Insights: July 2022

Market Overview and Performance

Without dispute, it has not been a pleasant 6 months for investors. Equities broadly speaking have declined -20 percent and bonds have declined -10 percent. As we have discussed in past Insights, drawdowns of this magnitude are by no means uncommon and are somewhat regarded as "the price of admission" for long-term investors in risk assets. What is uncommon thus far in 2022 however, is the fact that virtually every asset class has declined at the same time with the exception of commodities. Typically, during past similar episodes, investors seeking long-term capital appreciation would be stepping in to buy assets at current levels. However, the crosscurrent of narratives seems to be holding investors captive. On the one hand, the labor market and consumer spending continue to prove unfailingly resilient. On the other hand, inflation remains stubbornly high and the Federal Reserve appears committed to a rapid rise in interest rates which could potentially impede growth and perhaps push the US economy into recession.

JP Morgan Chairman, Jamie Dimon, articulated this contradictory environment after the bank reported earnings results last week. As he stated, "Consumers are in good shape. They're spending money. They have more income. Jobs are plentiful. They're spending 10% more than last year, almost 30% plus more than pre-COVID. Businesses, you talk to them, they're in good shape. They're doing fine. We've never seen business credit be better ever like in our lifetimes. And that's the current environment. The future environment, which is not that far off, involves rates going up, maybe more than people think because of inflation, maybe stagflation, maybe soft -- there might be a soft landing. I'm simply saying there's a range of potential outcomes from a soft landing to a hard landing, driven by how much rates go up." The path forward for the Consumer, earnings and interest rates will be key to returns as we look to the second half of the year.

As always, thank you for reading our latest Insights.

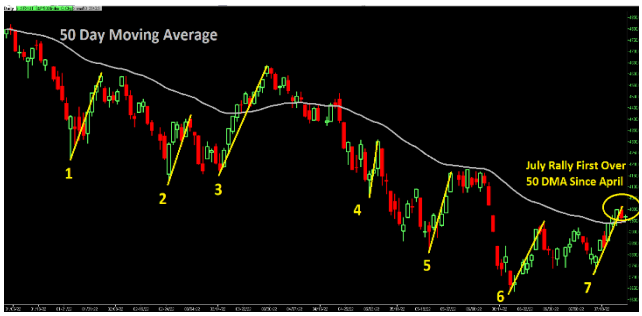
	Quarter to Date June 30	***Year to Date June 30***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	**-16.10**	**-20.60**
Russell 2000 Index	-17.20	-23.43
MSCI EAFE Index	-14.51	-19.57
MSCI Emerging Markets Index	-11.45	-17.63
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-4.69	**-10.35**
Barclay's U.S. Aggregate Credit Index	-12.59	**-22.40**
Barclay's U.S. Aggregate Corporate High Yield Index	-9.83	-14.19
Barclay's Municipal Bond Index	-2.94	**-8.98**
Macro Measures		
Gold	-7.51	-1.16
Crude Oil	5.46	**40.62**
CBOE Volatility Index	39.64	**66.72**
USD Dollar Index	6.49	**9.09**

Current Theme – A Unique Recession? Conflicting Narratives Leave Investors Confused with Slowing Economic Growth Counterbalanced by Resilient Consumer Spending and Earnings

Investors May Be at Risk of "Talking Themselves Into Recession" as Sentiment Falls to Historic Lows Despite Constructive Elements Remaining in Place

At the close of June, Goldman Sachs highlighted some "Worst" market statistics. They are not encouraging. Among them: US Bonds – worst start to a year since 1900; S&P 500 – worst start since 1970; US 60/40 Portfolio – 2nd worst start since 1900 (-17%) only bettered by 1932. Yet, optimism in markets can be found. The chart below shows that the S&P 500 has experienced 7 notable rallies thus far in 2022 with the most recent reaching +10% and breaking out of significant technical resistance levels.

S&P 500 - 7 Rallies YTD, Now Above 50 Day Moving Avg.



Source: Refinitiv

Further, while declining markets are never pleasant, they historically have set the stage for stronger gains in future periods as one can see below.

Returns Following Weak 6-Months Have Been Strong

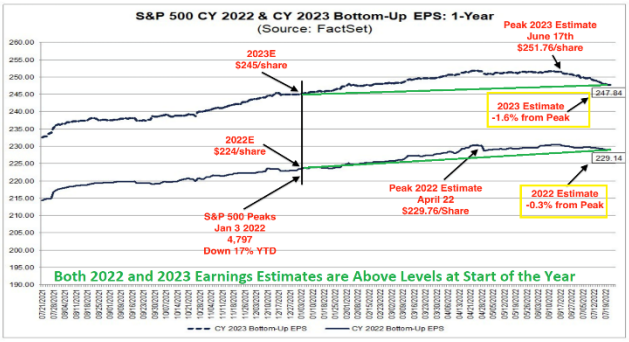
Wilshire 5000 - Worst 6 Months Periods & Forward Returns (1971 - 2022)

Worst 6 Month Periods				Forward Total Returns					
Rank	Total Return	Start Month	End Month	3-Month	6-Month	1-Year	3-Year	5-Year	10-Year
1	-42.4%	Sep-08	Feb-09	26%	42%	56%	102%	189%	372%
2	-36.4%	Jun-08	Nov-08	-16%	6%	27%	53%	132%	288%
3	-34.7%	Aug-08	Jan-09	8%	23%	35%	73%	147%	309%
4	-33.3%	Apr-74	Sep-74	9%	36%	41%	84%	153%	392%
5	-31.0%	Oct-08	Mar-09	17%	36%	52%	91%	167%	341%
6	-29.5%	Jul-08	Dec-08	-11%	4%	28%	52%	134%	246%
7	-29.4%	May-08	Oct-08	-14%	-7%	11%	41%	108%	250%
8	-27.3%	Apr-02	Sep-02	8%	4%	26%	66%	115%	129%
9	-26.3%	Mar-74	Aug-74	-1%	18%	29%	62%	121%	333%
10	-21.4%	Oct-00	Mar-01	7%	-10%	3%	9%	33%	55%
11	-20.9%	Jan-22	Jun-22						
12	-20.4%	Jun-87	Nov-87	18%	17%	24%	49%	120%	432%
13	-19.6%	Sep-00	Feb-01	2%	-7%	-8%	2%	22%	44%
14	-19.3%	Feb-74	Jul-74	-5%	1%	21%	50%	90%	255%
15	-18.5%	Aug-87	Jan-88	5%	10%	21%	44%	103%	387%
16	-18.3%	Jul-87	Dec-87	8%	15%	18%	43%	109%	405%
17	-18.2%	Jul-74	Dec-74	25%	46%	38%	70%	135%	356%
18	-17.9%	May-74	Oct-74	7%	22%	26%	51%	100%	318%
19	-17.9%	Feb-02	Jul-02	-3%	-5%	13%	51%	85%	98%
20	-17.8%	Jun-74	Nov-74	19%	35%	36%	65%	123%	334%

Source: Charlie Bilello, Compound Capital Advisors

The chart from Compound Capital illustrates that the evidence from the previous largest 6-months equity drawdowns overwhelmingly results in positive returns in the subsequent 3, 6 and 12 months and beyond.

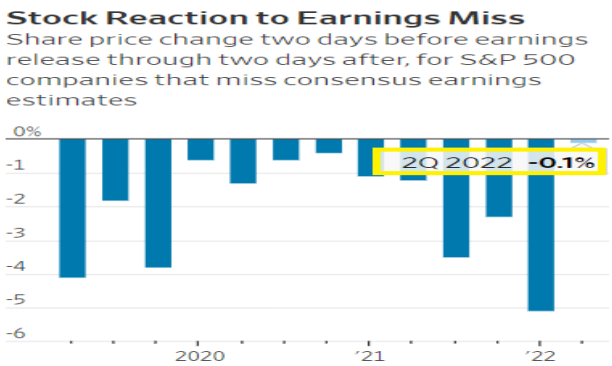
Earnings Estimates Have Not Collapsed as Some Feared



Source: Datatrek; Factset

Given the overall risk aversion, what could potentially spark a recovery rally like we have seen in the past? Jurrien Timmer, Director of Global Macro for Fidelity, suggested the following "Recipe for a Rally"- "The Fed nears neutrality, inflation outlook and long rates fall, equity valuations down from their peaks (16.7x vs 22.7x), while 2Q earnings growth holds up." And in fact, we find today that many of those elements have come to fruition. Starting with earnings, the chart above highlights that despite broadly published handwringing over an earning collapse, earnings have held up quite well thus far this quarter. Estimates for both 2022 and 2023 are above the levels at the start of the year with growth at 4.8% and revenue growth of 10.1%. In fact, as seen below, the stocks of companies that have disappointed on results have hardly been sold at all suggesting that earnings expectations were exceptionally low heading into reporting season.

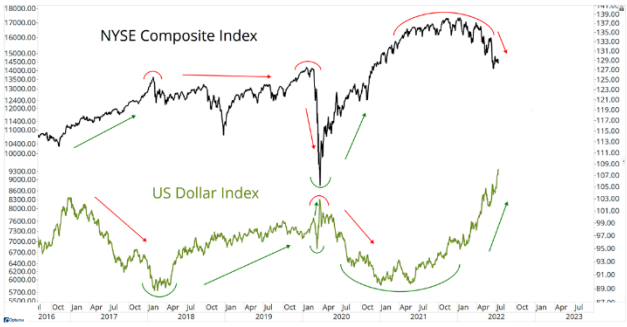
Earnings Misses Not Being Punished = Low Expectations



Source: Factset; Wall Street Journal

This comes as a pleasant surprise for market participants particularly in light of the fact that the US Dollar has increased almost +15% since January which acts an anchor on earnings for US based companies.

US Dollar Strength Has Been a Headwind for Us Equities



Source: All Star Charts; Optuma

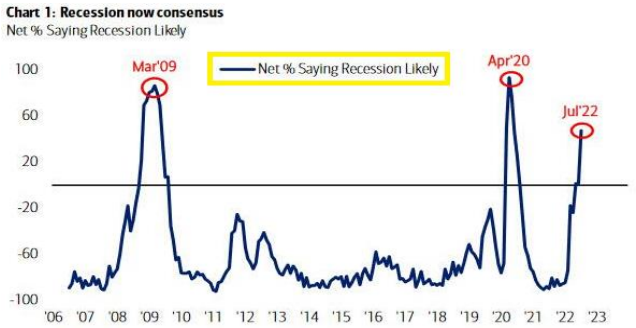
While a headwind for earnings and thus stock prices, a strong Dollar is hardly enough to fuel the extreme pessimism present in the market currently. Consider the next few charts from the July update of BofA's Global Fund Manger Survey. They are remarkable.

Fund Manager Growth Expectations at All Time Low

Source: BofA Global Fund Manager Survey

First, expectations for future global growth are at an all-time low – *below* the level seen in October of 2008 during the Global Financial Crisis.

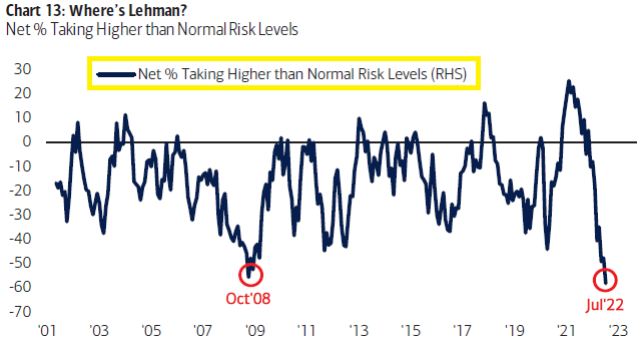
Recession Now The Consensus View Priced Into Markets



Source: BofA Global Fund Manager Survey

Second, as seen in the previous chart, a recession is now the consensus view. While that debate continues, the consequence of this prevailing view is that fund manager risk levels are now lower than those being taken during the Global Financial Crisis highlighted by the third chart below. This is completely illogical. There is literally nothing exisitng in the current global economy that comes even close to the contagion risk of the highly levered financial system present in 2008.

"Where is Lehman?" - Risk Levels Below Financial Crisis



Source: BofA Global Fund Manager Survey

We see this pessimism present in other surveys such as the Richmond Fed CFO survey and the Conference Board Consumer Survey which we show below. In those surveys (and others), there is an interesting contradiction – in general, people feel pretty good about their present situation while they rate the overall economy and the future prospects poorly.

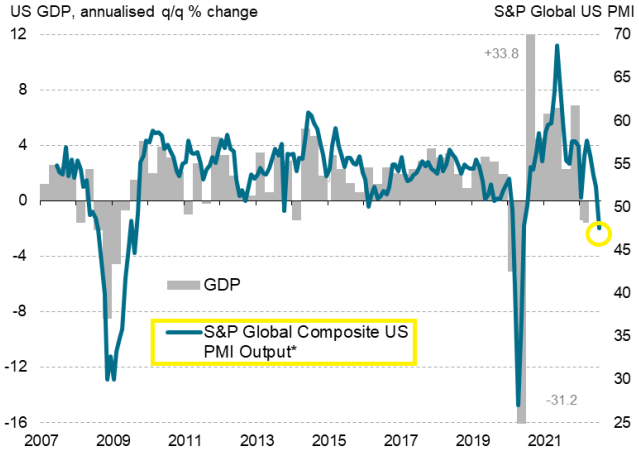
Consumers Confident Personally But Worry About Future

Source: The Conference Board; NBER

So despite what people may be experiencing personally, they remain cautious and will tend to act accordingly. From an investment point of view, there is clearly evidence of a slowdown in the US economy (and globally), but there are also several other important pillars of the economy that remain remarkably resilient which act as a counterbalance to

the slowdown (and recession) narrative. Of concern, we have measures like S&P's Global Composite PMI measure which attempts to capture real time private sector activity by tracking variables like sales, employment, inventories, and prices. Their Index is now at a 26-month low and showing contraction.

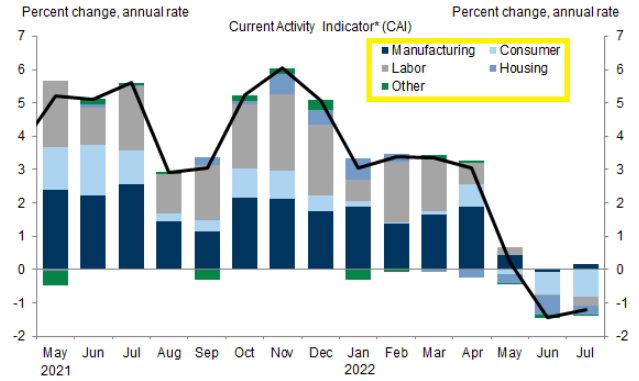
S&P Measure of Private Sector Activity at 26 Month Low



Source: S&P Global; BEA; Chris Williamson

Similarly, Goldman Sachs has created a Current Activity Indicator to assess real-time indicators of economic growth utilizing manufacturing, labor, consumer and housing data. Their measure has fallen sharply since April and has now declined into negative territory.

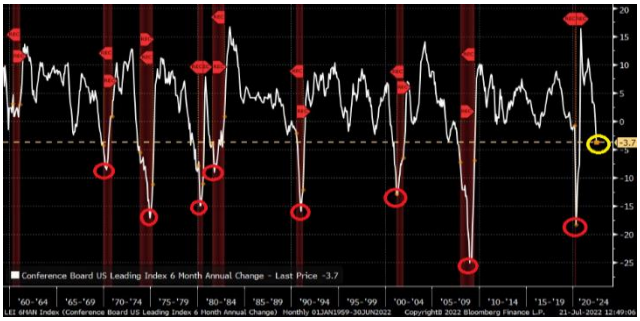
GS Current Activity Indicator In Third Month of Decline



Source: Goldman Sachs Global Investment Research

Further, one of best tools for identifying changes in the business cycle is the Conference Board's Leading Economic Index. Unlike other indices, it attempts to anticipate or signal turning points by several months. The measure has a good track record of predicting coming recessions and at present, the Index has declined for 4 straight months and is also now in negative territory – a precursor of past recessions.

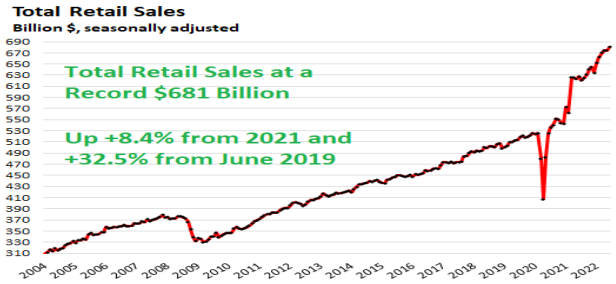
Leading Economic Indicators Approaching Warning Level



Source: The Conference Board; Liz Young

Given these trends, it's somewhat paradoxical that the US consumer, who comprises 70 percent of US GDP, remains steadfastly robust. Consider Retail sales below which have rocketed up to $680 billion and have grown over +30% since pre-pandemic levels in 2019.

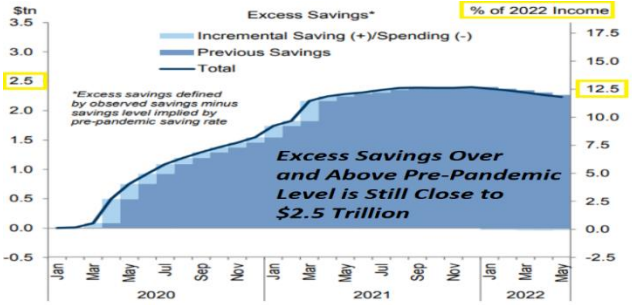
Total Retail Sales Have Exploded Since the Covid Period



Source: Census Bureau; WolfStreet.com

Even accounting for inflation, real consumer spending has increased quarter over quarter in every period since 2Q 2020. And the Consumers' balance sheet has not deteriorated. Excess Savings, those beyond a pre-pandemic baseline, stand at $2.5 trillion. And Net Charge Offs, a measure of amounts failed to be paid to credit card issuers, has declined -30% in the past year to an average of just 1.9%, suggesting a strong consumer financial foundation.

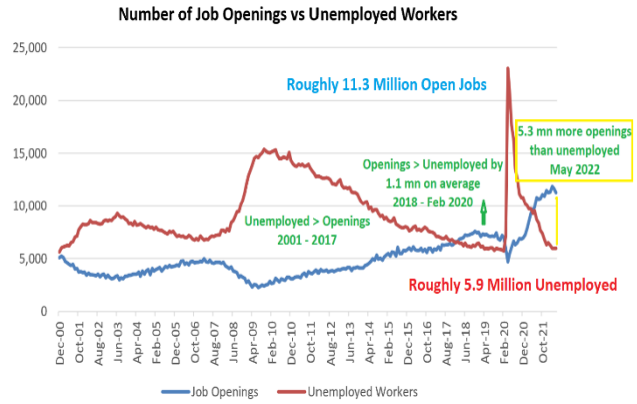
Consumer Excess Savings Still Close to $2.5 Trillion



Source: Goldman Sachs Global Investment Research

It really cannot be overstated how important the consumer is to US economy which serves as the lead train for the entire global economy. Consumers will continue to spend at record levels if they feel confident in both their own personal financial situation and in their ability to secure employment.

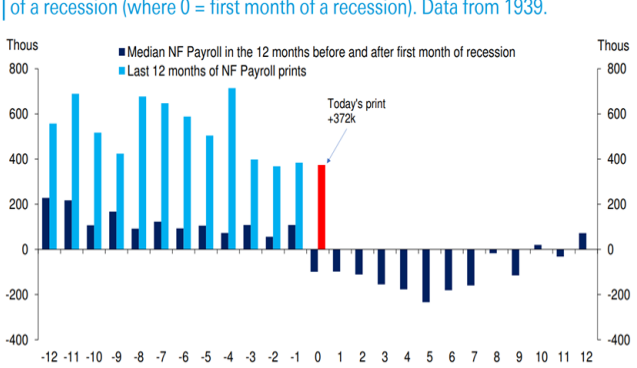
+5 Million More Open Jobs Than Available Workers



Source: Datatrek; Bureau of Labor Statistics

Perhaps the strongest argument for why the economy is not currently in recession is the labor market. As seen above, US job openings total over 11 million right now while the total amount of unemployed available in the workforce is only about 5 million. Jobs are plentiful. When they are not, as was the case during past recessions, consumers begin to reign in their spending and somewhat of a vicious cycle begins. However, the current environment is in stark contrast to what Deutsche Bank has found regarding labor during all of the recessions since 1939. In each case, Payrolls have declined as the recession began. Today, we continue to see robust payroll data with June experiencing an employment rise of 372,000 people.

Recessions Have Always Coincided with Job Losses



Source: BLS, NBER, Haver Analytics, Deutsche Bank

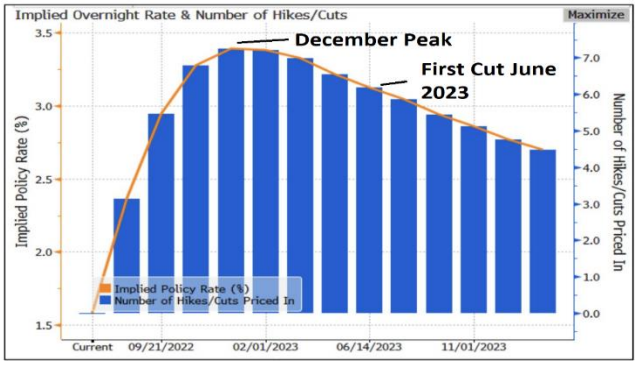
So while we see evidence of both strength and a slowdown within different segments of the economy, the truth is, most people do not experience GDP growth or contraction in their daily lives. What most people feel is the prices of things like gasoline, food, cars, houses, etc. Fortunately, we have seen a notable amount of contraction in the prices of many goods since the "peak inflation" fears of mid-June. The housing and auto markets have cooled, international shipping rates have collapsed and prices for important commodities like lumber have come down rapidly. And gasoline, the most important influencer on consumer sentiment has seen a price decrease for 43 straight days. What this means is inflation expectations are also falling. As the chart below illustrates, futures markets have priced inflation falling to 3.5% or below by 2023.

Futures Market Pricing In a Sharp Decline in Inflation

Source: The Daily Shot

And finally, with the Federal Reserve raising rates to what Chairman Powell suggested is the neutral rate, futures markets are also pricing in a peak in interest rates by December at just below 3.5% before rate cuts begin sometime in the second quarter of 2023. This is all very constructive for risk assets.

December Peak in Rates Seen Before Cuts Begin in 2023



Source: Bloomberg; Danielle DiMartino Booth

Going Forward

The past few months have been a unique period for investors like ourselves who have been allocators of capital for decades. As we discussed, despite a large amount of evidence suggesting that the US economy is still quite strong, the sentiment among many of our clients and associates has simply been awful. As such, we think the discussion about whether we are in a "technical recession" is a not a productive use of time. Due to the frankly non-systematic manner in which the National Bureau of Economic Research, the arbiter of the label "recession", makes their assessment of economic conditions, the first half of 2022 is unlikely to be determined as a recessionary period due to the steady growth seen in several areas (consumer, labor, corporate profitability, etc,). However, the truth is it doesn't really matter.

The US economy is undoubtedly experiencing a slowdown, with conditions in Europe even worse and Asia remaining a wildcard due to COVID restrictions. In fact, it's more likely the second half of 2022 or the early part of 2023 mark a "true" recession. Regardless, perceptions are often reality and the US at this point seems to be in danger of "talking itself" into a recession. By that we mean if consumers and investors believe we are in an economic slowdown (and we clearly have strong evidence that they do) then they will begin to restrain activities. This in itself slows economic growth and the cycle becomes a self-fulfilling prophecy. To monitor progress of this potential development, we would suggest keeping a close watch on initial jobless claims, leading economic indicators (LEIs), and consumer spending.

With the Federal Reserve meeting this past week being widely interpreted by the market as Dovish, investors also need to consider the possibility of the stronger markets in the second half of 2022. Essentially, the market now believes that the Fed will be done with raising rates by the end of the calendar year. That would mean the high for bond yields has been reached for now. We see the consequences of this with bond yields falling sharply (and prices rising) post Fed meeting. This is also very constructive for equities and growth equities in particular. A backdrop of rates not going up for much longer combined with a declining inflation environment has become much closer to reality, and thus we have now quietly seen a rally of +12% for the S&P 500 and over +15% for the Nasdaq 100 since the lows in mid-June. Depending on how things transpire, we could end up seeing a mirror image of performance from the early part of this year. That would mean commodities declining and growth equities and bonds posting positive returns.

Due to the choppiness of the market through the end of June, we have maintained a higher than normal cash allocation. However, with portions of the US equity market down by anywhere from -10 to -20% or more, we believe there are opportunities in quality companies which we view as trading at discounts to their long-term value, namely in the information technology, financial, energy, healthcare and material sectors. We anticipate allocating capital to selected positions across industry groups that we believe are well positioned in the near future, particularly in light of what has been a better-than-expected earnings season thus far.

Small and mid-cap stocks have suffered more than their large cap alternatives throughout the first half of 2022. However, if rates and inflation trend lower and the US Dollar remains high, this area of the market could prove attractive.

Regions outside of the US remain challenged at the moment, particularly in light of the rise in the US Dollar. Given the conflict in Europe and the severe policies being used to combat COVID in Asia, we prefer to wait for better entry points.

Within fixed income, we continue to place our emphasis on shorter duration exposures and unconstrained strategies. We also continue to find opportunities within municipal bonds. More recently however, we have taken advantage of the climb in treasury yields to allocate some cash balances into laddered short-term treasuries as a way to capture risk-free yield for fixed income portfolios.

We believe that commodity exposure including both gold and non-precious metals (agriculture, industrial metals, energy) will continue to be additive due to the nature of the current supply constraints.

Thank you for taking the time to read our thoughts on the markets and we look forward to speaking soon.