KEY POINTS

The first half of 2022 was difficult for investors as both global stocks and bonds had significant losses with only energy and commodities posting strong gains. The combination of an aggressive Fed tightening cycle, rising inflation, the Ukraine war, and China's zero Covid policy weighed on investor sentiment and capital markets. Stocks entered a bear market as the S&P 500 fell 20%, the worst first half since 1970, while the technology heavy NASDAQ Index dropped 29%. Bonds yields jumped due to inflation and Fed tightening, which led to a negative 10.3% return in the Aggregate Bond Index in the first half. A standard 60/40 stock-bond portfolio is lower by 16% year-to-date, which is the worst start to a year in a century. Markets are pricing in aggressive rate increases, slowing growth and a higher probability of a recession in the next 6 to 12 months. On the positive side, valuation levels have moderated to 15.7 times forward earnings compared to the 25-year average of 16.8 times.

Hawkish Fed Pivot and Inflation: Inflation is at 40-year highs due to the exogenous supply shocks from the pandemic and the Ukraine war, coupled with overheated demand from the economic reopening and fiscal stimulus. The Fed is in a bind and must manage the trade-off between growth and inflation. Hiking rates too aggressively will risk a recession, while not tightening policy enough could cause inflation to become embedded in the economy. We have entered a regime change away from free money/quantitative easing with zero interest rates to quantitative tightening with rising interest rates and less liquidity. The Fed is just beginning to normalize monetary policy. The Fed hiked short-term rates 0.75% in June and may increase another 0.75% in July, while at the same time beginning to shrink its balance sheet. The Fed has made it clear it intends to slow demand and growth to steer inflation towards its 2% goal. A key question is whether the Fed can lower inflation to its 2% target without causing a recession.

Fed Rate Hike Cycles: Since World War II, there have been 14 periods where the Federal Reserve has embarked on a rate hike cycle. In 11 of those periods, the economy landed in recession. Using history as a guide, there's a one-in-five chance that the current cycle will not end in a recession.

Recessions and Growth: In the U.S., there have been 14 recessions post-WWII. The median length is 9 months and the median peak-to-trough decline in the S&P 500 is 23.9%. The good news is once the S&P 500 reaches the bottom, the average returns over the next 12 months are about 46%.

Bear Markets: The threshold for a bear market is a 20% decline in the stock market. The average bear market post-WWII had a 34% peak-to-trough drawdown (with a range of -20% to -50%) and lasts an average of 15 months. The combination of a hawkish Fed tightening cycle and the U.S. stock market entering into bear market territory increases the odds that a recession will occur within the next 6 to 12 months.

Positioning: We are cautious near-term as supply constraints and inflation persist, and markets digest the Fed's aggressive monetary tightening. Entering 2022, we reduced our equities overweight to neutral and raised cash and short-term fixed income holdings, expecting heightened volatility as the Fed raises interest rates and supply constraints continued. Our base case for 2022 is for a marked slowdown in growth to around 0 to 1% in the second half of the year with rising odds of a recession in the second half of 2022 or early 2023. We favor balanced positioning emphasizing high quality, flexibility, and liquidity to take advantage of dislocations created by market volatility.

ECONOMIC DATA

- Global growth rebounded in 2021 as the economy reopened leading to estimated U.S. growth of 5.6% and global growth of 5.8%. Growth will slow the next two years. For 2022 and 2023, U.S. consensus growth is forecasted to slow to 2.6% and 1.9%, respectively, while global growth is estimated to slow to 3.2% and 3.2%, respectively. 2022 estimates are likely to be reduced further as financial conditions tighten.
- S&P 500 earnings were $163 (+2%) in 2019, $140 (-14%) in 2020 and $208 (+48%) in 2021 (+16% revenue growth). Consensus earnings estimates for 2022 are $229 (+10%) with revenue growth of 10.7% (FactSet), indicating slowing growth. Estimates for 2023 are $250 (+9%) and will likely be revised lower.
- After the end of the longest U.S. expansion in postwar history, a new economic cycle that began in the third quarter of 2020 has transitioned to late cycle.
- Valuations continue to be above the long-term average. Warren Buffett's favorite valuation measure, the stock market capitalization to GDP ratio, is near historic highs as is Professor Shiller's CAPE ratio.
- The trailing 12-month operating price-earnings ratio is 17.3 times operating earnings compared to the 50-year average of 14.2 times earnings.
- The forward operating PE ratio is 15.7x earnings, which is below the 5-year historical average of 18.6x earnings and the 25-year average of 16.8x earnings.

PORTFOLIO POSITIONING

There is a high level of uncertainty in the macro environment currently with a wider range of possible outcomes for financial markets. Timeless investment principles of diversification, asset allocation and focusing on the long-term horizon are keystones we use to navigate the landscape to protect clients from market extremes, while positioning portfolios for long-term opportunities.

Tactically, we are neutral on stocks and stay underweight government bonds as interest rates have trended higher. Portfolio diversifiers are important in hedging downside risks and providing flexibility and liquidity. Inflation-linked bonds, commodities, and gold provide a hedge against inflation and excessive monetary creation. We have cash and short-term fixed income investments to minimize the risk of rising yields and to take advantage of opportunities.

In equities, we are overweight U.S. equities, preferring the U.S. over international developed markets given their geographical proximity to Ukraine and exposure (energy, supply chains) to Russia/Ukraine. We are overweight large cap U.S. equities, emphasizing the quality factor, due to their strong balance sheets and profit margins in a period of slowing growth. We lowered emerging markets positions due to their vulnerability to higher energy and food costs, and exposure to China.

In fixed income, we reduced our underweight to duration based on the significant increase in yields this year. We prefer U.S. investment grade bonds that have relatively higher yields, providing greater protection for portfolios to hedge equity risk. We remain overweight inflation-linked bonds (TIPS), which are high quality U.S. government bonds that hedge against rising inflation expectations. In the credit sector, we reduced exposure early in the year on the hawkish Fed pivot and prefer floating rate loans that benefit from rising interest rates.

In an environment with historically low interest rates and evaluated equity valuations, forward-looking expected asset class returns are lower than historical averages. We expect market volatility to persist due to monetary tightening, higher inflation/interest rates, supply constraints and geopolitical risks. Overall, we are confident our approach, which we continuously refine, will continue to enhance returns and reduce risk.

MARKET RECAP (AS OF JUNE 30, 2022)

- The first half of 2022 was difficult for investors as both global stocks and bonds had significant losses with only energy and commodities posting strong gains.
- The U.S. stock market made a record high in early January before a hawkish Fed tightening pivot and the Russia invasion led to a sharp drop into bear market territory. Year-to-date, the S&P 500 declined 20.0%, the worst first half since 1970. Global stock markets were also weak as international equities and emerging markets declined 19.5% and 17.9%, respectively. Style-wise, Value trumped the Growth style by a wide margin (1500 basis points).
- Bond indices experienced widespread price declines as yields roughly doubled on the 10-Year U.S. Treasury that hit a peak of 3.5%, the highest level since 2011. Global bonds fell 14.3% and the Barclays Aggregate Bond Index declined 10.3%. Credit spreads widened significantly.
- Gold declined 1.2%. WTI oil prices jumped 46% higher after reaching a 14-year high over $125 per barrel. Commodities surged 18% due to pent-up demand coinciding with supply constraints.
- In Alternatives, fixed income substitutes outperformed traditional bond indices and inflation/commodity-oriented alternatives posted strong returns.

Period Ending June 30, 2022   *Source: Bloomberg.*   *Past performance is not indicative of future results.*

		Trailing Performance (annualized for periods > 1 year)					
Asset Class	**Index**	**MTD**	**YTD**	**1Y**	**3Y**	**5Y**	**10Y**
EQUITIES							
Benchmark	MSCI All Country World IMI	(8.6)	(20.4)	(16.5)	6.0	6.7	8.7
Large Cap	S&P 500	(8.3)	(20.0)	(10.6)	10.6	11.3	12.9
Long-Short	S&P 500 / LIBOR plus 3	(4.1)	(9.9)	(5.2)	5.6	6.2	6.8
Small/Mid Cap	Russell 2500	(9.6)	(21.8)	(21.0)	5.9	7.0	10.5
International	MSCI World Ex US (net)	(9.7)	(19.5)	(17.7)	1.7	2.6	5.5
Emerging Markets	MSCI Emerging Markets (net)	(7.1)	(17.9)	(24.8)	1.1	2.3	3.2
FIXED INCOME							
Benchmark	FTSE World Broad Investment Grade	(3.1)	(14.3)	(16.0)	(3.5)	(0.7)	0.1
U.S. Aggregate	Barclays US Aggregate	(1.6)	(10.3)	(10.3)	(0.9)	0.9	1.5
U.S. TIPS	FTSE U.S. Inflation Linked Securities	(3.2)	(8.9)	(5.1)	3.0	3.2	1.7
Tax Exempt	BOFA Merrill Lynch US Municipal	(1.8)	(8.4)	(7.9)	0.0	1.6	2.5
U.S. Corp High Yield	Barclays US Corporate High Yield	(6.7)	(14.2)	(12.8)	0.2	2.1	4.5
U.S. Floating Rate	S&P/LSTA Leveraged Loan	(2.2)	(4.6)	(2.8)	2.1	2.9	3.7
International	FTSE Non USD WGBI	(4.9)	(18.7)	(21.9)	(6.7)	(2.6)	(1.7)
Emerging Markets	JPM Emerging Markets	(6.2)	(20.3)	(21.2)	(5.2)	(1.2)	2.2
REAL ASSETS							
Benchmark	Gold	(2.2)	(1.2)	2.0	8.5	7.8	1.2
Inflation	Consumer Price Index (CPI)	0.0	4.1	7.6	4.5	3.6	2.5
Commodities	Bloomberg Commodities	(10.8)	18.4	24.3	14.3	8.4	(0.8)
ALTERNATIVES							
Benchmark	LIBOR + 3	(1.6)	(3.9)	(2.0)	2.6	3.1	3.1
Multi-Strategy	Hedge Fund Research HFRI RV Mu		0.7	0.7	5.5	4.2	4.7
Global Macro	Credit Suisse Global Macro Ind		21.6	25.5	13.5	10.2	6.4
Managed Futures	Credit Suisse Managed Futures		17.3	19.4	9.2	7.3	3.6