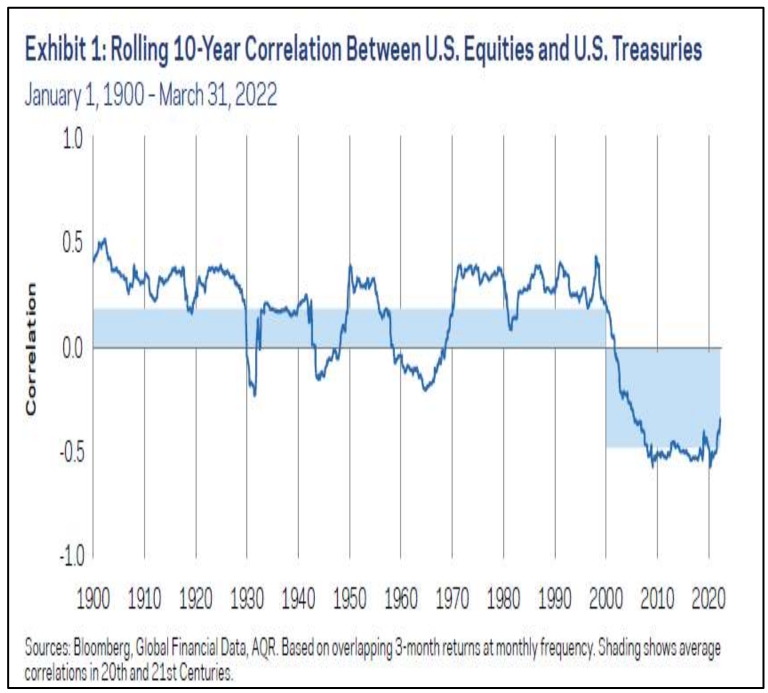
The reason for the market turmoil was accelerating inflation combined with the Federal Reserve's (Fed) attempts to curtail it by aggressively raising interest rates. Inflation indicators such as the Consumer Price Index (CPI) and the Personal Consumption Expenditure (PCE) came in higher than expected in June rattling both the bond and the equity markets. In its June meeting, the Fed raised interest rates by 0.75%, the largest single increase since 1994, citing elevated inflation as the reason for the hike. It also reiterated its commitment to curb inflation. Inflation is a lagging indicator, and the Fed usually hikes until there are clear signs that it is under control often causing a recession, at which point it starts cutting interest rates. Financial markets have been acting accordingly- early in the second quarter, both stocks and bonds fell as inflation numbers came in worse than expected. Towards the end of the quarter, as recession fears took hold, stocks fell but bonds appreciated in anticipation of interest rate cuts by the Fed in the future.

Fig 1: Inflation has spiked up



Source: US Bureau of Labor Statistics

Fig 2: Historical stock-bond correlation

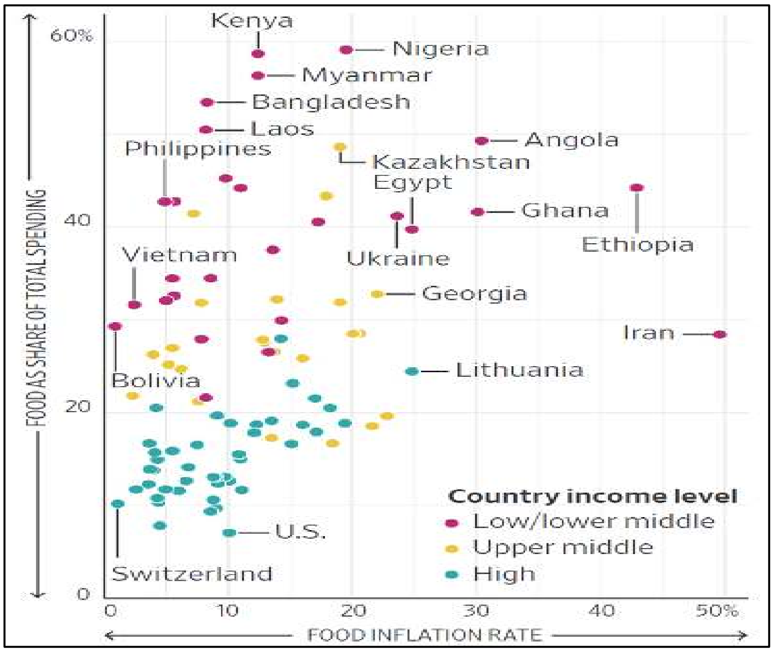


Source: AQR

While a positive correlation between stocks and bonds is problematic from a diversification point of view (because ideally you would want bonds to appreciate when stocks fall), historically, stocks and bonds have had positive correlation for a long period of time as seen figure 2. However, apart from diversification, bonds play other roles such as providing ballast to portfolios (by falling less than equities even when correlations are positive) and providing income, both of which they are still capable of providing.

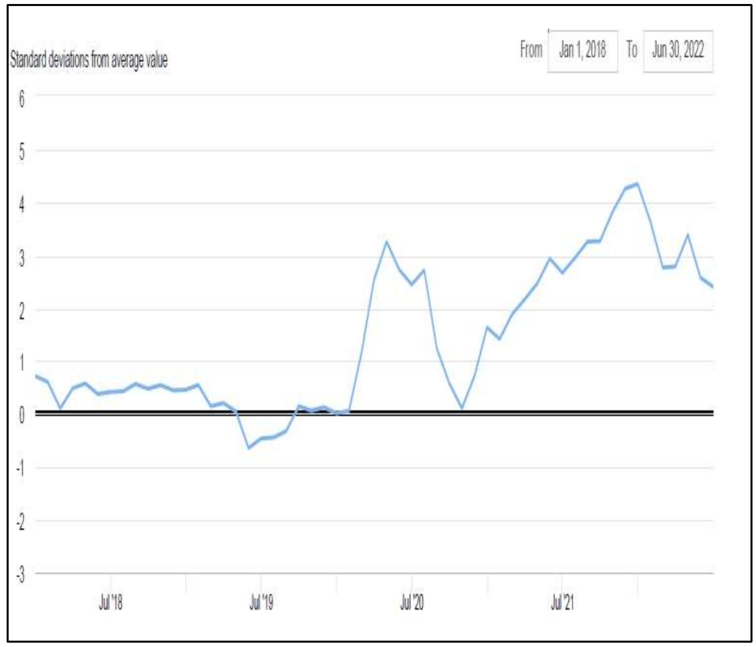
High inflation has caused significant hardship to consumers, especially those with low income, not just in the US, but around the world. As seen in Figure 3, in poorer countries people spend a higher percentage of their income on food- this is also true for low-income families in richer countries. High food inflation has caused significant hardship to this segment of the population. While the US is experiencing historically high food inflation, it is worse in some poorer countries.

Fif 3: Food as a percentage of income versus food inflation



Source: Wall Street Journal

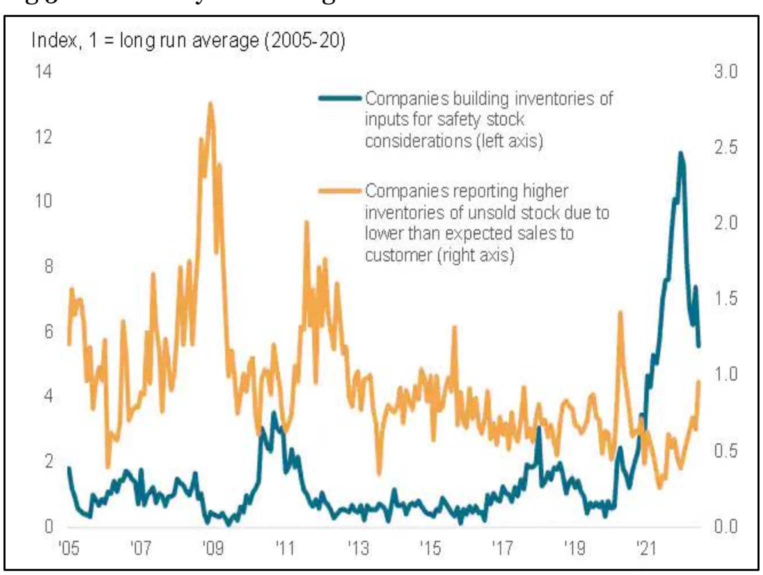
Fig 4: Global Supply Chain Pressure Index is easing



Source: Federal Reserve Bank of New York

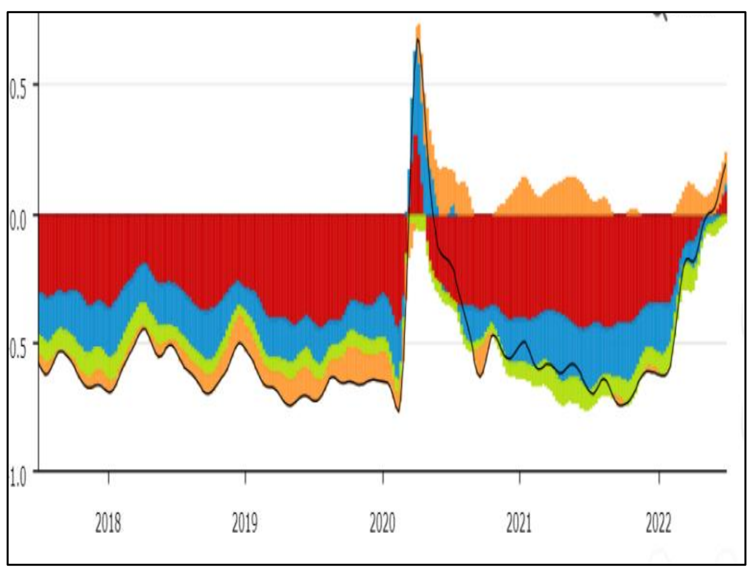
There are early signs that inflation maybe tapering – for example, commodity prices have fallen from their peak and the housing market is showing some signs of reduced activity. Drilling down a bit deeper, supply chain pressures are easing as evidenced by the Global Supply Chain Pressure Index constructed by the Federal Reserve Bank of New York (Figure 4). On the demand side of the equation, growth in manufacturing is cooling because of slower than expected sales to customers and because of companies destocking to cut costs in the face of an economic slowdown (Fig 5).

Fig 5: PMI surveys and the global shift towards lower inventories



Source: S&P Global, PMI surveys

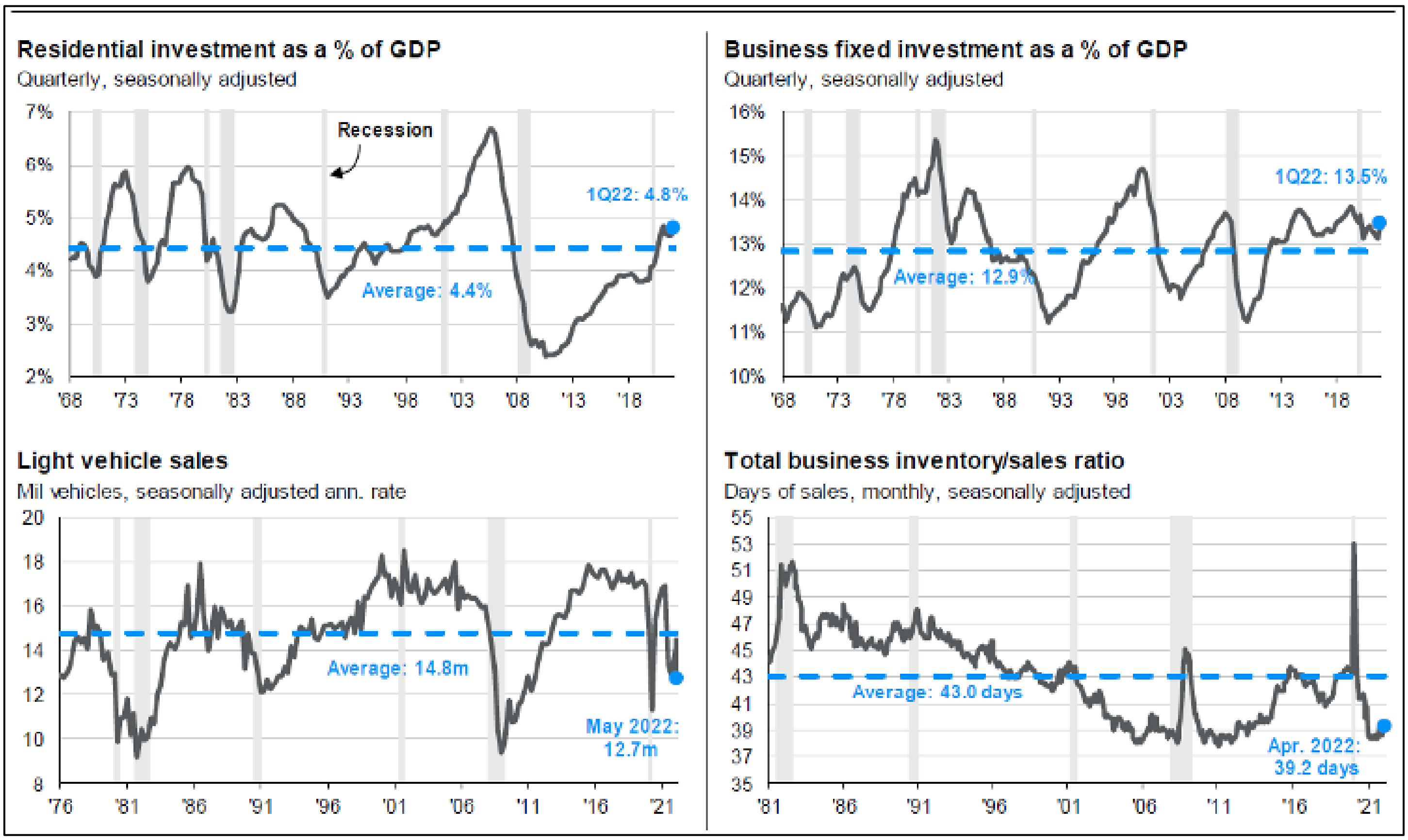
Fig 6: National Financial Conditions Index



Source: Federal Reserve Bank of Chicago

The appreciation of the US dollar against other currencies is also a development that can put a lid on inflation since a strong dollar makes imports cheaper and the US imports more goods than it exports. All the above factors that suggest inflation may have peaked could also indicate that the economy is on the cusp of a recession. Other factors such as tightening financial conditions (Fig 6) and the inversion of the US treasury yield curve (i.e., shorter maturity Treasury debt yielding more than longer maturity debt, which is usually a harbinger of a recession) support this hypothesis. However, there are reasons to believe that the recession could be a shallow one- for example, the cyclical sectors of the economy are not as elevated as they usually are before a deep recession (Fig 7).

Fig 7: The cyclical sectors of the economy are not as elevated as they usually are before a deep recession.



Source: JP Morgan

US companies are set to release second quarter earnings and according to FactSet, earnings are expected to grow 4.3% as compared to last year. Usually, companies deliver better than expected earnings and if you factor in the average positive surprise, earnings are expected grow by 9 to 12% as per calculations by FactSet. Using current 12-month forward earnings, the S&P 500 has a price earnings valuation of 15.94 which is lower than its 25-year average. However, Analysts' earnings expectations for the full year 2022 maybe a bit optimistic and could be brought down through the year.

What should investors do in anticipation of a recession?

While there are signs that we could experience a recession in the future if we are not already in one, it will only be identified with certainty after the fact. The National Bureau of Economic Research (NBER) identifies a recession as 'a significant decline in economic activity that is spread across the economy and lasts more than a few months'. By the time a recession is called, its impact on the market has already passed. This is because the NBER uses several indicators such as consumption, income data, employment rates, and gross domestic product growth none of which individually have been dominant in calling past recessions. As seen in Figure 8 the market bottomed out well before a recession was called in most cases since 1980. Reducing exposure to stocks when a recession is called would lead to missing future performance.

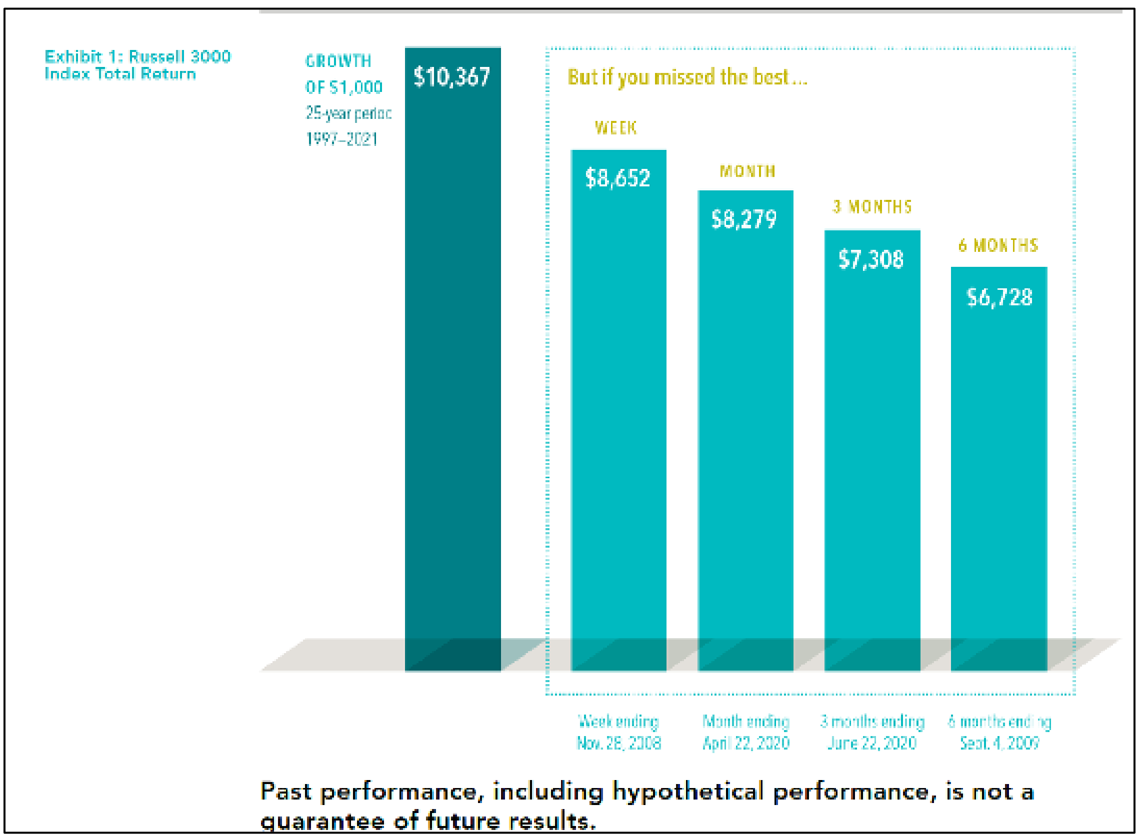
Fig 8: Stocks bottom out well before a recession is called

Peak Month	Announcement Month	US Market Low Month	Months from Announcement to Market Low
Jan-80	Jun-80	Mar-80	−3
Jul-81	Jan-82	Jul-82	6
Jul-90	Apr-91	Oct-90	−6
Mar-01	Nov-01	Sep-01	−2
Dec-07	Dec-08	Feb-09	2
Feb-20	Jun-20	Mar-20	−3

Source: Dimensional Fund Advisors

Missing a short period of market performance can have a significant impact on portfolios. Fig 9 shows the impact of missing the best week, month, 3 -month or 6-month period on a portfolio of stocks since 1997. Since there is no proven way to consistently invest during the best periods or avoid the worst, the best course of action is to invest for the long term.

Fig 9: Missing the best period of stock performance can have a significant impact on portfolios



Source: Dimensional Fund Advisors