Shearwater Creek Investment Matters

2nd Quarter 2022 Market Update

The Fed's Fight Against Inflation

<u>2nd Quarter 2022 Review:</u>

Higher inflation and aggressive rate hikes by the Federal Reserve hammered equity and bond markets in 2nd Quarter 2022, pushing stocks clearly into bear market territory. After misreading early signals at the beginning of 2022, the Fed raised the overnight fed funds rate by 0.75% on June 15th (its largest increase since 1994) to a range of 1.5%-1.75%. Longer-term rates also increased as the 10-year U.S. Treasury note yield climbed to 3.49% on June 14, its highest level in more than a decade.

In his press conference following the rate hike, Fed Chair Powell acknowledged the risk of higher rates, however made it clear that price stability and fighting inflation were the Fed's primary objectives and that further rate hikes were likely. While future rate hikes will be data dependent, the current consensus view is that the Fed will raise rates by another 0.75% in July and possibly September and the range by year-end will be 3.25% to 3.50%.

From a historical context, U.S. equities recorded their worst half year performance since 1970. Among the major U.S. indexes, the Dow Jones Industrial Average delivered the best performance declining (-14.44%) while the S&P 500 was down (-19.97%.) Small-cap stocks, represented by the Russell 2000 Index, declined (-23.01%) while the Nasdaq Composite fell (-29.2%.) Energy stocks were the best-performing sector despite giving up some of their strong first-quarter gains as oil prices retreated from record highs. Defensive stocks including utilities, health care, and consumer staples held up best while higher interest rates punished growth stocks by sharply discounting future years' earnings.

No surprise, bonds also suffered as a result of rising inflation and Fed rate hikes. U.S Treasury bonds have experienced their steepest declines since the late 1980's. The Bloomberg U.S. Bond Aggregate Index fell -4.69% in Q2 alone, resulting in a 2022 ytd return of -10.35%. High yield corporate bonds as measured by the Credit Suisse High Yield Bond Index fell -9.66% in 2nd Quarter bringing its 2022 ytd return to -13.42%.

Although some data indicated that inflation pressures peaked late in Q1, consumer and producer prices remained near multi-decade highs in the 2nd Quarter. Also disconcerting were signs that inflation pressures were spreading beyond energy and manufacturing supply chains. Consumer prices for services (excluding energy services) surged 0.7% in April while airline ticket prices jumped +18.6%, the largest increase on record.

Despite evidence of continued strong job growth especially in service, hospitality and travel sectors, investors grew concerned that the Fed's aggressive tightening will push the economy into a recession similar to the early 1980's and 1990's. Existing home sales fell sharply with higher mortgage rates and retail sales and inflation-adjusted incomes declined in May. The University of Michigan's consumer confidence gauge for June fell to its lowest level on record.

International and emerging markets stocks were also hurt by inflation worries, aggressive monetary policy tightening by central banks and continued fallout from the Russia-Ukraine conflict. The UK FTSE 100 was a standout performer so far for 2022, declining only (-1.01%,) however most of this outperformance is attributed to the depreciation of the UK pound.

A weak pound helps bolster the index since many companies are multi-nationals with overseas revenues. The Japan Nikkei 225 declined -14.60% in U.S. dollar terms while the MSCI Emerging Markets Index fell (-17.57%.)

Surging energy and food prices caused inflation in the Eurozone to accelerate to a record high of 8.6% in June. Meanwhile business activity slowed to its lowest level since February 2021 as supply chain disruptions and weakening consumer demand caused manufacturing output to contract for the first time in two years. Service sector growth also cooled considerably.

The European Central Bank signaled plans to raise its key deposit rate (currently at -0.5%) by 0.25% in July; adding that it might also consider a larger increase in September if inflation worsens. Central banks of Sweden, Norway, and Switzerland each increased rates by 0.50% at the end of the quarter while the Bank of England (BoE) stuck to a more gradual approach, raising its key rate for a fifth time since December by 0.25%.

Meanwhile, European Union leaders agreed to ban all seaborne Russian oil deliveries and announced a EUR 300 billion plan to end dependence on Russian energy imports before 2030. In response, Russia reduced pipeline supplies to Germany, Italy, France, the Netherlands and Slovakia, triggering worries of a winter shortage and industry closures. Some EU countries are considering the reopening of coal plants and possibly extending the lives of nuclear power facilities.

Unlike other major central banks which have raised interest rates, the Bank of Japan (BoJ) has remained committed to a loose monetary stance which has led to the yen currently trading at its lowest level in 24 years at roughly 135.75 yen versus the U.S. dollar from 121.69 at the end of March.

The yield on the 10-year Japanese government bond (JGB) ended the 2nd Quarter essentially unchanged at 0.22%. Finally, China was the only major market to post positive returns in Q2 with the MSCI China Index earning +3.5% and the MSCI A Onshore Index gaining +1.65% in U.S. dollar terms. Most of these gains came in June when the government allowed an end to the strict omicron-related lockdowns in Shanghai and Beijing.

<u>2022 Outlook:</u>

Heading into the 2nd half of 2022, inflation and rising interest rates remain the biggest concerns facing financial markets. The Federal Reserve and other central banks need to further drain down excess liquidity injected in the global economy during the coronavirus pandemic while at the same time not choking off economic growth. Adding further uncertainty, the Russia-Ukraine conflict has the potential to further disrupt global supply chains and push food and energy prices even higher.

From a valuation perspective, central bank liquidity was a key catalyst in lowering interest rates and driving asset valuations to historical extremes. A big question now is whether we are witnessing an end of an era of ample liquidity, low inflation and low interest rates. The bear market correction in the first half of 2022 has certainly lowered market valuations, however there's no guarantee that valuations can't go even lower. A key question now is whether these risks cause a sharp slowdown in growth or push major economies into full-blown recessions.

Countering this pessimistic view, we maintain a more constructive view that a deceleration in growth presents the potential for a new, more sustainable expansion in both developed and emerging markets stocks. The combination of a strong, liquid global banking system, coupled with very healthy corporate and individual balance sheets present solid sources of stability in the midst of global uncertainty.

Within equities, we think corporate earnings, personal income and consumer demand will remain positive and support higher prices going forward. Bonds may struggle amid higher inflation, however we believe the worst of the interest rate adjustment is behind us and there are now more compelling yield opportunities than we have seen in years. We expect commodity prices to remain high over the near term given the structural supply/demand imbalances across multiple precious metal and agricultural markets. Finally, we expect volatility to continue across markets until we get further clarity on the macro inflationary environment.

Here’s a recap of major market indexes for Q2 2022:

<u>Equity Indexes</u>:

	Q2 2022	2022 YTD
S&P 500	-16.10%	-19.96%
Dow Jones Industrial Average	-10.78%	-14.44%
Nasdaq Composite (Principal Return)	-22.44%	-29.51%
Russell 2000	-17.20%	-23.43%
MSCI China	3.50%	-11.19%
MSCI Europe	-14.17%	-20.38%
MSCI Emerging Markets	-11.34%	-17.47%

<u>Bond Indexes</u>:

Bloomberg Barclays U.S. Aggregate	-4.69%	-10.35%
Bloomberg Barclays Global Aggregate Bond Ex-U.S.	-11.01%	-16.49%
Credit Suisse High Yield	-9.66%	-13.42%
Bloomberg Barclays Emerging Markets Bond	-10.55%	-18.83%

Note: Returns are for the periods ended June 30, 2022. The returns include dividends and interest income based on data supplied by third-party provider RIMES and compiled by T. Rowe Price, except for the Nasdaq Composite Index, whose return is principal only.
Sources: Standard & Poor’s, LSE Group, Bloomberg Barclays, MSCI, Credit Suisse, Dow Jones, and J.P. Morgan (see Additional Disclosures).

Sources: [1]Thomson Reuters. Past performance is no guarantee of future results. Yields may be lower or higher than quoted above. Yields fluctuate as market conditions change. An index is unmanaged and not available for direct investment. The indices are presented to provide you with an understanding of their historic long-term performance and are not presented to illustrate the performance of any security. Large Cap = S&P 500 Index (The S&P 500 index is weighted by market value, and its performance is thought to be representative of the stock market as a whole.), Mid-cap = Russell Midcap Index (The Russell Midcap Index measures performance of the 800 smallest companies (31% of total capitalization) in the Russell 1000 Index, with weighted average mark et capitalization of approximately $6.7 billion, median capitalization of $3.6 billion, and market capitalization of the largest company $13.7 billion.), Small-cap = Russell 2000 Index (The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index.), DM Ex-U.S. = MSCI EAFE Index (The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. & Canada.), Emerging Markets = MSCI EM Index (The MSCI Emerging Markets Index is an index created by Morgan Stanley Capital International (MSCI) designed to measure equity market performance in global emerging markets.), Bloomberg Barclays U.S. Aggregate Bond Index (The Bloomberg Barclays US Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type.), ICE U.S. Treasury 20+ Year Bond (The ICE U.S. Treasury 20+ Year Bond Index measures the performance of Treasury securities and is selected by a Market Value process.), Markit iBoxx USD Liquid High-Yield Bond Index (Consists of liquid USD high yield bonds, selected to provide a balanced representation of the broad USD high yield corporate bond universe. The index is used as a basis for tradable products, including ETFs.)

SHEARWATER CREEK
WEALTH ADVISORS LLC