PDS Wealth Management

Quarterly Investment Report – Q2 2022

The first half of 2022 was one for the record books, and not in a good way. Nearly all asset classes lost ground as investors were buffered by wave upon wave of negative economic and geopolitical headlines. Stocks suffered their worst start to a year since 1970. Bonds and commodities also fell. The war in Ukraine rages on and inflation remains at eye-popping heights, while the Fed hikes interest rates to combat it. Consumer sentiment (see chart below), a gauge of how people feel about current and future economic prospects, is probing depths last visited during the 2008 financial crisis and the recessionary period of the early 1980s.

Source: University of Michigan, St. Louis Federal Reserve Bank

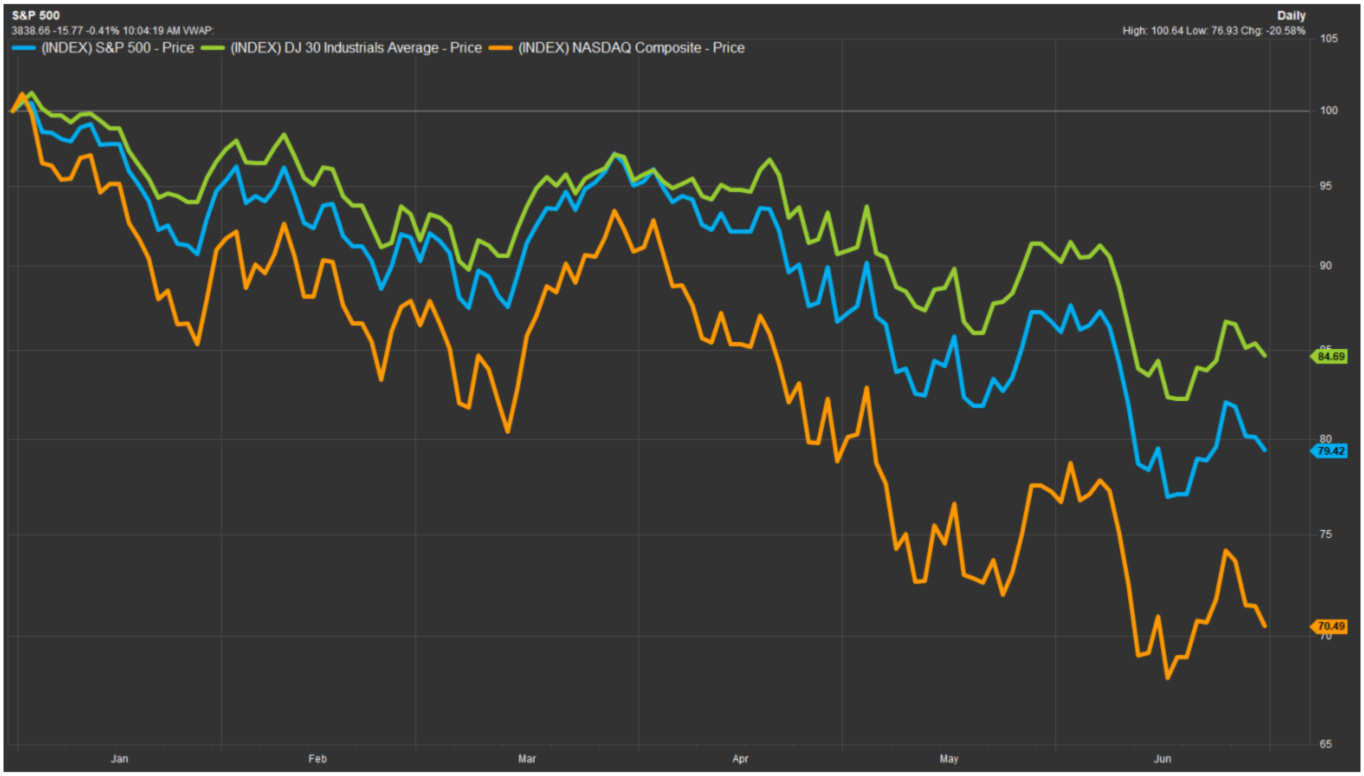
But are things really that bad? The unemployment rate, at 3.6%, is near historic lows and consumer and corporate balance sheets are sound. There are twice as many job openings as people seeking employment. Markets are a discounting mechanism and currently reflect a fair amount of skepticism. Some would argue they are pricing in a dramatic downturn which has yet to, and may not, materialize. The skies will eventually clear; markets will likely turn up well in advance of the evening newscast.

If your patience is being tried, know that you're not alone and don't hesitate to reach out if we can offer any guidance and support.

Markets Review

Stocks

US Stock Indices YTD – S&P 500, Dow Jones Industrial Average, Nasdaq Composite



Source: FactSet

Stocks across geography, sector, style, and size declined sharply in the quarter. The S&P 500 fell 16% in Q2, bringing its year-to-date decline to 20%. The Dow Jones Industrial Average lost 11% in Q2 and 15.5% for the entire first half. The Nasdaq dropped 29% through June 30 and a whopping 22% in the second quarter.

No sector of the equity market was spared in the second quarter. The Consumer Discretionary, Technology, and Communication Services sectors all lost more than 20% in Q2, bringing their year-to-date losses to -33%, -27%, and -30%, respectively. Historically "safe-haven" sectors – Healthcare, Consumer Staples, and Utilities - each lost between 4-6% in Q2. Energy remains the best performing sector of the year, with a 30% gain through June 30, though the sector fell 5% in the Q2 and remains under pressure into July as recession fears grow.

The small-cap Russell 2000 Index ended the first half of 2022 with a 21.4% decline, after a 14% slide in Q2. International markets, as measured by the FTSE All-World ex-US Index, declined 13.6% in Q2 and 18% in the first half.

In what could be viewed as a positive sign, Chinese stocks rose 5% in Q2 and are now outperforming on a relative basis year-to-date with (only) a -12% decline. Chinese stock markets led to the downside throughout 2021, could they now be leading to the upside?

Bonds

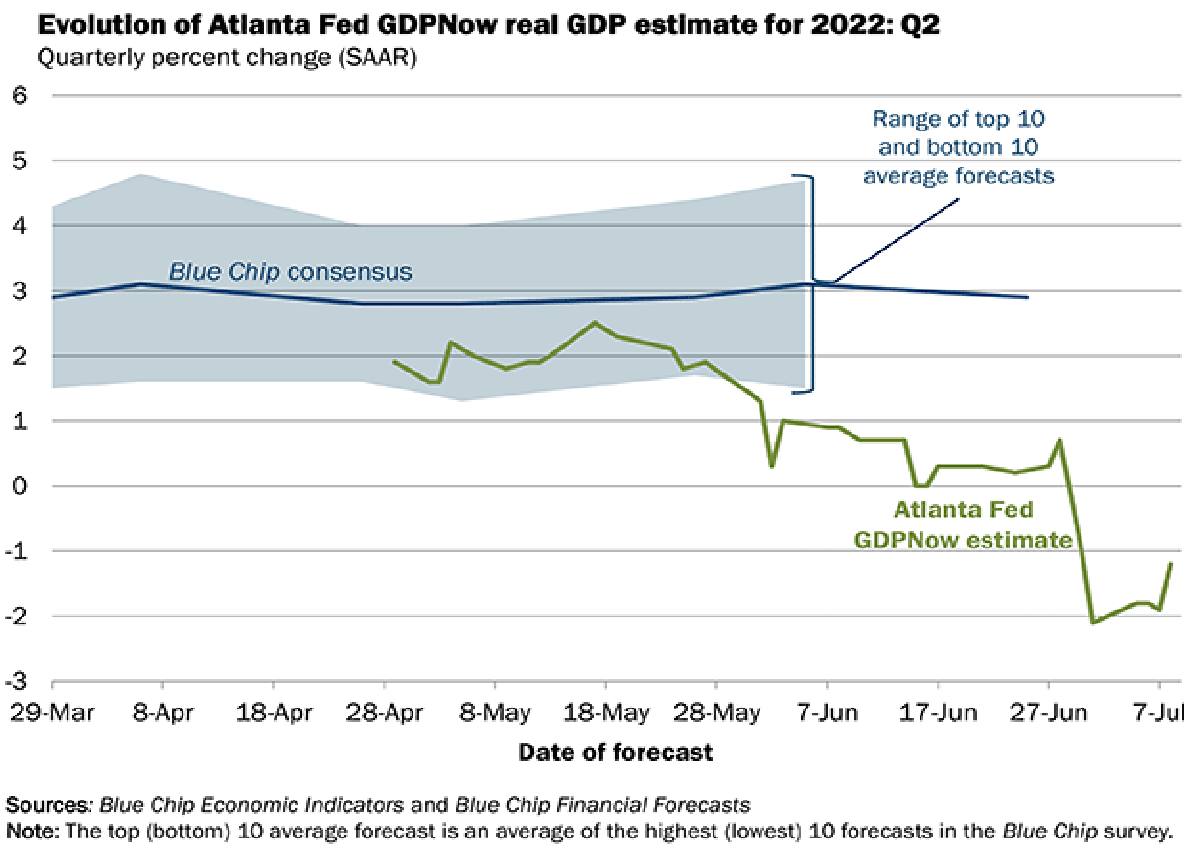
For the second quarter in a row, bonds failed to provide a respite for weary investors as the Fed raised rates further and embarked on culling their bloated balance sheet. Yields rose across maturities during the quarter with the 10-Year Treasury Note yield touching 3.5% in mid-June before settling at 2.98% to close out the quarter. Yields on shorter-dated maturities tracked the increase in the Fed Funds target, which was raised 125bps in the quarter to 1.75% and is expected to increase by another 50-75bps at the end of July.

One benefit of sliding bond prices is yields are becoming more favorable. The S&P 500 Investment Grade Corporate Bond Index fell 13% in the first half of 2022 and currently yields 4.6%, up from 2.3% at the beginning of the year. The S&P 500 High Yield Corporate Bond Index declined 8.5% in Q2, following a 6% slide in Q1; the index currently yields over 7%.

Economic Review

It was a busy quarter on the economic front. Initial reports for GDP in Q1 showed a surprise drop of 1.4% in real (inflation-adjusted) terms. The Federal Reserve Board raised the Fed Funds Target rate by 50bps on May 4th and laid out a schedule of planned reduction of their bond holdings, otherwise known as "quantitative tightening." Rates were hiked again by 75bps in mid-June to 1.75% and expectations are for similar moves at upcoming meetings on July 27 and September 21. The Fed is talking tough on inflation, and with the continued strength in the jobs markets, they have cover to continue their tightening regimen.

The prevailing narrative has changed in recent weeks, however, from expectations of a "soft-landing" to growing acceptance of the inevitability of a recession. As mentioned above, GDP in Q1 was negative and the forecast for Q2 is also negative (see the latest Atlanta Fed GDP Now forecast below). Technically two negative GDP quarters in a row equates to a recession, so we may already be in one. If so, it would be highly unusual without seeing a deterioration in employment.



Source: Federal Reserve Bank of Atlanta

Employment

Job growth was strong throughout the second quarter and remains so into Q3. The monthly release of Non-Farm payrolls grew by ~400,000 in each month of Q2. The June report, released last Friday, showed another solid increase, albeit at a slower pace, of 372,000. Unemployment has been holding steady at 3.6%, enabling the Fed to focus entirely on the inflation side of their dual mandate.

Inflation

It was another quarter of high inflation readings hovering around 8.5% year over year, and north of 6% excluding food and energy prices. This Wednesday's release of June CPI showed a blistering 9.1% year over year increase. The recent decline in energy prices should provide some relief to future headline numbers, but it will take a few sequential reports to confirm if inflation has peaked.

Outlook

As we cross the half-way point of 2022, the list of issues to consider has not shortened. Below is an abbreviated list of topics that have our attention...

Geopolitics/Global Issues

- Does the Russia/Ukraine conflict reach a resolution, escalate, or plod along?
- COVID persists with new flare-ups around the world; does China continue its "zero COVID" policy, causing widespread lockdowns and more supply chain disruption?
- Is China's continued harassment of Taiwan a prelude to an invasion?
- With the disruption of oil and gas markets caused by Russia/Ukraine, countries are focused on energy policy and dependence on (potentially hostile) foreign partners. Will Europe have enough energy supply to survive the winter without Russian oil and gas?

Economic

- How long can the Fed continue on their aggressive tightening cycle and at what pace?
- When will inflation peak, and potentially allow the Fed to slow or stop their rate increases?
- The war in Ukraine appears to be having a deleterious effect on European economies, does that weakness spread overseas?
- Does a recession arrive in the US and/or abroad? Is it already here?

Corporate Fundamentals

- Expectations are for corporate earnings estimates and guidance to come down. Is this the next shoe to drop? When does that show up and to what degree?
- Coincident with falling earnings prospects, do corporations pull back from hiring? (Several retail, financial, and tech companies have announced hiring freezes or layoffs in previous weeks).
- Will rising interest rates put pressure on sectors like housing and autos?

US Politics

- US midterm elections will be held on November 8; do Republicans take back either or both houses?
- Are Biden and the Democrats able to pass further stimulus, raise taxes, or any part of the "Build Back Better (Smaller?)" agenda?

All the best for the back half of '22!

Paul Spencer, CFA®

Director

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