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Investment Insights Quarterly

From The Desk of Bill Hornbarger, Chief Investment Officer July 2022

Please Don't Tell Me 'Bout the News

"It would be silly to expect every bear market to turn into the Great Depression. It would be equally wrong to expect that a fall from overvalued, to more fairly valued, couldn't badly overshoot on the downside."

Seth Klarman
Hedge Fund Manager and Author

We have all, at one point or another, had someone start a conversation with the phrase, "I have some good news and some bad news. Which do you want first?" If you are like me, you usually opt for the bad news first so you can close on a high note. With that in mind, let's look at some of the news that is swirling around the financial markets, starting with the "bad news" first:

- Inflation remains elevated – Inflation (as measured by the consumer price index or CPI) hit a 41-year high in June, increasing 9.1% on a year-over-year basis. Just about every category was elevated, with food at home up 12.2%, gasoline up 11.2%, and shelter increasing 5.6% from a year earlier.

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- The yield curve is inverted – The yield curve (10-year Treasury less 2-year Treasury) briefly inverted in early April before retaining a positive slope. The latest batch of employment and inflation data, however, has resulted in it inverting again and even deeper this time, with the spread currently at -16 basis points – the largest inversion since late 2006. An inverted yield curve is a sign that bond investors believe the economy will slow and potentially fall into recession.
- Leading economic indicators have fallen for three consecutive months and are forecast to fall for a fourth, a development consistent with past recessions.
- The financial markets have offered few (if any) bright spots – In reviewing the first half performance of the markets that we track on a regular basis, few have shown positive returns. Most equity indices were down 15% or more while the traditional safe haven of core fixed income was off 10.4% as measured by the Bloomberg Barclay's Aggregate Bond Index.
- Monetary policy is rapidly changing – Global central banks have been gradually moving away from the extraordinarily stimulative monetary policy, and the U.S. Federal Open Market Committee (the Fed) is no exception. The Fed has increased the target Fed funds rate from 0% to 1.50% and started the process of slowly shrinking its balance sheet (known as quantitative tightening), resulting in higher bond yields and a general repricing of many asset classes.
- The economy – Economic activity has softened this year with consumer sentiment at record lows, housing activity showing visible signs of slowing, and Q1 GDP at a negative level. Second quarter GDP estimates continue to be revised lower ahead of its release on July 28, and many economists are now forecasting a recession.

Despite the seemingly unending supply of negative news provided by the financial media, there are still some reasons for optimism. These include:

- Jobs remain plentiful – The official unemployment rate remained steady at 3.6% during Q2, and the latest JOLTS data (Job Openings and Labor Turnover Survey) indicates there are more than 11 million jobs available.
- Forward return prospects have improved – The sharp decline in asset prices has improved valuations in many areas and generally leads us to believe that for longer term investors, projected returns have improved. Another way of putting it is that price matters.
- Energy prices are off their highs – While they are still elevated, crude oil is currently trading at $94 per barrel, well below its recent peak near $120 and retail gas prices (national average) have fallen for 30 consecutive days.
- Core inflation has fallen – Core inflation (excluding food and energy prices) as measured by core personal consumption expenditures (the Fed's favored inflation measure) has declined three consecutive months and stands at 4.7% in the latest reading after peaking at 5.3% in February of this year.
- The U.S. dollar is very strong – Dollar strength is a double-edged sword, making exports more expensive but we will point out two aspects that we view as positives: a stronger dollar tends to help with inflation, and dollar strength indicates foreign investors view the U.S. as an attractive place to invest.

As we pass the midpoint of what has been a challenging year for investors, these are some of things we are watching closely as the investment landscape continues to evolve:

- Earnings – Despite the headwinds of inflation, deteriorating consumer sentiment, and evolving Fed policy, corporate earnings have been relatively resilient to date. The current earnings season and CEOs'

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guidance on business conditions and prospects will be important as we head into the second half of the year. S&P 500 earnings per share are expected to grow approximately 5.5% in Q2 and more than twice that without financials. If the markets are able to meet these expectations, that will help restore investor confidence and increase interest at the current lower valuations.

- The consumer – In the face of multi-decade high rates of inflation and weaker stocks, will the consumer continue to spend? Anecdotally, it appears travel and leisure activity are red hot this summer, but will that (and other spending) continue?
- Credit and credit spreads – Credit spreads have been increasing in recent months as the economic outlook has deteriorated, and equity volatility has increased. Higher benchmark yields and wider credit spreads are contributors to tighter financial conditions, and they're also an indicator of potential stress in the markets and investors' appetite for risk.

With equities in a bear market and the economy slowing, it is natural to ask how bad can it get and what could happen next. While it is impossible to predict the future, it is important to remember that the financial markets are forward looking. The 20+% decline in equities, in our opinion, has already discounted a slowing economy and even the risk of a mild recession. It is also important to note that bear markets happen on average about every five years and the average bear market lasts almost a year. In other words, they are inevitable. While many investors remain wary of a repeat of the 2008-2009 Global Financial Crisis, the markets continue to function with ample liquidity, and the economic downturn has been milder (to date). At the lows of the current selloff, the S&P 500 was off 23.6%, slightly less than the "average" bear market (if there is a such a thing) and significantly less than the 50%+ drawdown from 2007 to 2009.

In a recent investment committee meeting we discussed the current environment relative to history, and based on what we currently know, we don't believe this will be a severe downturn, such as the Global Financial Crisis. The markets continue to function normally, and the ongoing rotation in the markets argues that investors remain interested in investing in equities. The group consensus was that a bottom in the 3400-3500 area (basis the S&P 500) is possible and would represent a good entry point long term. However, we fully acknowledge that the economic and monetary outlook continues to evolve.

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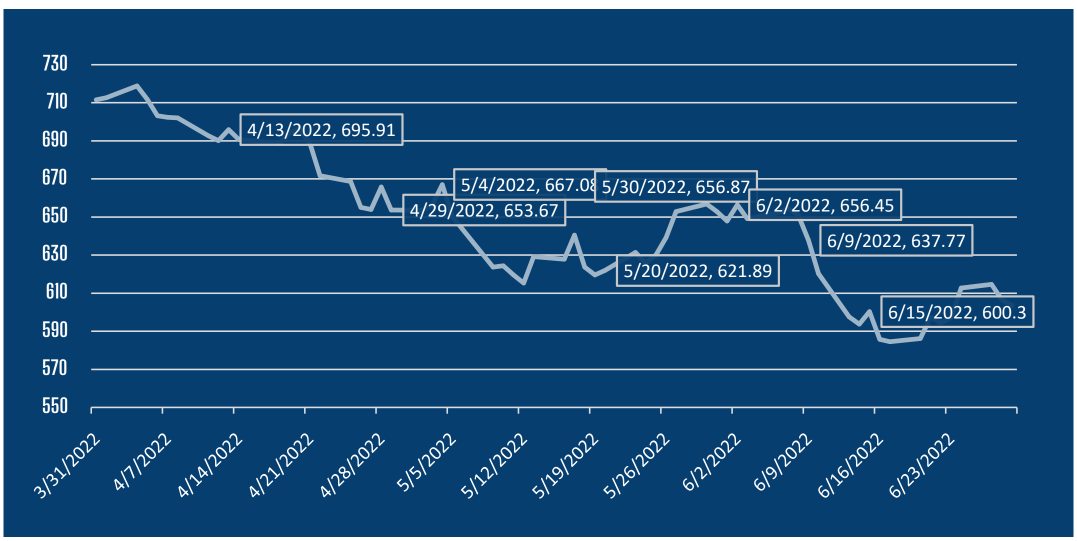
Key Q2 Dates

- April 13 – Elon Musk makes $44 billion offer to buy Twitter.
- April 29 – The worst April performance for the Dow and S&P 500 since 1970, and the biggest April drop for the Nasdaq since 2000.
- May 4 – The Federal Open Market Committee raises rates 50 bps.
- May 20 – At the intraday lows, the S&P 500 fell into bear market territory before rallying to end the day higher.
- May 30 – Core CPI declined for the second consecutive month.
- June 2 – OPEC+ agrees to increase production by 648k barrels/day in July and August.
- June 9 – The European Central Bank announces its intent to stop its asset purchase program on July 1 and to increase key ECB interest rates by 25 bps on July 9.
- June 15 – The FOMC raises rates 75 bps.

Global Stock Market

MSCI ACWI in USD



Source: Bloomberg

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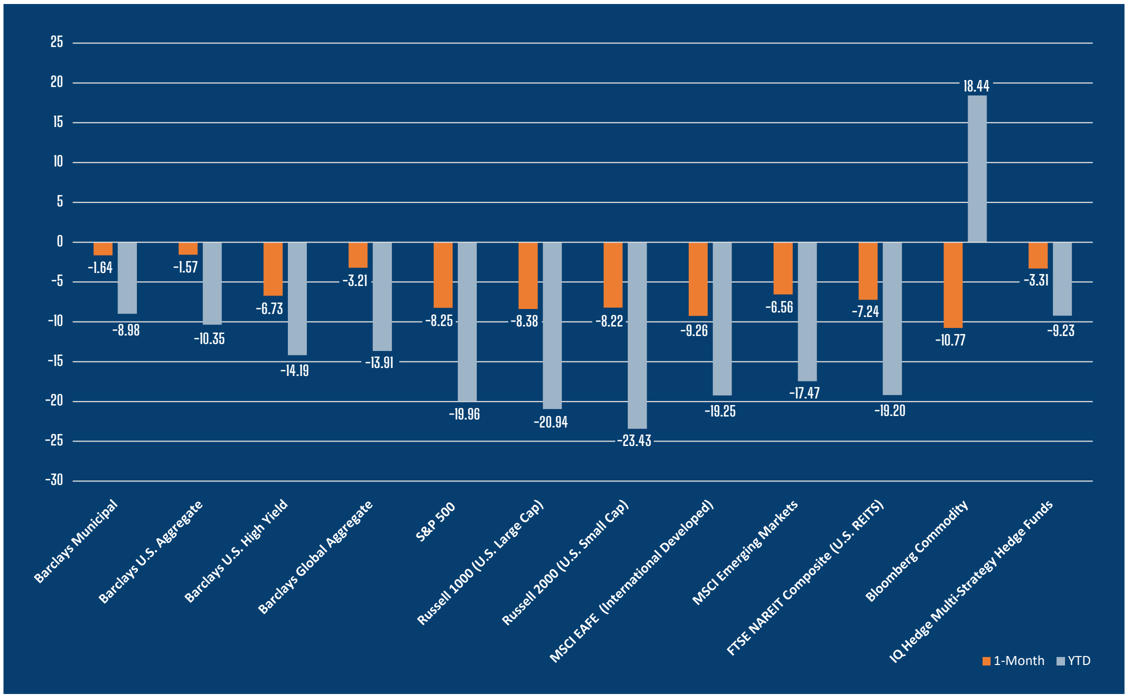
Asset Class Returns

Q2 2022



Source: Conway

Fixed Income

- Yields continued their march higher in June, and this led to another difficult month for core fixed income and high-grade municipal bonds.
- Credit was hit hard in June with cracks finally emerging in high yield, bank loans and emerging market debt.
- The stronger U.S. dollar negatively impacted non-U.S. assets.

Equities

- U.S. equities were weak across the board last month with small cap value under extended pressure.
- Growth outperformed value in June and there was little difference between small cap stocks and large cap stocks.
- The Nasdaq has fallen 29.5% YTD.
- Non-U.S. equities generally underperformed U.S. equities in June, with the strong U.S. currency providing a major headwind.
- Like the U.S., international value lagged international growth, but small cap stocks underperformed large cap stocks.
- The stronger U.S. dollar hurt investors last month as it added to already negative local returns.

Alternatives

- Real estate was lower for the quarter, hurt by higher interest rates and broader market weakness.
- Commodities in general and energy related MLPs were down more than the broader stock market in June, and down for the quarter overall.

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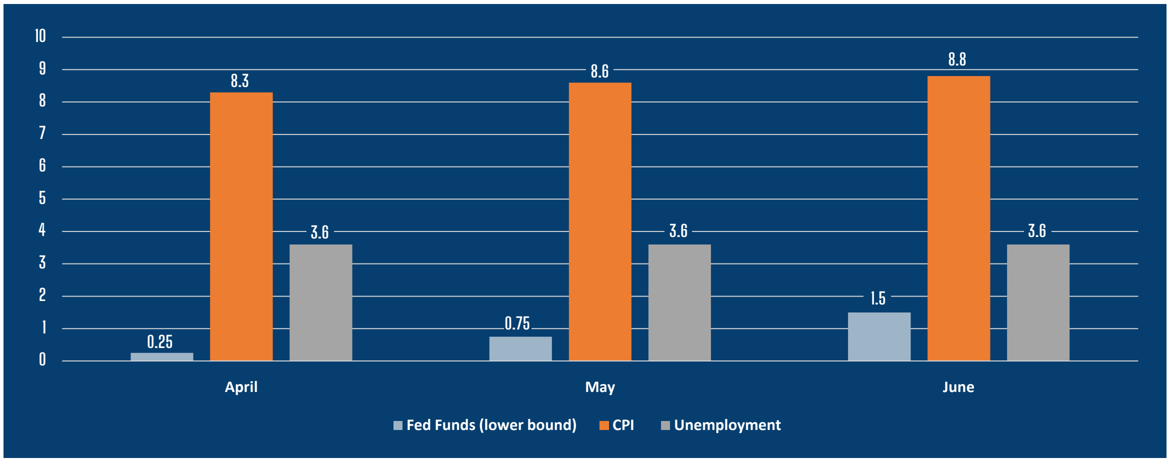
Fiscal and Monetary Policy Highlights

The Fed's Dual Mandate

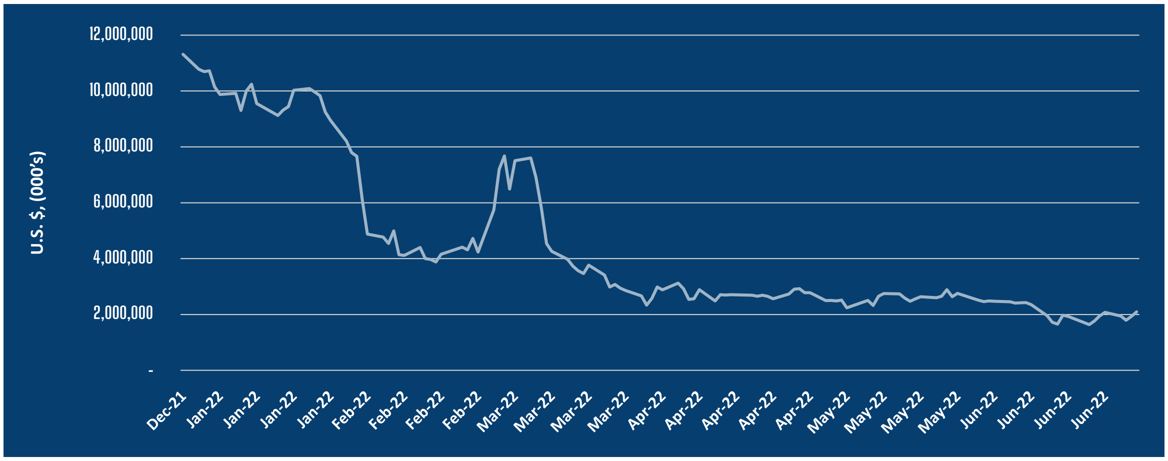


Source: Haver, Bloomberg

- The Fed raised rates at both scheduled meetings during Q2.
- Inflation accelerated, reaching the highest level in 40 years, forcing the Fed to raise rates in larger increments.
- The Fed moved more aggressively, as the markets worried it is "behind the curve."
- The June 75 bps increase was the largest since 1994.
- The employment outlook remains positive, with a low unemployment rate and abundant open positions per the JOLTS data.

Bond Yields

Global Aggregate Negative Yielding Debt, Market Value



Source: Bloomberg

- Bond yields are rising across the globe.
- The bond market sell off accelerated late Q1/early Q2.
- The amount of sovereign global debt trading with negative yields has collapsed this calendar year.
- Higher yields have led to a repricing of many other asset classes.

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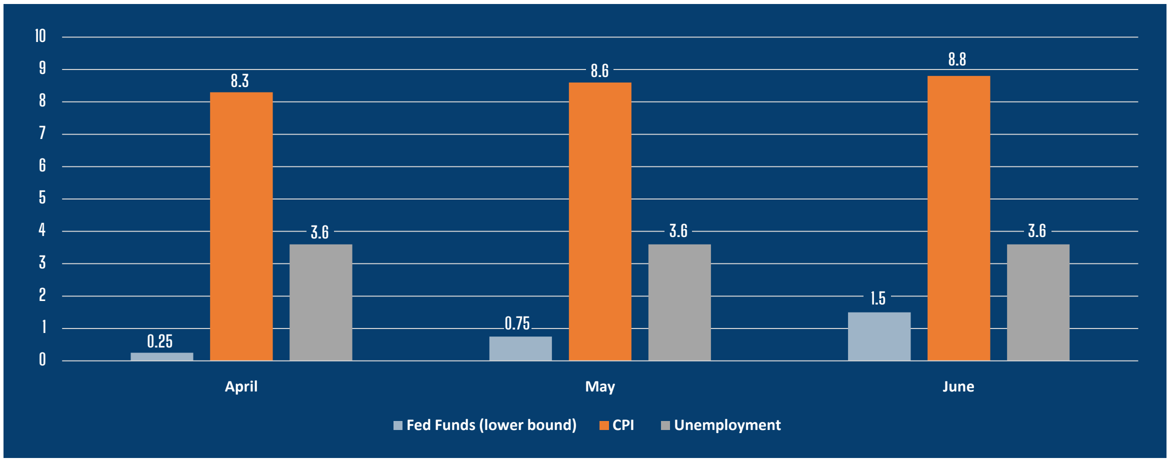
The Dollar

The U.S. Dollar Index

YTD 2022 through end of Q2



Source: Bloomberg

- The U.S. Dollar Index (DXY) indicates the general international value of the dollar against a basket of six developed currencies with the Euro (57.6%) being the dominant weight.
- The U.S. dollar has been very strong against these currencies as the U.S. central bank (the Fed) has been most aggressive in terms of raising rates to fight inflation.
- Longer-term, a strong currency can help with inflationary pressures.
- A strong U.S. dollar is a headwind for U.S. based investors in international assets.

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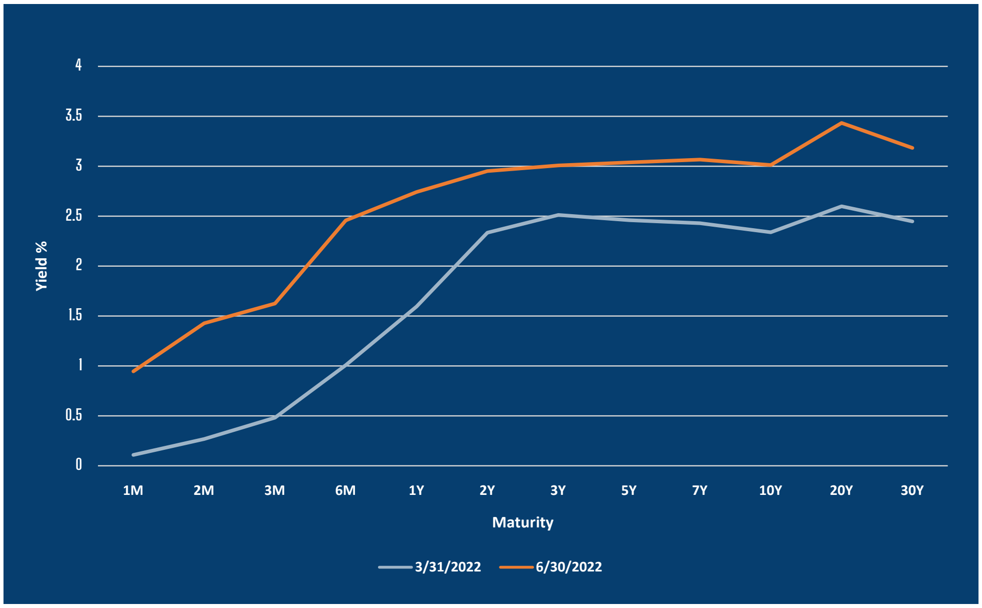
U.S. Treasury Curve

Treasury yields rose during the quarter in response to Fed activity and higher inflation readings. Bonds in general are suffering through one of the worst years on record.

Treasury Yield Curve



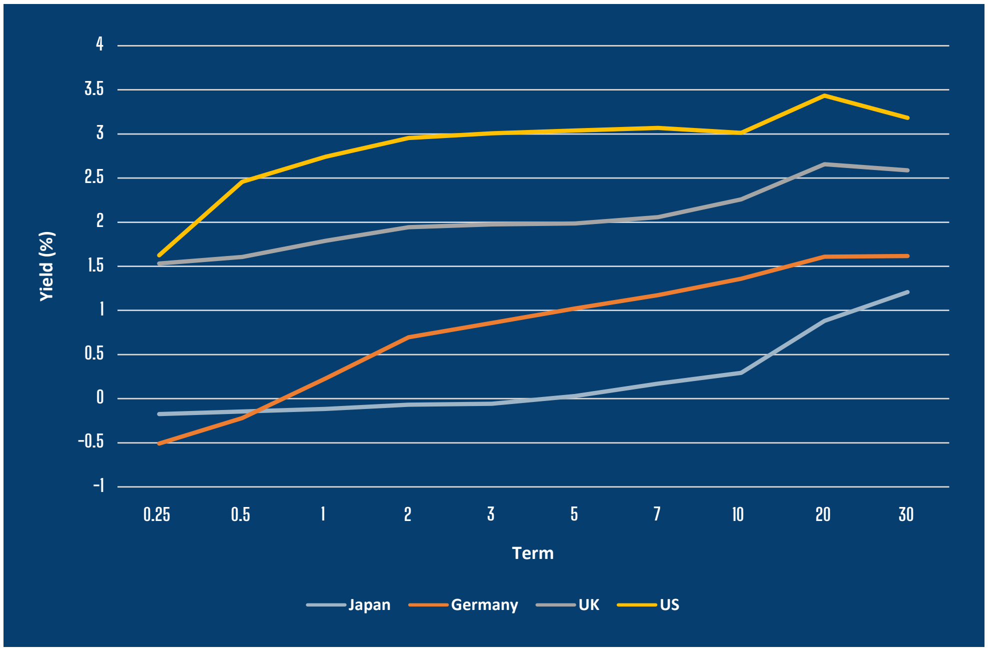
Source: Bloomberg

Government Bond Curves

Global yield moved higher during the quarter as inflation and central bank activity pressured the fixed income markets. U.S. yields remain high relative to most other developed markets.

Government Bond Yield Curves

End of Q2 2022



Source: Bloomberg

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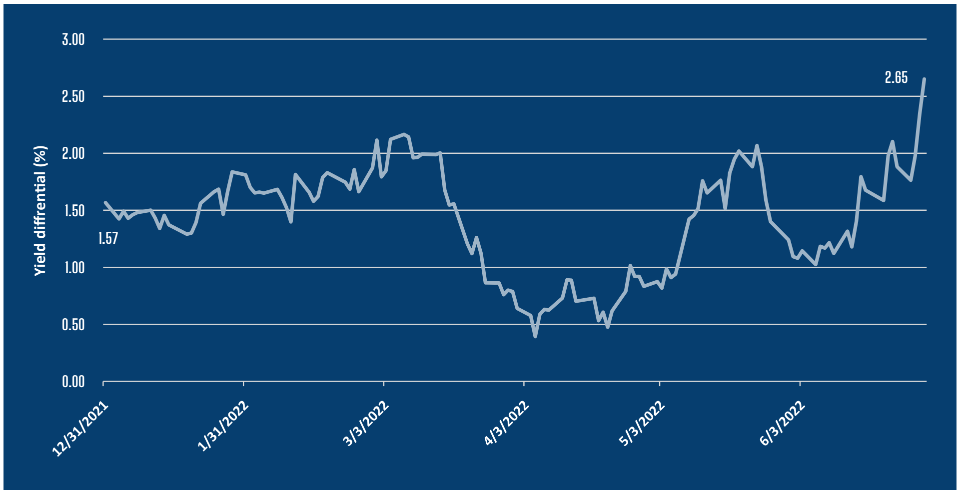
High Yield Spreads

High yield risk premiums (spreads) increased significantly towards the end of Q2 as investor appetite for any risk asset waned.

High Yield Risk Premiums

Bloomberg U.S. High Yield Average Yield less 5-Year Treasury
YTD 2022 through Q2



Source: Bloomberg

Fixed Income Performance (Q2)

Fixed income as an asset class was under extreme pressure again in Q2 with all major sectors of the market posting negative returns. Rising benchmark Treasury rates were a heavy headwind. U.S. investment grade credit was the poorest performer as benchmark yields increased and credit spreads widened. High yield was aided by relatively high starting yields.

Fixed Income Performance

Q2 2022

Source: Bloomberg

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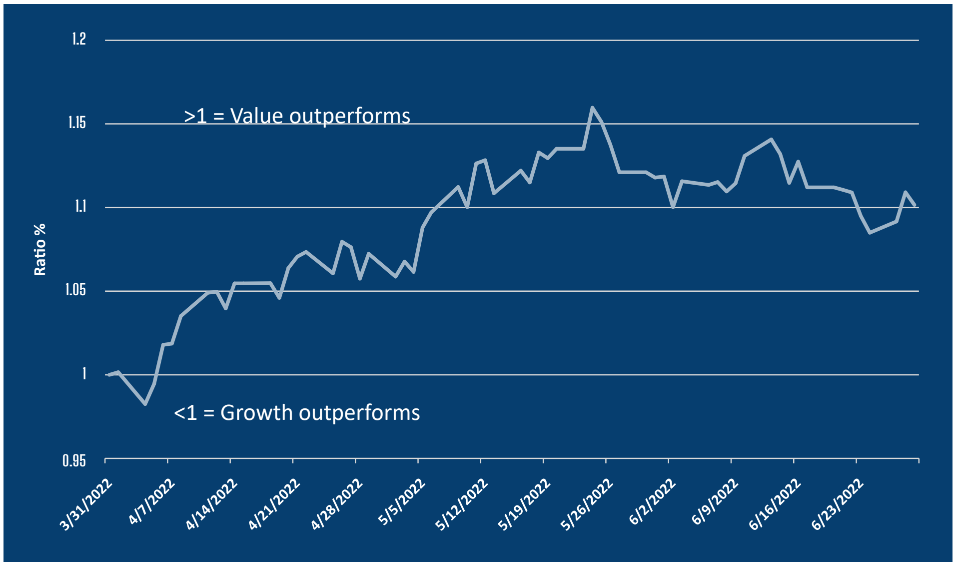
Equity – Value vs. Growth

Value stocks continue to outperform growth.

Large Cap Value/Large Cap Growth - Q1 2022

Russell 1000 Value/Russell 1000 Growth



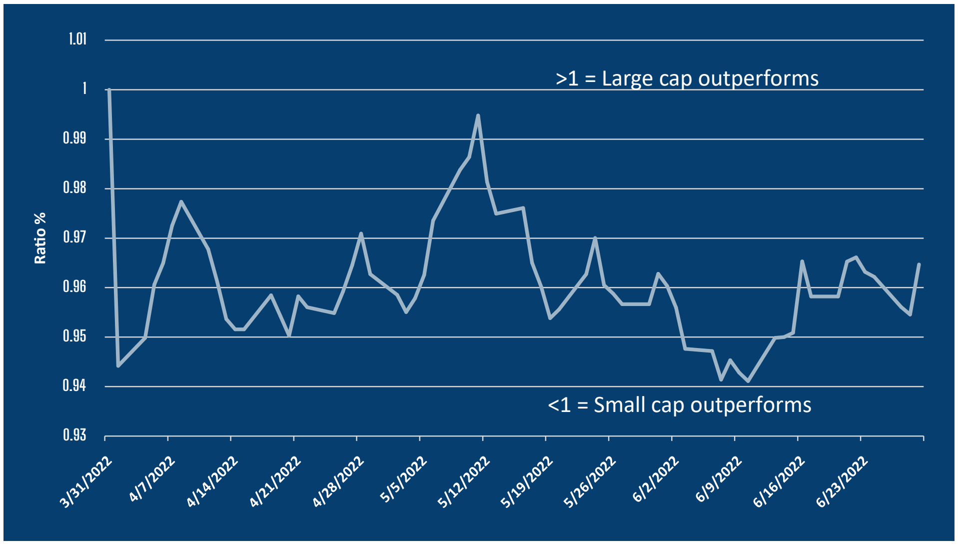
Source: Bloomberg

Equity – Large vs. Small

Small cap slightly outperformed large cap during Q2 but still lags YTD.

Large Cap/Small Cap - Q2 2022

S&P 500/Russell 2000



Source: Bloomberg

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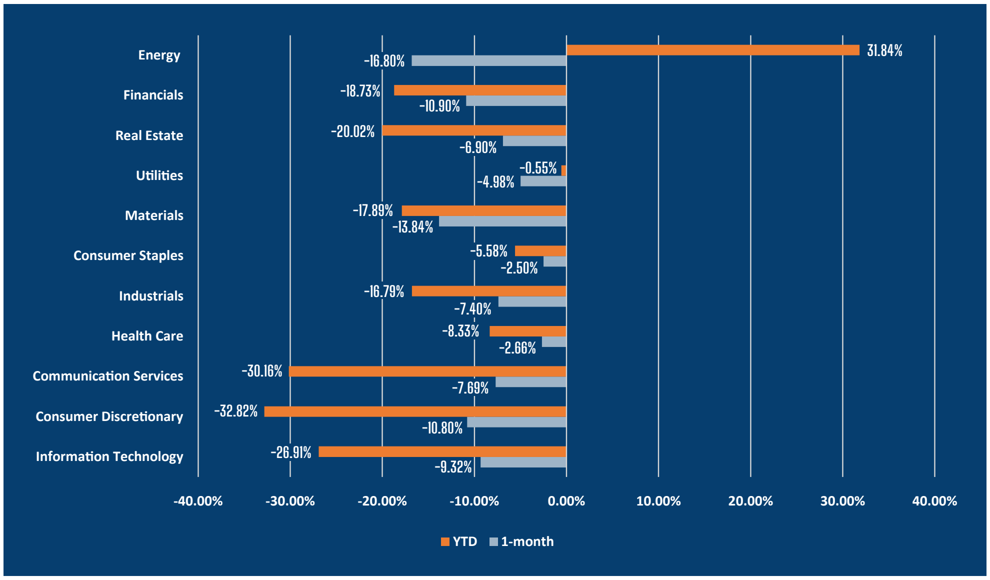
EQUITY MARKET UPDATE

U.S. Equities – Return by Sector

A difficult quarter for the broad market with all sectors lower. Energy is the lone sector higher YTD.

S&P 500 Sector Returns

Q2 2022

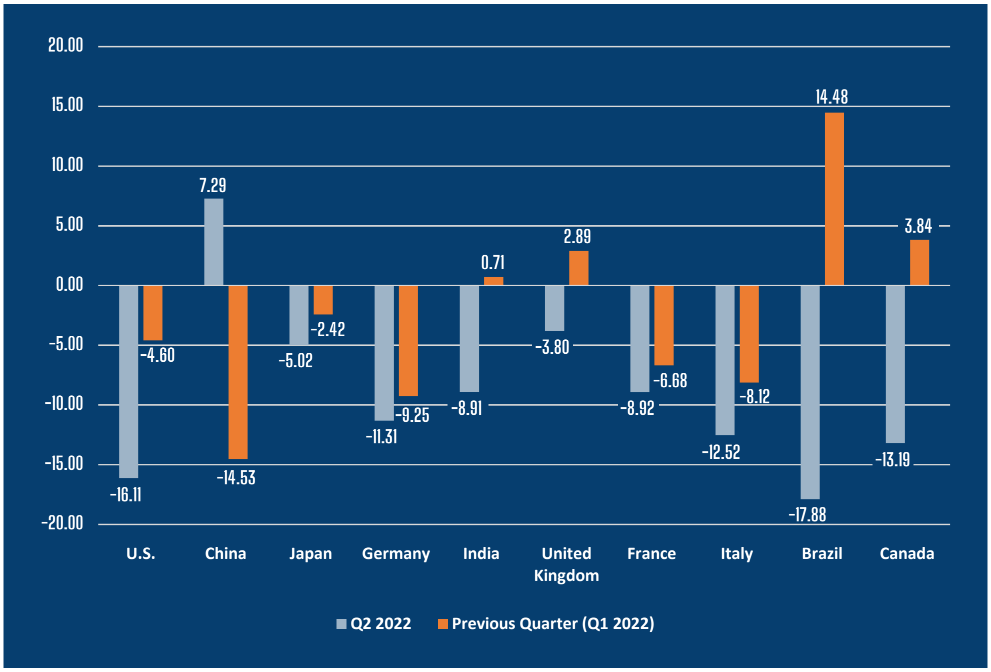


Source: Conway

Country Total Returns (%) – 10 Largest Economies

Global equities fell in Q2 as inflation surged, bond yields rose, and fears of recession increased.

Country Total Equity Market Returns



Source: Bloomberg

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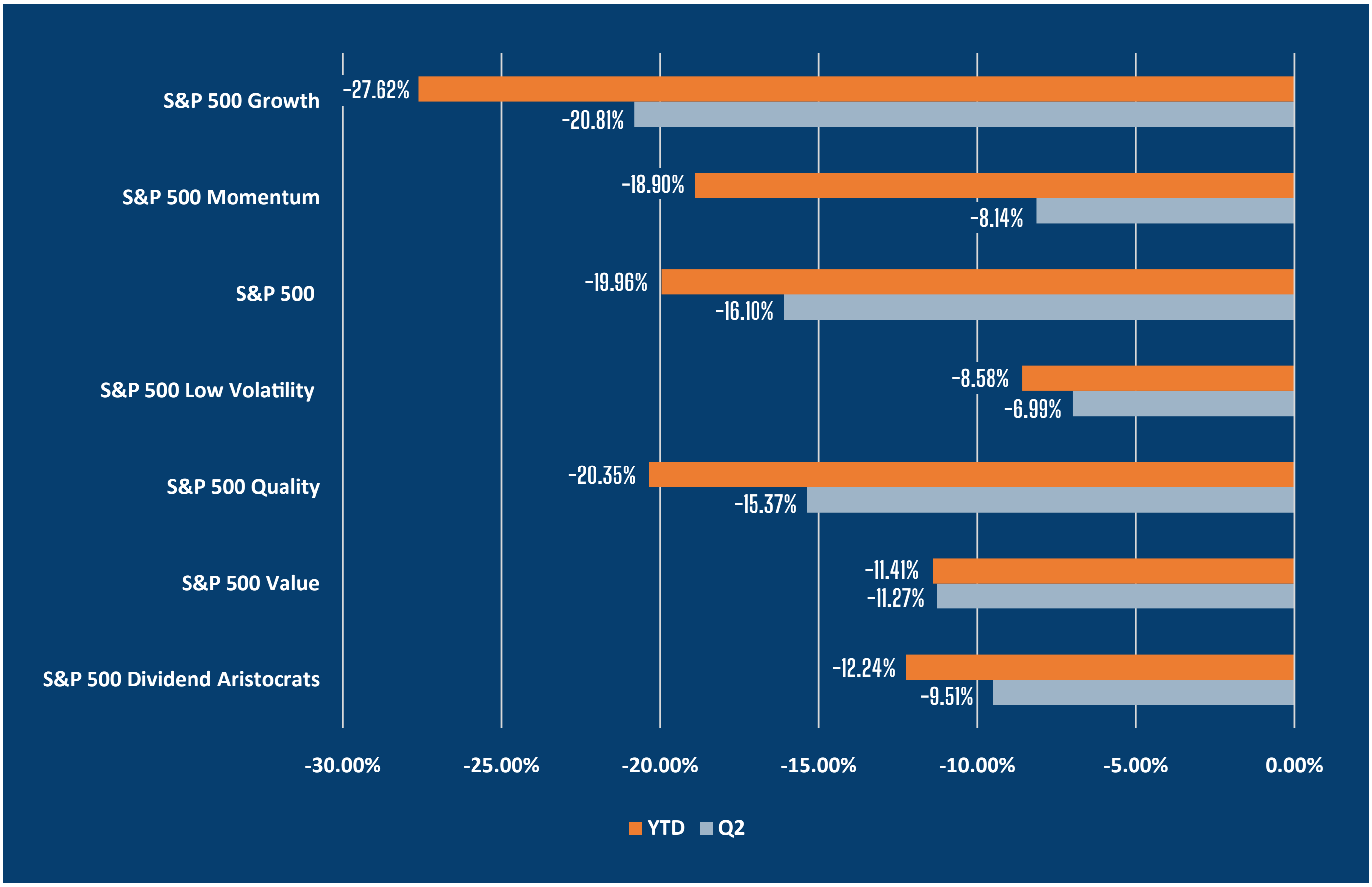
U.S. Equity Factors – Total Return Q2

All the core factors were lower for the quarter deepening the losses for the year. More defensive sectors (low volatility, dividends) and value outperformed.

Total Return: Core Factors
Q2 2022



Source: S&P

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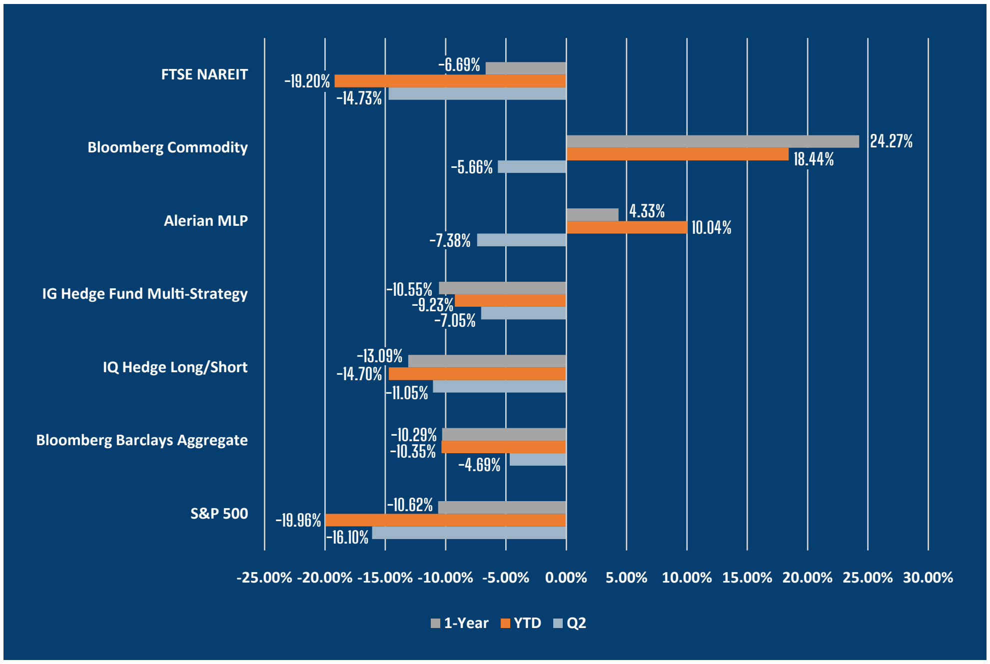
Alternative Returns

Alternative strategies and asset classes were also weak in the global "risk-off" trade during Q2.

Alternative Returns

Q2 YTD



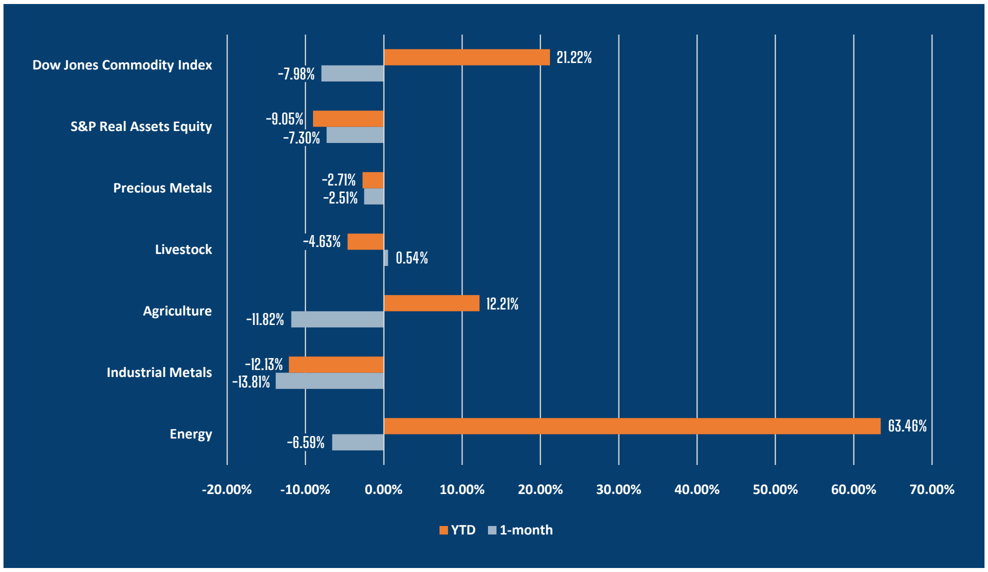
Source: Conway

Commodities

Commodities were weaker in Q2, and many have turned negative YTD.

Commodity Performance

YTD 2022



Source: S&P

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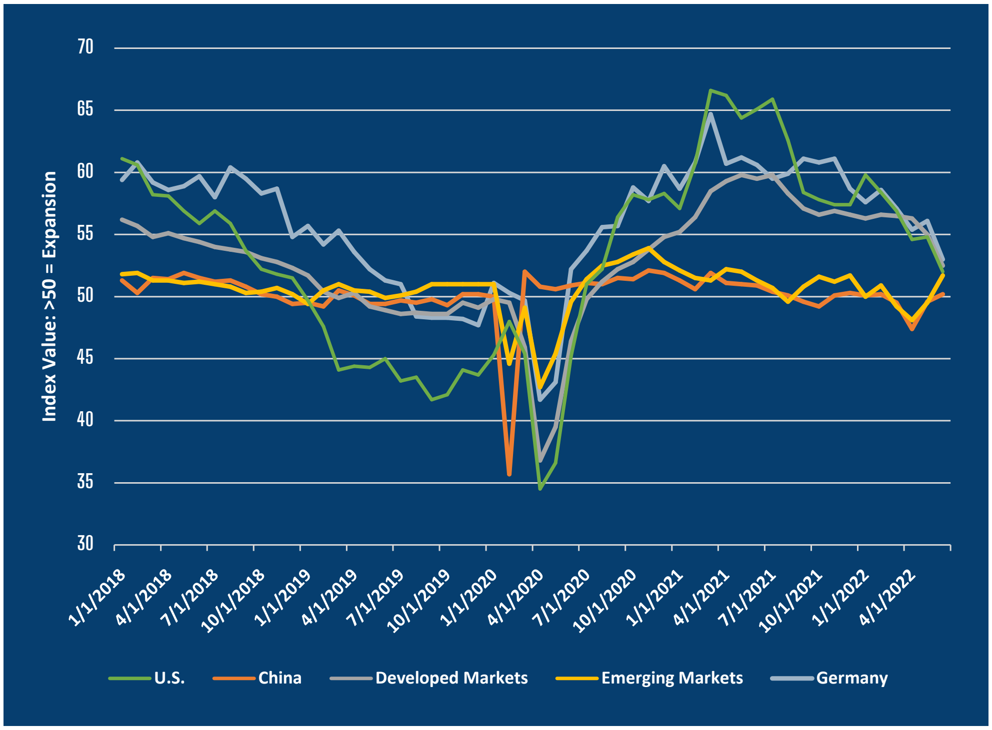
PMI Composites

The Purchasing Managers Index (PMI) is a survey-based measure of the prevailing direction of trends in the manufacturing sector. Readings >50 equal expansion and <50 contraction. By this measure, the global economy generally softened in Q2 although China and other emerging markets moved back slightly into positive territory.

Global Manufacturing Surveys



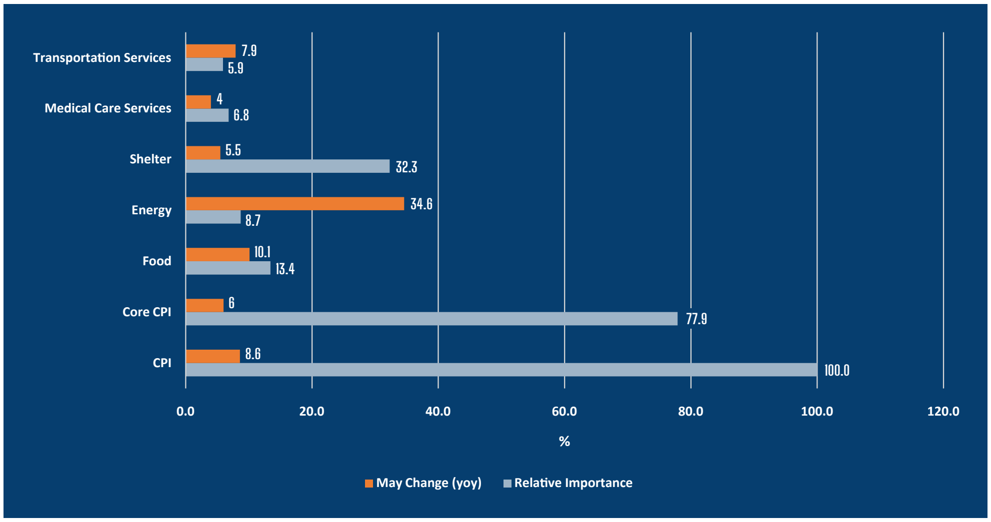
Source: Bloomberg, Haver

Inflation

Inflation remains elevated and accelerated during Q2. Overall inflation reached a 40-year high.

Consumer Price Index: Selected Components

Year-over-Year % Change and Index Weights



Source: Haver

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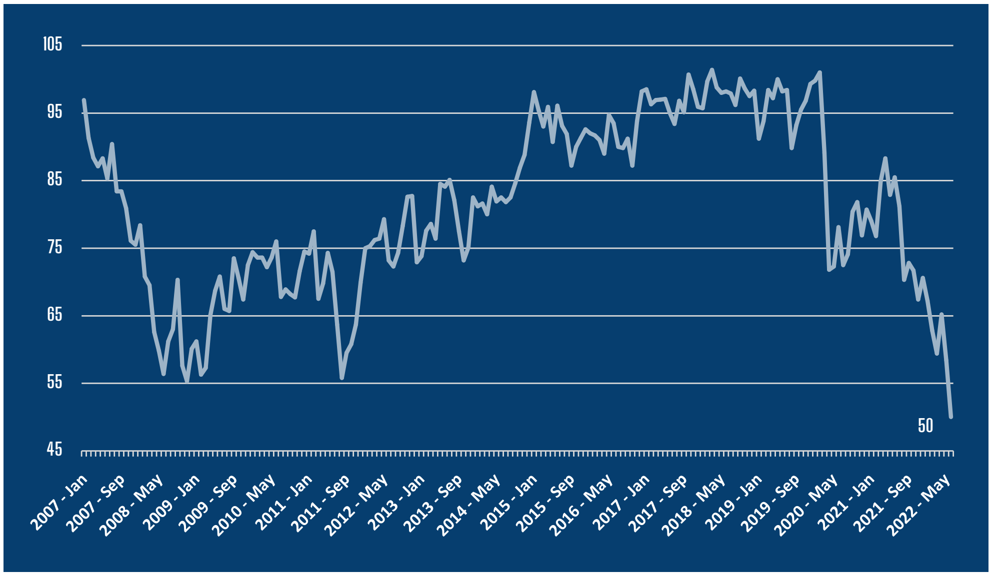
Consumer Sentiment

Consumer sentiment fell to lowest level on record in June. Both components declined (current conditions and expectations) with current conditions also setting a record low. Consumer expectations are the lowest since 1980. Weaker stock prices, high inflation, and high gas prices are weighing on consumers.

University of Michigan: Consumer Sentiment
NSA, Q1-66=100

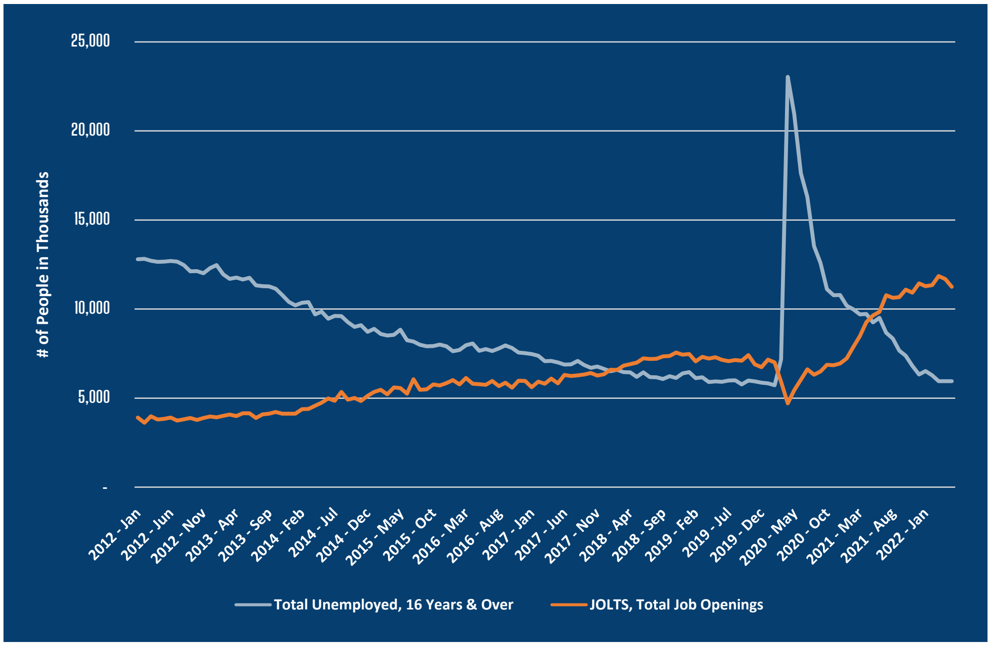


Source: Haver

Employment

The job market remained strong through Q2. The unemployment rate stands at 3.6%, and the number of open jobs is in excess of the number of people that are unemployed.

Total Job Openings Remain in Excess of Number of People Unemployed



Source: Haver

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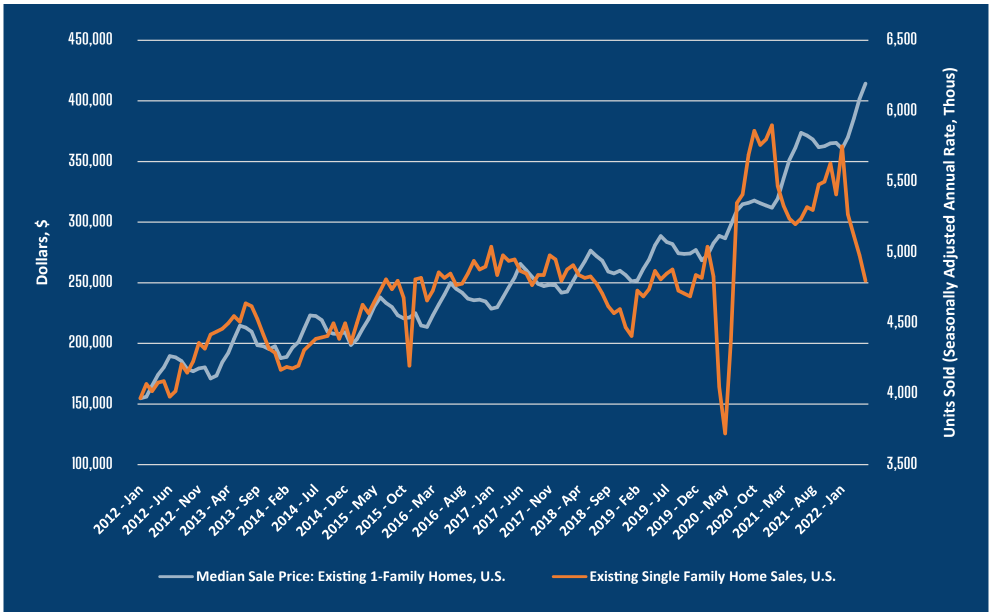
Real Wages

Home prices have climbed to record levels, but housing activity has slowed as mortgage rates have risen and housing affordability has declined.

Housing Activity

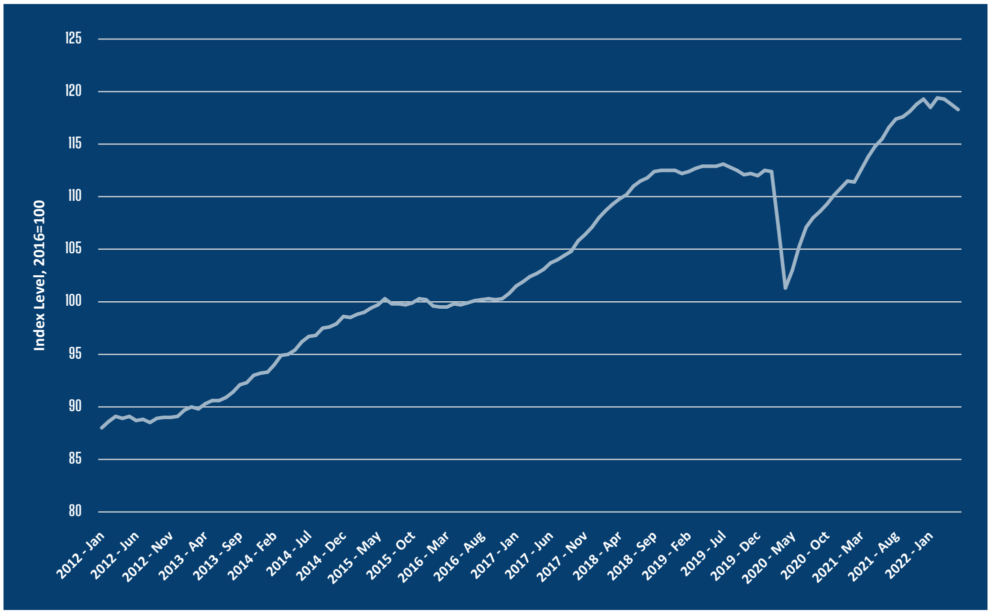


Source: Haver

Leading Economic Indicators

The leading economic indicator index fell four consecutive months through May. This has historically been an indicator of recession.

Leading Economic Indicators



Source: Haver

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June 30, 2022	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Barclays U.S. Treasury Bill 1-3 Month	0.05%	0.12%	0.16%	0.18%	0.57%	1.05%	0.60%
Barclays Municipal	-1.64%	-2.94%	-8.98%	-8.57%	-0.18%	1.51%	2.38%
BBgBarc U.S. Govt/Credit Intermediate	-0.70%	-0.63%	-3.11%	-3.56%	0.31%	1.07%	1.01%
Barclays U.S. Aggregate	-1.57%	-4.69%	-10.35%	-10.29%	-0.93%	0.88%	1.54%
Barclays U.S. High Yield	-6.73%	-9.83%	-14.19%	-12.81%	0.21%	2.10%	4.47%
S&P/LSTA Leveraged Loan	-2.16%	-4.45%	-4.55%	-2.78%	2.09%	2.91%	3.74%
Barclays Global Aggregate	-3.21%	-8.26%	-13.91%	-15.25%	-3.22%	-0.55%	0.11%
JPM GBI EM Global Diversified	-4.45%	-8.63%	-14.53%	-19.28%	-5.80%	-2.31%	-1.49%
U.S. Equity Indices							
DJ Industrial Average	-6.56%	-10.78%	-14.44%	-9.05%	7.24%	9.98%	11.70%
S&P 500	-8.25%	-16.10%	-19.96%	-10.62%	10.60%	11.31%	12.96%
NASDAQ Composite (Price)	-8.71%	-22.44%	-29.51%	-23.96%	11.27%	12.43%	14.15%
Russell 1000	-8.38%	-16.67%	-20.94%	-13.04%	10.17%	11.00%	12.82%
Russell 1000 Growth	-7.92%	-20.92%	-28.07%	-18.77%	12.58%	14.29%	14.80%
Russell 1000 Value	-8.74%	-12.21%	-12.86%	-6.82%	6.87%	7.17%	10.50%
Russell Mid Cap	-9.98%	-16.85%	-21.57%	-17.30%	6.59%	7.96%	11.29%
Russell 2500	-9.55%	-16.98%	-21.81%	-21.00%	5.91%	7.04%	10.49%
Russell 2000	-8.22%	-17.20%	-23.43%	-25.20%	4.21%	5.17%	9.35%
Russell 2000 Growth	-6.19%	-19.25%	-29.45%	-33.43%	1.40%	4.80%	9.30%
Russell 2000 Value	-9.88%	-15.28%	-17.31%	-16.28%	6.18%	4.89%	9.05%
Non-U.S. Equity Indices							
MSCI World	-8.63%	-16.05%	-20.29%	-13.94%	7.52%	8.22%	10.10%
MSCI ACWI	-8.39%	-15.53%	-19.97%	-15.37%	6.71%	7.54%	9.32%
MSCI ACWI Ex-U.S.	-8.56%	-13.54%	-18.15%	-19.01%	1.81%	2.98%	5.31%
MSCI EAFE	-9.26%	-14.29%	-19.25%	-17.33%	1.54%	2.69%	5.89%
MSCI EAFE Growth	-8.57%	-16.74%	-26.62%	-23.53%	1.64%	3.84%	6.67%
MSCI EAFE Value	-9.93%	-12.11%	-11.67%	-11.29%	0.79%	1.13%	4.85%
MSCI Europe	-9.93%	-14.17%	-20.38%	-17.05%	1.81%	2.77%	6.05%
MSCI Japan	-7.87%	-14.60%	-20.10%	-19.64%	1.38%	2.13%	5.92%
MSCI AC Asia	-5.61%	-10.94%	-17.54%	-22.97%	2.08%	2.92%	5.94%
MSCI EAFE Small Cap	-10.94%	-17.50%	-24.46%	-23.64%	1.51%	2.11%	7.57%
MSCI ACWI Ex-U.S. Small Cap	-10.99%	-17.38%	-22.69%	-22.08%	3.35%	2.96%	6.62%
MSCI Emerging Markets	-6.56%	-11.34%	-17.47%	-25.00%	0.92%	2.55%	3.43%
MSCI EM Asia	-4.75%	-9.20%	-17.05%	-25.60%	3.46%	3.70%	5.88%
MSCI China	6.63%	3.50%	-11.19%	-31.70%	-0.44%	2.29%	5.69%
MSCI EM Eastern Europe	-10.01%	-23.54%	-83.43%	-83.35%	-42.19%	-22.69%	-12.52%
MSCI EM Latin America	-16.95%	-21.73%	-0.34%	-15.65%	-6.00%	-0.22%	-1.86%
MSCI EM Small Cap	-10.46%	-16.28%	-19.85%	-20.29%	6.24%	3.89%	4.67%
MSCI Frontier Markets	-5.31%	-13.70%	-20.45%	-17.06%	0.82%	1.92%	5.41%
Hedge Fund Indices							
IQ Hedge Long/Short	-6.56%	-11.05%	-14.70%	-13.09%	2.61%	2.69%	--
IQ Hedge Multi-Strategy	-3.31%	-7.05%	-9.23%	-10.55%	-0.02%	1.23%	2.33%
Real Assets Indices							
FTSE NAREIT Composite	-7.24%	-14.73%	-19.20%	-6.69%	4.74%	6.30%	8.01%
Alerian MLP	-13.95%	-7.38%	10.04%	4.33%	0.07%	-0.29%	0.74%
Bloomberg Commodity	-10.77%	-5.66%	18.44%	24.27%	14.34%	8.39%	-0.82%
S&P Global Infrastructure	-7.73%	-7.42%	-0.51%	5.60%	3.49%	4.83%	7.22%
Other							
Oil Price Brent Crude	-6.54%	6.39%	47.61%	52.82%	19.93%	19.09%	1.60%
CBOE Market Volitility (VIX)	9.62%	39.64%	66.72%	81.36%	23.94%	20.76%	5.33%

Source: Morningstar

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