Fundamentum

2022 Q2 Market Commentary

Inflation, Russia's invasion of Ukraine, China's COVID lockdowns, the Federal Reserve's aggressive rate hikes, and now concerns surrounding a slowing U.S. economy have led to increased levels of volatility and a challenging first half of the year with broad declines in the equity and fixed income markets. Following the first quarter's negative returns, the market's risk-off sentiment accelerated in the second quarter as high-profile companies began to miss expectations while inflation burned bright, interest rates jumped, the Russian/Ukraine war continued, and the Federal Reserve completed a hawkish pivot. For the 2nd Quarter, equity and fixed income returns were strongly negative with year-to-date returns ending near their lows in June. The S&P500 Index's (-19.77%) return marks the worst first-half performance of the index since 1970 while the Bloomberg/Barclay's U.S. Bond index delivered its worst performance (-10.35%) since data began in 1981.[1]

Total Returns by Asset Class	2nd Qtr.	YTD [2]
Dow Jones Industrials Index	-11.14%	-14.44%
MSCI EM Index	-11.72%	-17.57%
Russell 1000 Value Index	-12.64%	-12.87%
MSCI EAFE Index	-13.91%	-19.23%
S&P 500 Index	-16.39%	-19.77%
Russell 2000 Index	-18.04%	-23.45%
Russell 1000 Growth Index	-21.18%	-28.07%
NASDAQ Composite	-22.49%	-29.22%
Bloomberg/Barclay US Bond AGG	-4.44%	-10.35%

In the 2nd Quarter, equity sectors with defensive leadership continued to outperform, led by Consumer Staples (-5.2%), Utilities (-5.7%), and Energy (-6.1%) while Consumer Discretionary (-26.3%), Communication Services (-20.9%), and Technology (-20.4%) continued to lag.[3] The Russell 1000 Value Index outperformed the Russell 1000 Growth Index by more than 15 percentage points through the first six months of 2022. This was the second best run for value since the inception of the Russell style indices in 1978.[4] The Mega-Cap, popular stocks that drove the equity markets higher from the 2020 pandemic lows have reversed in 2022. The NYSE FANG+ Index, which tracks Apple, Amazon, Microsoft, Google, and a handful of other large, technology-related names declined over 34% in the first six months of the year.[5] The three best-performing stocks in the S&P500 Index were Lamb Weston Holdings (+19.3%), AT&T (+17.5%), and Monster Beverage Corporation (+16.0%) while the three worst-performers were Arista Networks (-32.6%), HCA Healthcare (-32.9%), and Target Corporation (-33.5%).[6]

Year-to-date, the equity market drawdown has been driven by valuation/multiple compression due to a higher level of interest rates. With valuations approaching long-term averages, profitability and earnings growth will be the key drivers of performance in the second half of the year. Overall company profits and earnings have been a bright spot this year. For the 2nd Quarter, S&P500 companies are expected to deliver positive (+4%) earnings growth. However, analysts have started to lower their quarterly estimates by a small margin - reacting to growing concerns about the economy. Still, in the second half of the year, analysts forecast double-digit earnings growth according to FactSet Research.[7] However, a combination of supply input pressures, lingering high input cost, tightening financial conditions, currency headwinds, slowing economic growth, and poor CEO sentiment has increased concerns about corporate earnings and the downside risk for the remainder of the year.

Inflation as measured by the consumer price index (CPI) soared during the quarter rising to the highest level in over forty years. The CPI climbed 1.0% in May with the annual rate increasing to 8.6% – the largest 12-month increase since 1981.[8] After starting an interest hike regime with an initial hike of 0.25% in March, the Federal Reserve responded to this higher-than-expected inflation by accelerating its rate hikes. In May, the Federal Reserve raised the Fed Fund's rate by 0.50% and another 0.75% in June with another 0.75% expected in July with more hikes coming this fall and next year. Expectations are for Federal Reserve to continue to raise rates peaking above 3.0% in the first half of 2023.

In the currency markets, rampant inflation and the Federal Reserve's aggressive tightening policy have led to a historically strong dollar compared to other currencies - approaching multi-decade highs. This strong-dollar regime has begun to hinder the earnings of U.S. companies with large international operations.

However, there are indications that the Federal Reserve's inflation-fighting actions are starting to have an impact as seen in commodities and housing markets. In metals and agriculture, prices have stalled and fallen significantly. Even in the energy markets after hitting 10-year highs during the quarter, prices have begun to reverse their upward spiral. In housing due to rising mortgage rates, cracks have developed in housing affordability and refinancing activity.

Financial markets are forward-looking and have begun to fear an economic slowdown or recession as the Federal Reserve continues to raise interest rates to stamp out inflation. The back-and-forth expectations between rising inflation and recession fears have raised volatility in the fixed income markets. The 10-year U.S. Treasury yield started the quarter around 2.4%, spiked near 3.5% in mid-June, and then fell to the 3% level as investors worried about future economic growth and a move to safety. Following the Federal Reserve's rate hikes, the short-end of the yield curve continues to rise versus the long-end. This flattening of the yield curve could lead to an inversion (short-term rates higher than long-term rates) which is historically a major signal for a significant slowdown or recession.

During June, the markets began to fear we were already in a recession or near one due to the aggressive Fed actions to combat inflation. If we are currently in a recession (two quarters of negative GDP – Gross Domestic Product) it is highly unusual. The coincident indicators (non-farm payrolls, retail sales, industrial production, and real incomes) used by the government to confirm a recession are nowhere close to depressed levels and company earnings expanded in the second quarter. But Federal Reserve Chairman Powell did say in a speech this June that he was more concerned about record levels of inflation than the possibility of raising rates too fast or too much.

One area of continued strength in the economy is the labor markets. Employment is still displaying strong but moderating job growth as firms are still re-filling positions lost during the pandemic. During the quarter, weekly jobless claims fell to their lowest level since 1970 and the unemployment rate dropped to a pre-pandemic 3.6%.[9]

The financial markets are in a bottoming phase with economic and earnings fundamentals driving the returns for the rest of the year. Valuations have improved but are not nearly as attractive after adjusting for inflation or on a long-term basis. Historically - when the markets decline over 10% in the first half of the year, volatility continues in the second half of the year. In six of the seven years that the S&P500 Index fell by 10% or more through the first six months, the index rose or fell in the second half by at least 10%.[10] With the economy slowing, Fundamentum completed trades during the quarter resulting in lower cyclical exposure in both the value and growth styles and sectors while raising cash levels. Within fixed income, future returns will continue to be based on inflation concerns but now, credit quality has stepped up to the table. As Treasury yields move higher and credit spreads widen, fixed income yield levels are becoming more attractive.

Given slowing growth, increasing interest rates, inflation, and average valuation levels; Fundamentum strongly believes future, long-term investment returns will be below historical norms. Therefore, we continue to encourage Advisors to build diversified portfolios with lower capital market returns into their client's long-term financial plans and expectations.

Fundamentum Investment Committee:

John Nichol, CFA® - Chief Investment Officer
Trevor Forbes - Investment Committee
Robert Armagno, CFA® - Investment Committee

Sources:

1. Ned Davis Research, July 1, 2022.
2. Bloomberg Business News, June 30, 2022.
3. FactSet Street Account, June 30, 2022.
4. NASDAQ Markets, July 1, 2022.
5. Wall Street Journal – Markets, July 1, 2022.
6. Strategus - Quarterly Review in Charts, July 5, 2022.
7. FactSet Research - Earnings Insight, July 1, 2022.
8. Rivett Financial – 2nd Quarter Market Summary, July 1, 2022.
9. Rivett Financial – 2nd Quarter Market Summary, July 1, 2022.
10. Wall Street Journal – Markets, July 1, 2022.

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The Russell 1000 Index consists of the 1,000 largest securities in the Russell 3000 Index, which represents approximately 90% of the total market capitalization of the Russell 3000 Index. It is a large-cap, market-oriented index and is highly correlated with the S&P 500 Index.

The Dow Jones Industrial Average is comprised of 30 stocks that are major factors in their industries and widely held by individuals and institutional investors.

The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI EAFE Index consists of the following developed country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK.

The MSCI EM (Emerging Markets) Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the emerging market countries of the Americas, Europe, the Middle East, Africa and Asia. The MSCI EM Index consists of the following emerging market country indices: Brazil, Chile, Colombia, Mexico, Peru, Czech Republic, Egypt, Greece, Hungary, Poland, Qatar, Russia, South Africa, Turkey, United Arab Emirates, China, India, Indonesia, Korea, Malaysia, Philippines, Taiwan, and Thailand.

The Russell 2000 Index is an unmanaged index generally representative of the 2,000 smallest companies in the Russell 3000 index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index.

The NASDAQ Composite Index measures all NASDAQ domestic and non-U.S. based common stocks listed on The NASDAQ Stock Market. The market value, the last sale price multiplied by total shares outstanding, is calculated throughout the trading day, and is related to the total value of the Index.

The Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

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