Second Quarter 2022

Quarterly Letter to Clients

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During the second quarter, we entered a technical bear market. The S&P 500 posted its worst first half to start the year since 1970. A myriad of worries led by accelerating inflation, Federal Reserve rate hikes, the ongoing war in Ukraine, and COVID-19 lockdowns in China hurt performance. For only the second time in more than four decades, stocks and bonds posted losses for two consecutive quarters. The last time investors saw back-to-back down quarters for stocks and bonds was in 2008 and 1981.

In April, the S&P 500 dropped sharply to start the second quarter, down 8.7%. While some of the reasons for the decline were similar to the first quarter (e.g., inflation, rising interest rates, and geopolitical concerns), a major catalyst for the April sell-off was sparked by a strict COVID-related lockdown in China where, unlike most of the rest of the world, they continue to enforce a "Zero-COVID" policy. The lockdowns, which essentially halted the world's second-largest economy, added more pressure to existing global supply chain problems. And on April 28th, the first-quarter GDP report confirmed that the U.S. economy contracted for the first time since the 2020 pandemic outbreak.

In May, the Federal Reserve raised interest rates by 50 basis points, the single-biggest rate hike in 22 years. The 10-year Treasury rate hit 3.0% for the first time since 2018. Additionally, Fed Chair Jerome Powell signaled the Fed would continue to hike rates aggressively to quell inflation, which weighed on stocks, pushing the S&P 500 to fall to new 2022 lows in mid-May. Crude oil prices surged after the European Union imposed a ban on two-thirds of all Russian oil imports in response to its invasion of Ukraine.

Nevertheless, there were some positive signs in May. Consumer spending continued to increase. First-quarter corporate earnings were moderately favorable overall. The 10-year Treasury yield ended May about where it began the month. Prices at the pump fell to $4.10 per gallon, down from $4.33 in March. The Chinese economy started to reopen as COVID restrictions were lifted. Lastly, a late-month rally helped push the DJIA, S&P 500, and Russell 2000 slightly ahead of their April closing values. However, the tech-heavy Nasdaq closed two percent lower for the month.

The market relief didn't last long as stocks soured again in June. A slowdown in consumer spending, which accounts for nearly 70% of economic activity, prompted concerns about a recession. On June 10th, the May CPI report showed inflation accelerating to its highest level since 1982. Five days later, the Federal Reserve increased the federal funds rate by 75 basis points, which was more than expected. It was also the biggest rate hike since 1994. The unexpected higher rate hike prompted a stock sell-off, wiping out the late-May gains and sending the benchmark index well into negative territory for June. Crude oil prices fell for the first time since November, and the dollar surged as fears of a global recession increased.

Economic Overview

Americans paid more for almost everything they purchased in the second quarter. The headline Consumer Price Index (CPI), which measures what consumers pay for a basket of goods and services, climbed to its highest level since 1981. The CPI readings in April and May increased by 8.3% and 8.6%, respectively. No signs of relief were evident in the latest report – rising prices were broad-based, with shelter, gasoline, and food being the largest contributors. Additionally, the ongoing war and the COVID-19-related lockdowns in China suggest inflation pressures may not abate anytime soon. Inflation also outpaced wage growth for a 14th consecutive month, prompting many Americans to dip into savings and take on more debt. As high prices leave less income for discretionary purchases, the risk to the economy is a more pronounced slowdown in consumer spending and, potentially, a recession.

The Federal Open Market Committee (FOMC) raised the federal funds target rate by 50 basis points and 75 basis points in May and June, respectively, in a series of moves directed at tempering inflation pressures as they try to return inflation back to the 2.0% objective. The 75-basis point hike in June, which was more than expected, was the biggest rate hike since 1994. That put the federal funds target rate range at 1.50% - 1.75%. The Federal Reserve's so-called dot plot, which the U.S. central bank uses to signal its outlook for the path of interest rates, shows the median year-end projection for the federal funds rate at 3.4%, up from 2.0% in the first quarter. The FOMC also decided to begin reducing its balance sheet in June, which could potentially drive long rates higher. The level and pace of interest rate hikes suggest that the Fed is very committed to reigning in inflation; however, they are running the risk of turning a soft landing into a recession.

Gross Domestic Product (GDP), the primary measure of economic growth, fell at an annualized rate of 1.6% in the first quarter of 2022, compared with a 6.9% advance in the fourth quarter of 2021. This marked the first time the U.S. economy has contracted since the 2020 pandemic outbreak. The decrease in GDP primarily reflected declines in private inventory investment and government spending. A swelling trade deficit also subtracted from GDP. Spending on goods was unchanged, while spending on services climbed 4.8%. Economists generally expect the U.S. to rebound in the second quarter when reported in late July. The Conference Board forecasts that U.S. real GDP will rise to 0.8% in the second quarter of 2022.

Retail sales contracted in May for the first time this year after trending lower for the year's first four months as soaring inflation appears to be taking a toll on consumer spending. Six of the thirteen categories fell, with auto dealers, electronics, and online retailers leading the decline. Not surprisingly, Americans did spend more on gasoline (+4.0% month-over-month) as prices rose. With inflation running near its highest pace in 40 years, household savings falling near their lowest levels since 2008, and credit card debt hitting an all-time high, retail sales could be pressured in the months ahead.

Employment increased each month during the second quarter, with jobs rising by 428,000, 390,000, and 372,000 in April, May, and June, respectively. Job growth accelerated faster than expected in June, indicating that a central pillar of the U.S. economy remains strong despite a weak string of recently released labor metrics. Filings for first-time unemployment benefits increased to their highest level since January and have remained above 230,000 for the past five weeks. Continuing claims have also started to edge higher, hitting their highest level in nine weeks. And the number of announced corporate layoffs took a notable jump higher, posting the largest jump since December 2020. Although the unemployment rate remained unchanged at

3.6%, the labor participation rate moved in the wrong direction, suggesting fewer Americans are looking for work. Average hourly earnings increased by 5.1% year over year.

Economic activity in the manufacturing sector is still expanding, albeit slower, as the ISM Manufacturing index fell to its lowest level in two years. The index fell to 53.0% in June from 56.1% in May. While the headline number indicates expansion, there were some worrisome signs, as two of the five subindexes were in contraction territory. Higher prices, weaker demand, and lingering supply chain issues pushed the new orders index, considered a forward-looking indicator, into contraction for the first time since May 2020, when the economy was still reeling from the pandemic outbreak. The ISM employment index also contracted, hitting its lowest reading since November 2020.

Record home prices and higher mortgage rates caused the National Association of Realtor's housing-affordability index to fall to 102.5 in May, the lowest level since the index stood at 100.2 in July 2006. The higher costs are taking a toll on demand as some buyers can no longer qualify for mortgages, while others are unwilling to pay hundreds of dollars more a month compared to a few months ago. As a result, sales of previously owned homes slid in May for the fourth consecutive month. Housing starts and permits declined by 14.4% and 7.0% in May, respectively, to their lowest levels since April 2021 and September 2021. The sudden drop in demand is expected to lead to slower home-price growth; if not, price declines by the end of the year. The average rate on a 30-year fixed mortgage started the year around 3.0% and then began rising steadily. It briefly shot above 6.0% in mid-June before settling in around 5.75% to end the quarter.

The University of Michigan's U.S. consumer sentiment index, which provides a picture of how consumer spending may trend in the future, plunged in June to the lowest level on record as soaring inflation continued to batter household finances. Throughout the survey, consumers signaled strong concerns that inflation will continue to erode their income due to rising gas and food prices. The broad deterioration of sentiment may eventually lead consumers to cut back on spending and thereby slow economic growth. The gloomy data suggest weaker growth in the second half of 2022.

The U.S. Dollar Index surged higher and is nearly equal to the euro for the first time in 20 years. The euro is now worth just under $1.02. The dollar is appreciating partly because the Federal Reserve is raising interest rates more aggressively than central banks in other countries. As Treasury yields rise, there is more demand for dollar-denominated securities, which boosts the dollar's value. Additionally, the U.S. dollar is considered a "safe haven" relative to other currencies as fears of a global recession rise, increasing demand for the U.S. dollar. However, the trend threatens to hurt American companies because their goods become more expensive for foreign buyers and foreign sales are worth less when converted back to the dollar. If U.S. exports weaken, so would the already-slowing U.S. economy. However, Americans have a positive side, too: a stronger dollar makes imports less expensive, which could help reduce inflation.

Stocks

The Standard & Poor's 500 index posted its worst first half of the year since 1970 after falling more than 16% for the quarter – its biggest one-quarter fall since March 2020. The 30-stock Dow Jones Industrial Average (DJIA) lost 10.8% in the second quarter, putting it down more than 14% for 2022. The Nasdaq, meanwhile, suffered its biggest quarterly drop since 2008,

losing more than 22%. Those losses pushed the tech-heavy composite deep into bear market territory, down about 32% from an all-time high in November. It's also down 29.5% year to date. The Russell 2000 index, a benchmark for U.S. small-cap stocks, posted a loss of 17.5% for the quarter, putting it down almost 24% for the year.

Market Performance % Barometer			
U.S. Equity Indexes	**Q2 2022**	**Q1 2022**	**6/30/2022**
S&P 500	-16.1%	-4.6%	-20.0%
Dow Jones Industrial Avg.	-10.8%	-4.1%	-14.4%
Nasdaq	-22.4%	-8.9%	-29.5%
Russell 2000	-17.5%	-7.5%	-23.9%
Source: Morningstar Direct, Morningstar Index, Data as of June 30, 2022 in Total Return USD			

Within the stock market, the dominant trend continued to be the fall of growth stocks and the relative outperformance of value stocks. The Morningstar U.S. Growth Index lost 25.3% in the quarter, its worst performance since the financial crisis in 2008. Meanwhile, Morningstar's US Value Index fell 9.4%. Developed (ex-U.S.) and emerging markets fared slightly better, down 14.9% and 11.6%, respectively.

Market Performance % Barometer			
U.S. Equity Indexes	**Q2 2022**	**Q1 2022**	**6/30/2022**
U.S. Market	**-16.8%**	-5.3%	-21.3%
Value	**-9.4%**	2.4%	-7.3%
Growth	**-25.3%**	-12.0%	-34.3%
Developed Markets - ex-U.S.	**-14.9%**	-5.2%	-19.3%
Emerging Markets	**-11.6%**	-5.9%	-16.8%
Source: Morningstar Direct, Morningstar Index, Data as of June 30, 2022 in Total Return USD			

All eleven S&P 500 sectors finished the quarter with negative returns. Relative outperformers included healthcare, utilities, and consumer defense, all of which provide services required in both good and bad times. Energy also outperformed thanks to high energy prices for much of the second quarter. However, a late-June drop in energy-related commodities caused the sector to finish the quarter with a small loss. High-growth market sectors, including consumer cyclical and technology, took the hardest hits as former market leaders, including Amazon and Tesla, each lost over 35% for the quarter.

Bonds

The U.S. Treasury 10-year yield climbed to a high of 3.49% in mid-June and finished the quarter at 3.20%. The rate was up from 2.32% at the start of the quarter and 1.52% at the end of 2021. Meanwhile, the U.S. Treasury 2-year note yield finished the quarter at 2.92%, up from 2.28% at the end of March and 0.73% at the end of December.

Underlying the rise in yields were significant changes in expectations for Fed Reserve policy. To begin the year, investors only expected interest rate hikes from the Fed to around 2.0%. However, expectations changed in response to accelerating inflation. After raising the rate by 25 basis points in March, the Fed boosted the fed funds rate by 50 basis points in May and another 75 basis points in June.

As a result, long-term bonds took another punch during the second quarter, thanks to their vulnerability to rising interest rates. The Morningstar US Long Term Core Bond Index (10+ years) fell 12.1%. However, bonds with less sensitivity to changes in interest rates held up relatively well. The Morningstar US 1-5 Year Core Bond Index lost just 1.2%, while short-term Treasury bills finished the quarter with a slightly positive return. Corporate bonds underperformed as rising recession fears paired with already high inflation weighed considerably on corporate debt.

Market Performance % Barometer			
Broad Market	**Q2 2022**	**Q1 2022**	**6/30/2022**
Core Plus Bond (US 5-10 Year Treasury)	**-4.5%**	-4.5%	-10.2%
Sector			
U.S. Treasuries	**-3.7%**	-5.5%	-9.0%
Corporate	**-6.9%**	-7.9%	-14.3%
High Yield	**-9.9%**	-4.5%	-14.0%
Mortgage	**-4.0%**	-5.0%	-8.8%
Maturity			
Short-Term Core	**-1.2%**	-3.6%	-4.7%
Intermediate Core	**-4.2%**	6.0%	-10.0%
Long-Term Core	**-12.1%**	-11.3%	-22.0%
Inflation Protected			
TIPS	**-6.3%**	-2.4%	-8.5%
Source: Morningstar Direct, Morningstar Index, Data as of June 30, 2022			

We thank you for your ongoing confidence and trust. If you have questions or comments, please don’t hesitate to contact us.