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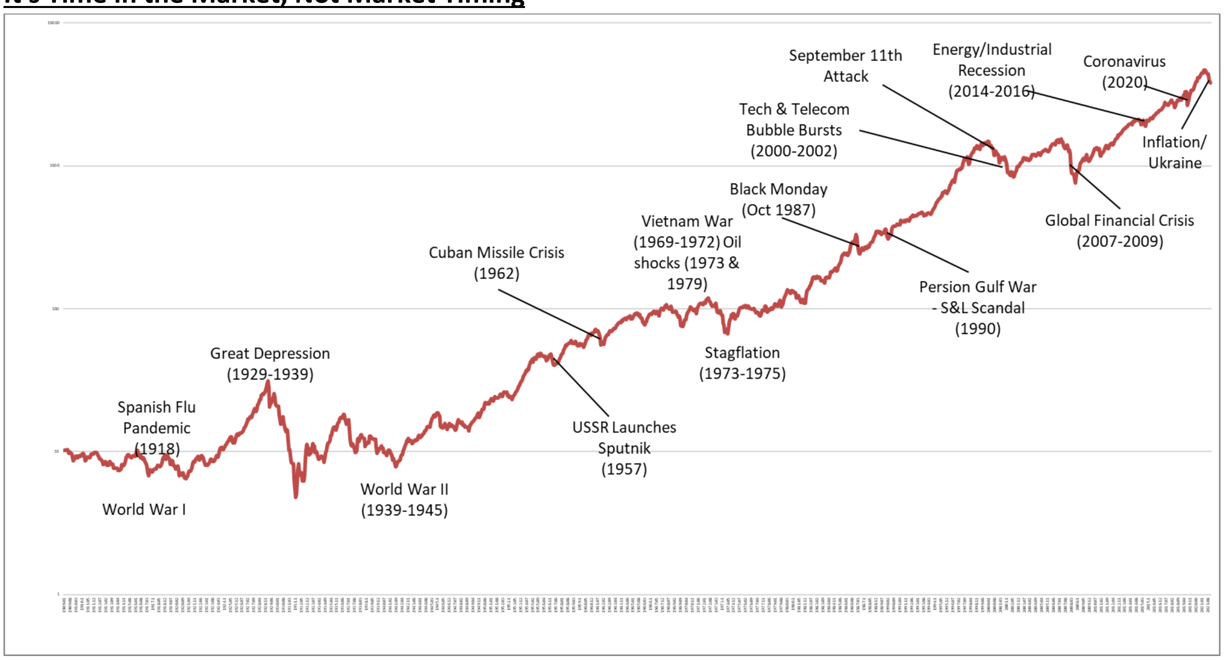
## *Our Latest Thoughts on the Markets*

It has been a challenging start to the year for investors. Those looking for shelter from the ongoing market storm have been left with few options, as both stocks and bonds have been under considerable pressure. The war in Ukraine helped exacerbate and elongate pricing pressures originally associated with supply-chain bottlenecks and surging demand. The associated spike in energy prices has kept inflation readings high, prompting a rapid repricing of interest rates and a sell-off in most areas of the bond market. Meanwhile, equity investors have been forced to contend with difficult growth comparisons, elevated valuations, and elevated sentiment readings. The result…few places to hide. The average U.S. stock is now trading 38% below its 52-week high, and "risk-free" Treasury bonds are now down more than 25% from where they started the year.

Not surprisingly, investors are nervous about seeing their account values dip below the levels seen six months ago. More experienced market participants know the value of staying invested rather than locking in losses, though that knowledge hardly makes the experience any more pleasant. The powerful gains and temporary pullbacks over the past dozen years have made the recent volatility feel abnormal. However, volatility is more the norm than the exception. Ten and even 20 percent pullbacks have happened with some regularity over the past century. The old adage, "it's time in the market, not market timing comes to mind," when dealing with times like this. The chart of the S&P 500 going back more than 100 years provides support to this notion.

**<u>It's Time in the Market, Not Market Timing</u>**




*The equity market volatility has felt unprecedented, but turmoil has been more the norm than the exception over the past century.*

*Source: Bloomberg, NBER.org, and Seeley Howard Private Wealth*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In this report, we attempt to make sense of what has happened, discuss some of the moves we have made for clients, and provide our thoughts on where we may be headed from here.

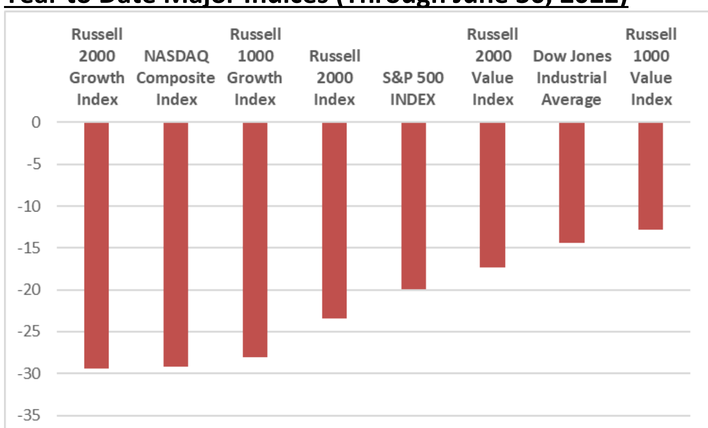
**A Look Back at the First Half**

U.S. equities posted their worst returns since Richard Nixon's presidency. The carnage was widespread, with both big and small companies under pressure. The broad-based S&P 500 declined 19.96% on a total return basis for the first six months of the year, its biggest decline since 1970. The final month of the quarter was particularly painful, with the S&P 500 down 8.26% in June alone. Those areas of the market like Energy and Materials – which had performed quite well for most of the first half – pulled back precipitously towards the end of the quarter.

The S&P 500 Energy Index has been the only winner this year among the benchmark's sectors. The energy sector is up roughly 25%, compared to consumer discretionary, communication services, and information technology, all of which are down nearly 30% and lead losses among sectors.

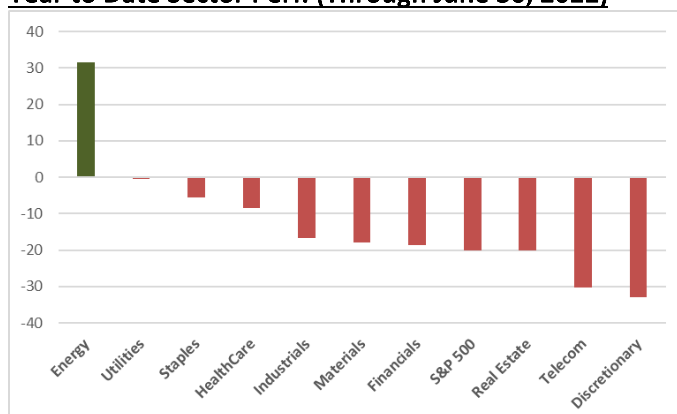
Despite significant outperformance on the year, energy retreated in the second quarter. Healthcare, Utilities, and Consumer Staples have beaten the other sectors by a large margin in the last three months, though they remain in the red.

**Year to Date Major Indices (Through June 30, 2022)**




*Source: Seeley Howard Private Wealth and Bloomberg*

**Year to Date Sector Perf. (Through June 30, 2022)**

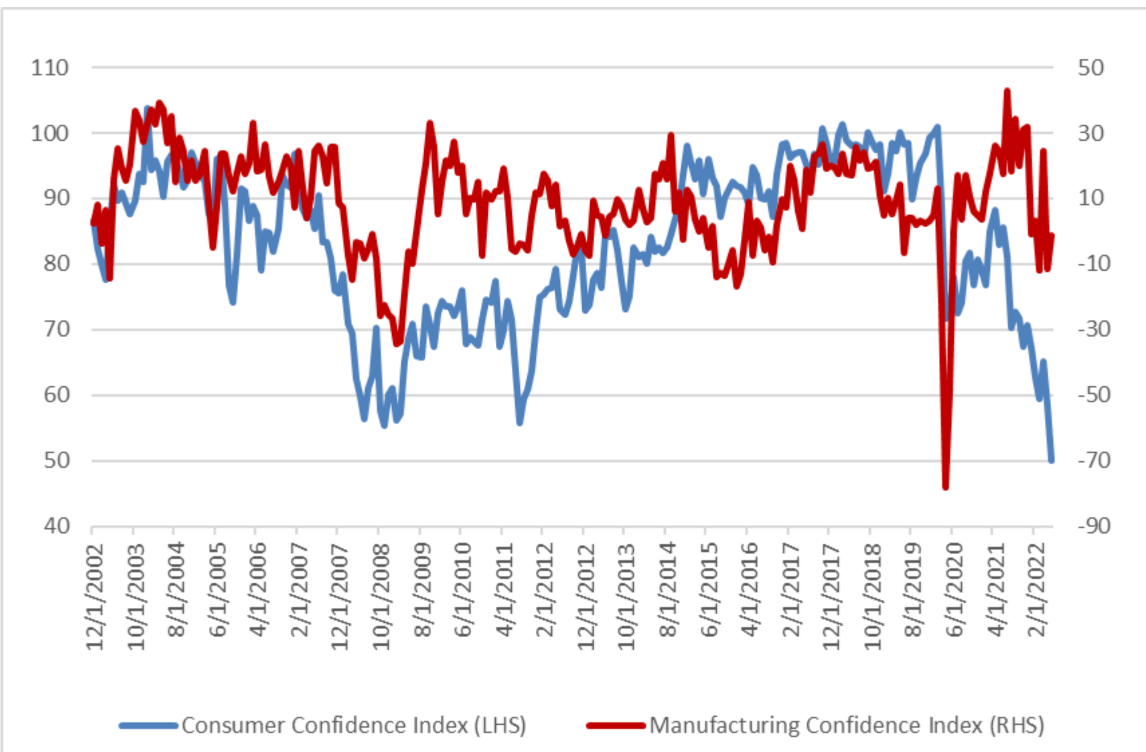



Over the last decade, growth stocks have outpaced value stocks. That relationship has reversed this year. Since November 2021, the S&P Value Index has returned roughly 8% while the Pure Growth Index has lost 25%. This switch can be credited to higher interest rates and higher inflation, which tend to weigh on growth stocks more so than value. In times of high uncertainty, steady or more 'boring' companies become more appealing to investors. This year, it has been difficult to avoid value and growth traps - stocks that seem ideal to buy but whose growth rates are slowing rapidly and haven't lived up to expectations. New technology companies that once seemed unstoppable are now down over 50% to start the year.

**The Economy**

The word unprecedented gets thrown around quite a bit, but these are unique times for the global economy. Depending on your vantage point, the current economic data can look very different. On the one hand, employment, nominal wages, consumption, and retail sales all point to a thriving economy. On the other, real income growth (adjusted for inflation), small business optimism, and ISM hiring intentions all point to a more challenging backdrop. The low-end consumer's wallet has been hit hard by the end of stimulus and surging gasoline prices have gobbled up an increasingly large share of household income. Indeed, one retail bellwether recently noted that they have seen a demonstrable shift from selling gallons of milk to half gallons as budgets have tightened. Overall, we would caution that some of the good news on the economic front may be backward looking.

**Consumer and Business Confidence Points to More Challenging Times**

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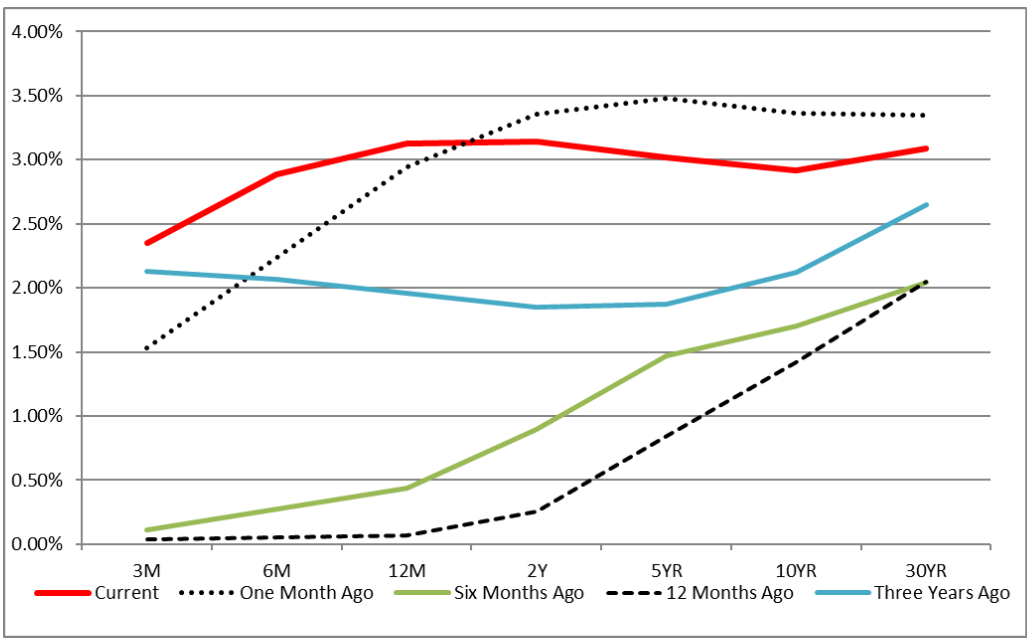
The Fed has been focused on cooling off the economy; put another way, it has been intent on creating some demand destruction. Higher interest rates have accomplished some of this in the housing market, while higher energy prices have captured an ever-larger portion of the consumer's wallet over the past year. Those hoping for a quick snap-back may be disappointed. The economy and corporations are just now entering the most challenging year-over-year comparisons in recorded history. For instance, retail sales have challenging base effects (strong numbers last year). Looking ahead over the next six months, it will be hard to look good compared to the +14% and 28% growth in the final two quarters of 2021.

We are often asked whether the economy is headed towards a recession. Prevailing forecasting models and history tell us that a recession at this point is on the table. Most tightening cycles in recent history have ended in recession; however, not every recession is as painful or as destructive as the financial crisis. Is a "soft landing" still possible? Absolutely, and we are rooting for one. *However, we think that investors should be prepared for more choppiness.* Stubborn (and potentially lagging) inflation readings mean that the Fed has fewer tools at this point to combat slowing demand than they have over the past several decades.

**<u>Yield Curve Over Time</u>**



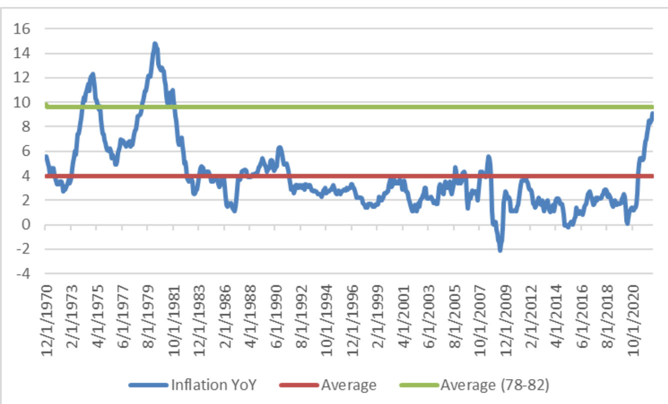

*The yield curve has been a strikingly prescient indicator of economic health. A steeper curve (short rates lower than longer-term rates) is an indicator that the economy is poised for growth. An inverted yield curve portends a slowdown or recession. The spread between the two-year note and the 10-year note now stands at -22 basis points.*

*Source: Seeley Howard Private Wealth and Bloomberg*

## Inflation

Against a backdrop of meaningfully steeper year-over-year comparisons beginning in the second quarter, we believe that there is a high probability of seeing a deceleration in the rate of inflation across developed and emerging market economies. That doesn't mean we are headed towards a period of deflation, but it could give the Fed some room to take their foot off the pedal. Our preferred research provider currently forecasts inflation above 7% through year end. To truly dampen inflation, we believe The Federal Reserve has a difficult task ahead, and their inflation-fighting resolve will likely be tested for a variety of reasons. For one thing, the stakeholders in the global economy have gotten quite comfortable with lower rates. For governments, it has allowed deficit spending to support social problems without a significant cost. For the consumer, it has allowed people to live a lifestyle that would be out of reach were it not for low interest rates and expanding credit balances.

**Inflation Readings at 40 Year Highs, but…**




**CRB Index: Commodities have begun to roll over**


Source: Seeley Howard Private Wealth and Bloomberg

## Earnings and Valuations

Throughout the first half of the year, confidence among consumers, CEOs, manufacturers, and suppliers has dropped significantly – a sign that rising prices and uncertainty about the economy have permeated all areas of the economy. Historically, this has not been a harbinger of accelerating growth and earnings.

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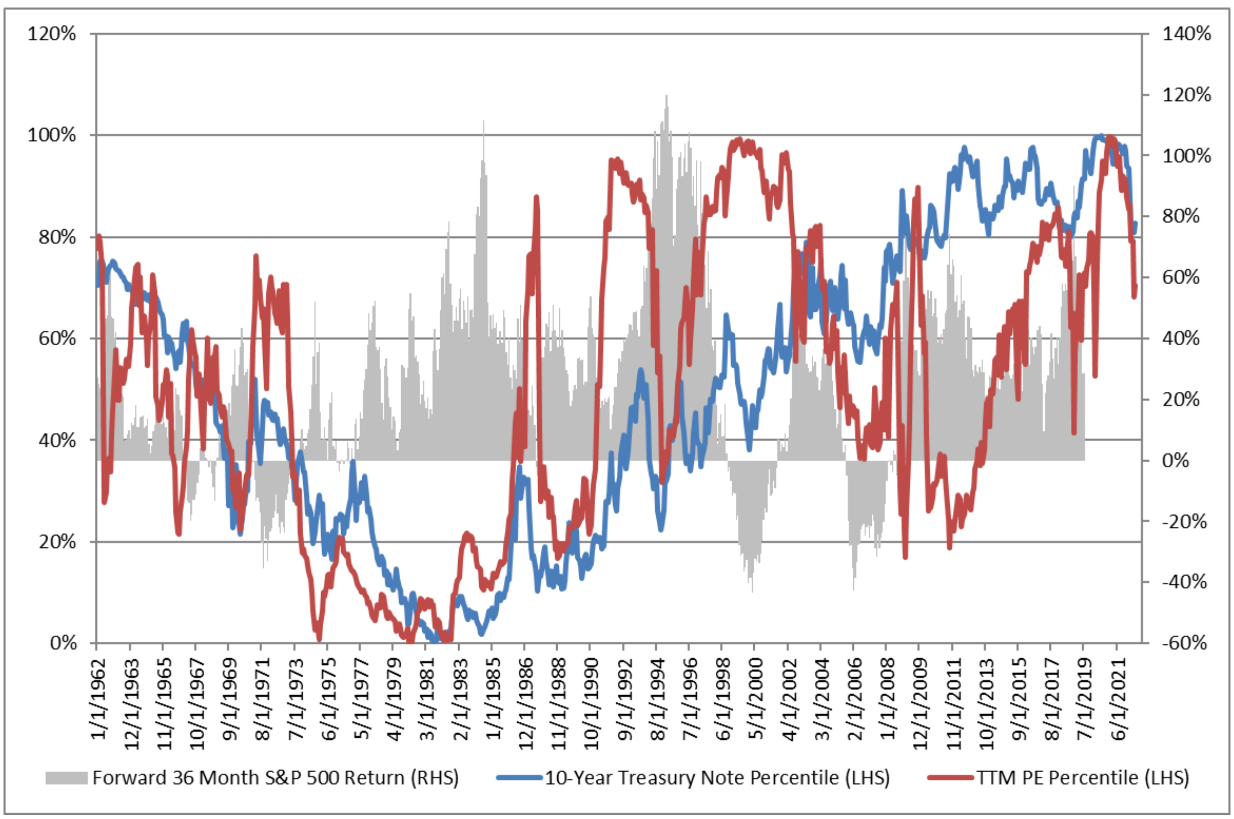
While painful, the poor performance of equities in the first half of 2022 has allowed valuations across the board to reset to more attractive levels (particularly profitable growth companies). The initial reset was spurred by inflation and interest rate concerns, which have now been largely factored into valuations. A word of potential caution: More recently, we have seen indicators pointing to the potential for slower economic and earnings growth. If earnings revisions turn negative as demand cools, the recent case for attractive equity valuations may prove fleeting. If economic growth stalls, corporate earnings will likely drop as well. On average, S&P 500 earnings drop approximately 26% from peak to trough during a recession, according to data compiled by Bloomberg. During the Global Financial Crisis, the decline was even more striking, as S&P 500 operating earnings declined nearly 50 percent.

Valuation has always been a bit of a Rorschach test, depending on your world view. Growth remains the best salve for high valuations, as patience leads to a lower valuation. However, overly optimistic assumptions or a slowing macro backdrop can lead to optical illusions for company valuations. A company may look like it's trading at 16x earnings, but if those earnings ultimately come in 20% lower than expected, the real multiple is north of 20x.

**Stock and Bond Valuations by Percentile and Forward 3-Year Return (1962- Present)**

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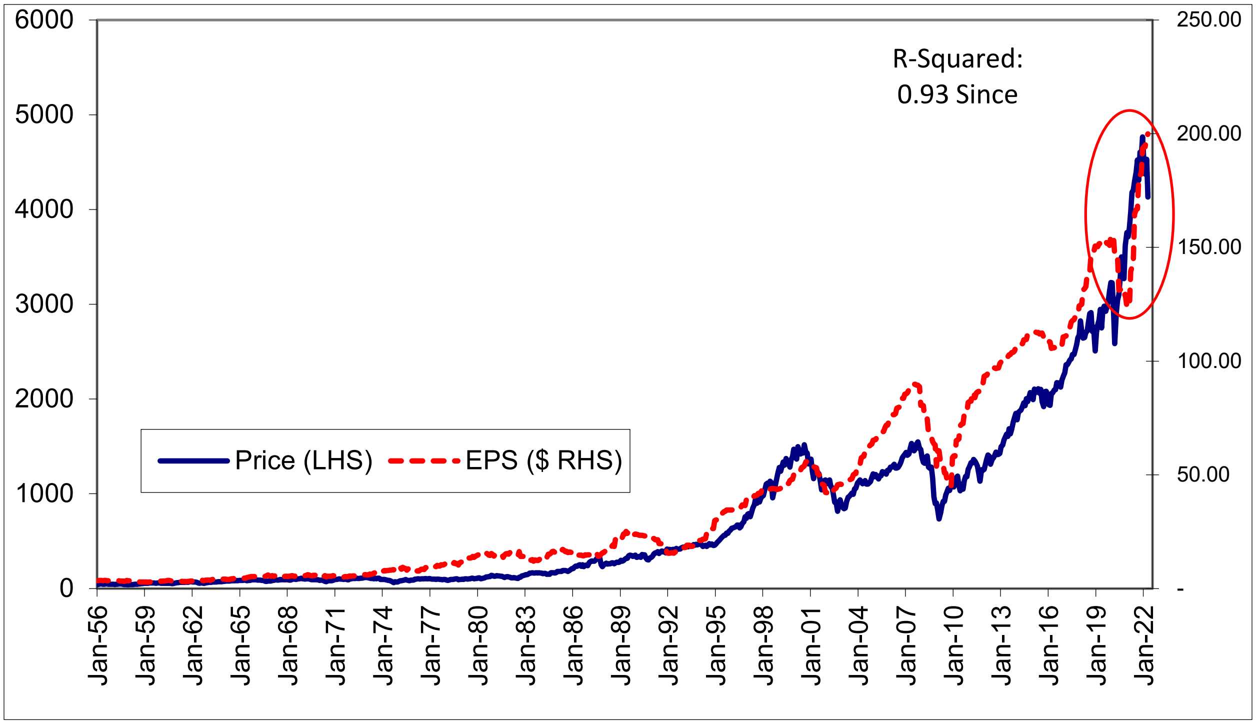
Without getting too bookish, one must also factor in the correct discount rate for future earnings. With higher interest rates, those future cash flows or earnings streams are worth considerably less than they were a year ago. People suffer from the recency bias, which tends to lead to overly pessimistic or optimistic assumptions at the wrong time. Long-term, however, it is the path of earnings that drive the market. Since 1956, there has been a very strong relationship (R-squared of 0.93) between the S&P 500 price and earnings.

**S&P 500: Earnings Are Critical Long-Term Drivers of Performance**




*Source: Seeley Howard Private Wealth and Bloomberg*

Looking ahead, analysts expect earnings growth of 4.1% for Q2 2022, 10.2% for Q3 2022, and 9.9% for Q4 2022. For CY 2022, analysts are predicting earnings growth of 10.1%. The forward 12-month P/E ratio is 17.1, which is below the 5-year average (18.6) but above the 10-year average (16.9). It is also below the forward P/E ratio of 19.4 recorded at the end of the first quarter (March 31), as prices have decreased while the forward 12-month EPS estimate has increased over the past several weeks.

**What are We Doing?**

First and foremost, we are doing our best to remain patient and to maintain perspective. Our clients run the gamut – one who first bought a high-quality mutual fund in 1953 and hasn't sold since (a very profitable strategy) to those who have yet to encounter a bear market that lasted for more than a few weeks. The best thing for any newer client would be a quick Zoom with the gentleman who has seen it all twice over the past 70 years. Despite tactical changes to portfolios, we maintain the view that a long-term approach to investing yields the best results. Below, we provide our thoughts on fixed income, cash, and equities.

*Currency: Dollar Hegemony?*

One of the only assets that has shown positive ytd performance this year is the U.S. Dollar. As the reserve currency, it typically attracts investors looking to hide out during periods of tumult. Furthermore, the Fed's hawkish stance means that domestic interest rates look quite favorable relative to other developed currencies. Where appropriate, we have utilized an ETF to participate in the strengthening of the US dollar versus other currencies.

*Commodities: Late to the Party?*

A combination of factors has led to a surge in commodity prices over the past two years. Supply shocks (Ukraine), bottlenecks (port delays), and underinvestment (Energy) along with surging demand following the pandemic lockdowns have all conspired to boost raw material prices around the world. It has been a winning trade (following nearly a half decade of frustration), but we caution that the good times may be nearing an end. First, commodity prices have begun to inflect. Second, if economic growth slows, it will likely prove difficult for commodities to counter economic gravity.

*Fixed Income: Are we there yet?*

Most investors under the age of 60 have never seen a persistent and painful bear market in bonds. Stubbornly high inflation readings have wreaked havoc on longer-duration and credit sensitive fixed income this year. Is the worst over? Time will tell, but we believe that the carnage in much of the fixed income market has begun to offer interesting risk-reward opportunities for patient investors in need of safe income. We see emerging opportunities in a variety of areas, including shorter-dated Treasuries, Municipals (for those in higher tax brackets), and non-Agency mortgage-backed securities. We would continue to avoid high yield (riskiest area of the bond market) and long-duration (though we are monitoring the situation).

*Equities*

Equities remain a critical tool in meeting one's long-term financial goals because they allow small players to take an ownership stake in some of the best and most dynamic businesses around the world. That stake in the firm also allows the investor to participate in the growth of the firm over time. At the end of a bull market (the easy and fun part of the cycle), investors often need to be reminded that companies should not be valued on one year's earnings growth (or lack thereof). Equities are worth what they are because of the cumulative delivery of cash flows into the future. Over the long-term, these cash flows have proven to be far less volatile than the underlying share prices. Having said that, we are not rushing to meaningfully add exposure presently, given our view that decelerating growth and rising short-term interest rates could lead to more attractive entry points over the next few quarters.

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## The Road Ahead

Over the past 25 years, we have seen our share of recessions, bear markets, and crises. Each bout of turbulence leaves its mark on the economy and investors. It has also shaped how the Fed has responded to market dislocations – typically with increasing amounts of stimulus. However, this most recent cycle has been punctuated by stubbornly high inflation, which has limited the Fed's ability to provide help. Indeed, they are one of the biggest drivers of investor angst at present. This leaves many wondering where we are headed from here. Unfortunately, we believe that the next step is slower economic and earnings growth. This argues for both patience and a need to focus on longer-term goals.

We continue to believe high quality equities should remain a core part of the allocation if there are no immediate need to access the funds.

Looking ahead, we see opportunities for investors, though patience and discipline are prerequisites. We continue to believe that a data-dependent process can help navigate challenging periods. Having a roadmap can help discern noise and narrative from real risks that stand in the way of achieving one's long-term investment goals.

### *Potential Positives for the Market*

- COVID case counts continue to show signs of improvement
- Employment trends remain robust
- Financial Conditions remain supportive and growth – while decelerating – remains positive.
- Household net worth remains near a record high for the U.S. boosted by stock market gains and rising house prices
- Interest rates remain low around the world
- Corporate default rates remain low
- Corporate earnings remain robust
- Household balance sheets remain in strong
- Sentiment has gone from complacent to fearful in fairly short order
- Beneath the surface, many stocks have fallen meaningfully from their recent highs, making forward return prospects potentially more attractive

### *Potential Negatives for the Market*

- Geopolitical risks abound following Russia's invasion of the Ukraine
- Energy prices have spiked to historic highs following economic sanctions on Russia, a major oil and gas producer
- Questions abound about the ability to maintain growth without outsized help from the Federal Reserve
- The domestic economy looks poised to slow meaningfully given challenging "base effects" and the lapping of significant stimulus payments
- Rising interest rates could dampen loan demand and curtail the current housing boom
- Overall corporate debt levels stand at historic highs
  Record deficits raise questions about financial stability and the need for future growth-dampening austerity

If you have any questions, don't hesitate to contact Steve or Chris.

Best,

Steve and Chris

These are the opinions of Steve Howard and Chris Seeley and not necessarily those of Cambridge, are for informational purposes only, and should not be construed or acted upon as individualized investment advice.


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