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Second Quarter 2022 Commentary

Dear Clients,

Please find enclosed your June 30, 2022 Investment Reports.

It has been an extremely challenging year for investors, with equity markets falling into bear market territory (down more than 20%) and bond markets registering low double-digit losses. Over the past few months, the economic backdrop has deteriorated with sustained high inflation and slowing growth, as the Federal Reserve and other global central banks aggressively tighten monetary policy. Exogenous shocks – the Russian war on Ukraine and China's zero-COVID lockdowns – continue to further disrupt the global economy and financial markets.

It is natural to be concerned about these developments and worry about what the future holds. Unfortunately, in the near-term we think it is prudent to expect more equity market volatility ahead as an economic slowdown and potential recession may well lead to corporate earnings disappointments. As always, investment discipline and patience – staying the course and remaining invested through these choppy waters – is necessary to be in position to realize the better returns to come. Given the wide range of potential outcomes, risks and unknowns, portfolio diversification also remains vitally important.

After a rough first quarter, global stocks and bonds suffered further sharp markdowns in the second quarter as stagflation fears (slowing growth with rising inflation) negatively impacted both stocks and bonds. U.S. large cap stocks dropped 16.8% in the quarter while developed international markets were down 14.7%. Emerging Market stocks held up a bit better, dropping 10.2% for the quarter. Core investment-grade bonds were down again in the second quarter, with the U.S. core bond market index down 4.7%. This puts this broad market bond index down a staggering 10.3% for the year to date – its worst first-half ever. Taken together with the equity bear market, this is the worst first-half performance for a traditional "60/40" balanced portfolio (60% S&P 500/40% Aggregate Bond Index) in modern history, down 16.1%. The previous worst first half was 1962, down 12%. Additionally, two consecutive quarters of negative returns for both the stock and bond markets has only occurred four times in history.

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	-16.8	-12.3	11.7
US Mid Cap Stocks	-17.0	-16.0	8.3
US Small Cap Stocks	-16.9	-20.7	6.9
Developed International Stocks	-14.7	-17.7	3.1
Emerging Market Stocks	-10.2	-21.2	3.6
US Bonds	-4.7	-10.3	0.9
Global Bonds	-11.0	-18.8	-1.8
US REITs	-17.2	-7.3	4.1

Data source: Morningstar Direct. Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Market indexes include:

US Large Cap Stocks: CRSP US Mega Cap TR USD
US Mid Cap Stocks: CRSP US Mid Cap TR USD
US Small Cap Stocks: CRSP US Small Cap TR USD
Emerging Market Stocks: FTSE Emerging TR USD
Developed International Stocks: FTSE Developed Ex US TR USD
US Bonds: Barclays US Aggregate Bond TR USD
Global Bonds: Barclays Global Aggregate Ex USD TR USD
US REITs: MSCI US REIT NR USD

In May, the year-over-year headline CPI inflation rate rose to 8.6%, from 8.3% in April, the highest in four decades. In response to the disappointing May inflation data, the Federal Reserve turned even more aggressive. At its June 15 Federal Open Market Committee meeting, the Fed hiked the policy interest rate (the federal funds rate) a larger-than-expected 75 basis points (0.75%), to a range of 1.50%-1.75%. The Fed committee members also sharply raised their median forecast for the year-end fed funds rate to 3.4% (from a 1.9% forecast at their March meeting), well above the Fed's 2.5% estimate of the "neutral" long-run equilibrium fed funds rate. The committee members also sharply downgraded their median forecasts for U.S. real GDP growth to 1.7% for both 2022 and 2023, reflecting their hope for a soft landing but not a recession. According to Chairman Powell, the Fed's' commitment to bringing down inflation "is unconditional." In other words, labor market conditions are no longer driving the Fed's "price stability and full employment" dual mandate. It is now all about inflation. Powell went on to say the Fed wants to see "a series of declining monthly readings for inflation" as "clear and convincing evidence that inflation is coming down" before "we can consider moving at a slower pace."

Tightening monetary policy leads to "tighter" financial conditions: higher borrowing costs for consumers and businesses, and a rising dollar. Tighter financial conditions in turn depress consumer and business spending, reducing aggregate demand in the economy. Lower demand should reduce overall price pressures and hence inflation. Those are the Fed's playbook and toolkit.

This simple economic cause-and-effect assumes the supply side of the economy remains steady. However, this has not been the case due to (1) the Russia/Ukraine war's impact on energy and agricultural commodities, and (2) COVID-related supply chain disruptions. These exogenous supply shocks should recede with time, but are not within the control of the Fed.

At the same time, there are several important economic indicators that remain strong. These include job growth (nonfarm payrolls increased 372,000 in June), a very low unemployment rate (3.6%), very low weekly new unemployment claims and consumer and corporate balance sheets that can support additional spending and borrowing. Given this strength, a recession is not inevitable. It is also important for investors to remember that recessions are a normal component of business cycles, and they are inevitably followed by economic expansions.

Looking ahead, investors will remain focused on the rate of inflation and the continued war in Ukraine. Any signs that inflation has begun to moderate will provide the Federal Reserve the opportunity to ease its aggressive tightening posture thereby reducing upward pressure on interest rates and bond yields. Investors will also be paying close attention to corporate earnings moving forward for any signs of economic weakness. Some movement towards a resolution to the crisis in Ukraine and any resulting improvements to grain and energy markets will be viewed positively by investors globally.

As always, we remain appreciative of your continued confidence and trust.

Leavell Investment Management, Inc.