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Investment Insights Monthly

From The Desk of Bill Hornbarger, Chief Investment Officer | August 2022

The Fed's in a Tough Spot

The Federal Open Market Committee (the Fed) raised interest rates for the fourth time this calendar year on June 27, and the lower limit of the target Fed funds rate currently stands at 2.25%, up from 0% to begin the year. The two sides of the Fed's dual mandate of stable employment and inflation show the potential for Fed funds to stay elevated in the near and medium term. The unemployment rate remains historically low (last at 3.5%) while inflation (as measured by CPI) remains at a historically high level (8.5%). Despite this, the path forward for monetary policy remains somewhat unclear, seemingly even to the Fed itself. During the press conference following the July increase, Fed Chairman Jerome Powell indicated that additional increases will be data dependent. Various other Fed officials have been more hawkish, indicating that additional and substantial rate increases are all but certain.

The Fed is also in the unusual position of raising interest rates into an equity bear market and an economic slowdown. Before recovering during July, the S&P 500 had touched the widely acknowledged bear market threshold of a 20% decline and the first two quarters of 2022 featured negative readings on Gross Domestic Product. With that as a backdrop, the futures market currently indicates that the Fed will need to continue to increase rates to the 3.50% to 3.75% range (lower bound) by the first part of 2023, and several respected economists have called for rates at 4% or higher. The next scheduled Fed meeting is September 21, and expectations are for another 75 basis point increase. Futures also currently indicate that after peaking in the first half of 2023, the Fed will pivot to lowering rates in the second half.

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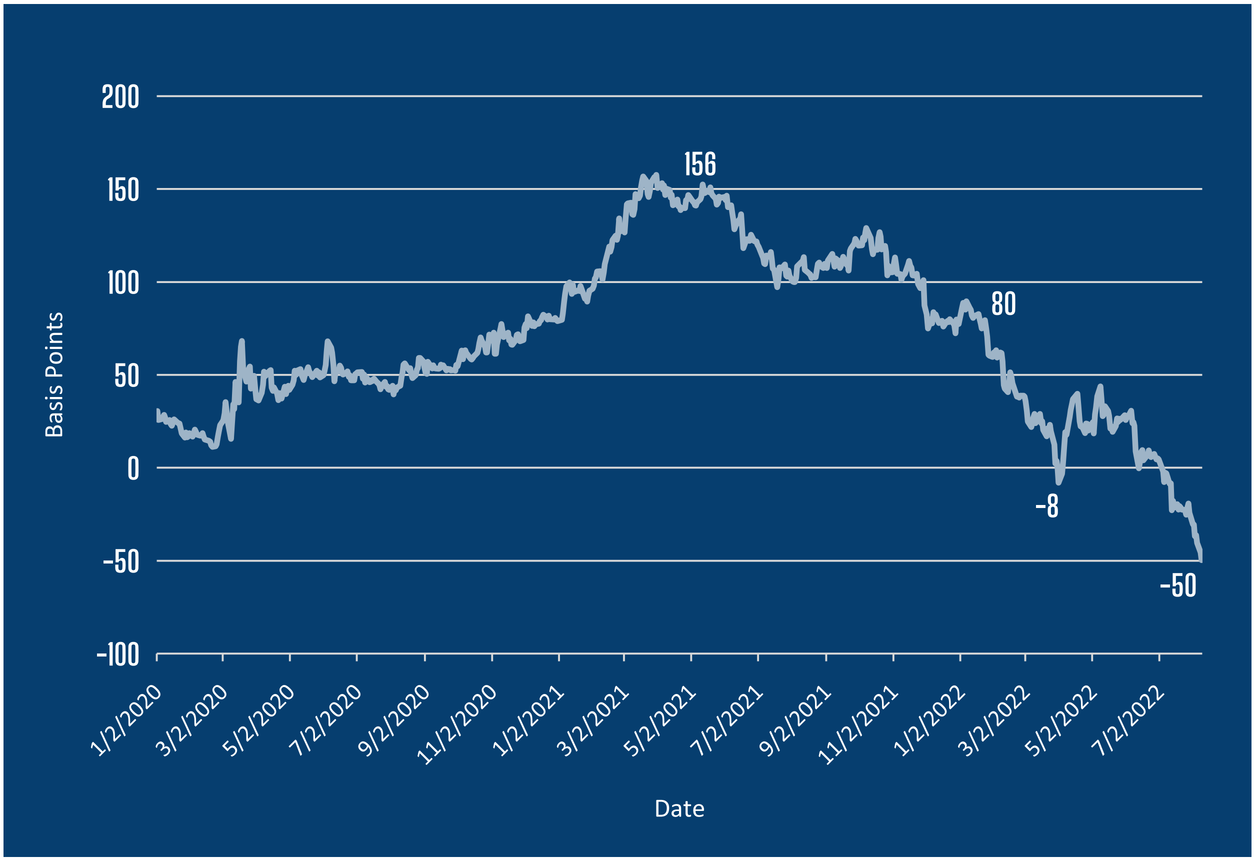
We will take Fed Chairman Powell at his word and believe that additional rate hikes will be data dependent, specifically inflation dependent. Inflation is the focus of both policy makers and market participants, and with the Fed's stated goal of 2% inflation over a market cycle, there remains much work to be done. Between increasing the target Fed funds rate, reducing the size of the Fed's balance sheet (quantitative tightening), and hawkish rhetoric, the Fed is actively using the policy tools at its disposal. While it is impossible to know exactly how high Fed funds will go, it is unlikely they are at/near neutral with Fed funds currently well below core inflation and inflation not showing signs of peaking yet.

What Does the Bond Market Know?

Parts of the bond market are flashing warning signs on the economy and are seemingly looking past the current inflation numbers. After briefly inverting in April, the yield curve has inverted with a vengeance, and longer-term bond yields have been declining despite the aggressive moves by the Fed (see chart). The yield curve is currently inverted between the 6-month Treasury bill and both the 10- and 30-year bonds.

The Treasury Yield Curve

10-Year less 2-Year (BPS)



Source: Bloomberg

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As we wrote earlier this year, we view the bond market and yield curve as one of the best economic indicators available. It reflects the wisdom of thousands of traders and trillions of dollars of capital. We also opined when the yield curve first inverted, an inversion reflects expectations that the economy will soon stagnate and even potentially fall into recession. Many market pundits are expressing this view publicly – despite high inflation, the economy is visibly slowing and tighter monetary policy will ultimately lead to a recession.

Credit spreads are another important bond market indicator. They represent the incremental risk of a corporate bond over a Treasury bond and tend to expand in times of economic and market stress. After widening out in June in sympathy with the weak equity market, credit spreads of various types of bonds have been tightening, a potential positive sign for the economy. As with the Fed, the credit markets are sending mixed signals, with the inverted Treasury curve and tighter spreads seemingly indicating different outlooks. The yield curve inversion is concerning, and we put a heavier weight there, but are encouraged by credit spreads (which also indicate ample liquidity in the markets). Taken in aggregate, we believe the bond market reflects the view that the Fed will be successful in engineering a soft landing, with the second most probable outcome a recession.

Stocks are Looking Ahead

The S&P 500 is currently down 11% for the calendar year but well off the lows of June. It is important to remember that the markets are forward looking and not always reflective of what is happening at the moment. Stocks spent the first half of the year under significant pressure, pricing in higher inflation, a softer economy, tighter Fed policy, and concerns over earnings. At the end of June, a significant amount of bad news had been discounted by stocks with valuations resetting for a different economic environment and a rotation in market leadership.

Earnings expectations had been marked down, and second quarter earnings have generally been able to eclipse those lowered expectations, helping the broad market indices to stabilize. With the prospects of still tighter monetary policy and an economy that is visibly slowing, earnings will be key going forward. We would not be surprised if the broad market retested the June lows but acknowledge that certain groups/sectors appear to have bottomed. We view the reset in valuations and market levels as a good entry point but also acknowledge that new highs are probably a fair distance away.

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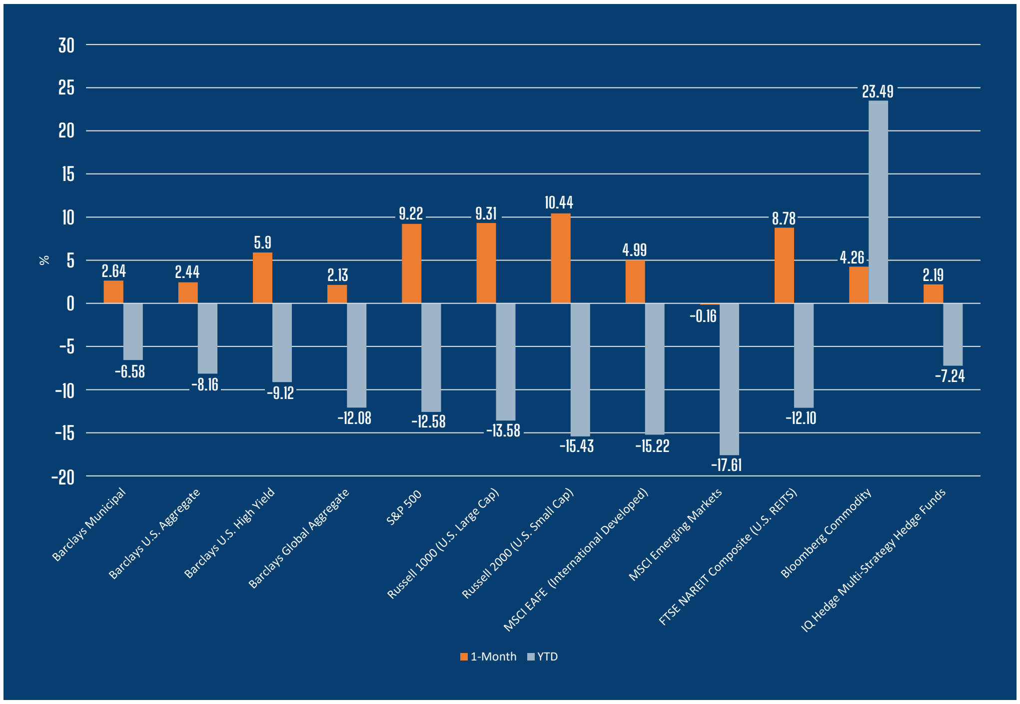
Asset Class Returns as of July 31, 2022
Comparing Recent Month and Year-to-Date Total Returns



Source: Morningstar

Asset Class Returns

Fixed Income

- Yields fell sharply in July, leading to strong gains across fixed income, specifically core and municipals.
- Credit spreads also tightened leading to outsized gains in investment grade, high yield, and floating rate loans.
- Gains were more muted in non-U.S. fixed income due to U.S. dollar strength.

Equities

- U.S. equities posted strong gains in July led by a strong rebound in growth/tech stocks and small cap stocks.
- Growth led value last month, and small caps slightly outperformed large caps.
- The S&P 500 gained 9.2% in July but is still down 12.6% YTD.
- Non-U.S. equities posted solid gains last month although they lagged their U.S. counterparts.
- Like the U.S., growth trounced value, and small caps beat large caps.
- Emerging market stocks lost ground in July, largely due to weakness in China.
- The strong U.S. dollar continues to provide a headwind for non-U.S. assets.

Real Assets

- REITs posted strong gains for the month, in line with domestic equities. They remain down over 12% YTD.
- Commodities continued their strong performance despite the stronger U.S. dollar.

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July 29, 2022	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Barclays U.S. Treasury Bill 1-3 Month	0.08%	0.08%	0.24%	0.26%	0.54%	1.05%	0.60%
Barclays Municipal	2.64%	2.64%	-6.58%	-6.93%	0.43%	1.88%	2.49%
BBgBarc U.S. Govt/Credit Intermediate	0.53%	0.53%	-2.60%	-3.22%	0.51%	1.12%	1.03%
Barclays U.S. Aggregate	2.44%	2.44%	-8.16%	-9.12%	-0.21%	1.28%	1.65%
Barclays U.S. High Yield	5.90%	5.90%	-9.12%	-8.02%	1.95%	3.06%	4.87%
S&P/LSTA Leveraged Loan	2.14%	2.14%	-2.51%	-0.68%	2.54%	3.21%	3.84%
Barclays Global Aggregate	2.13%	2.13%	-12.08%	-14.58%	-2.45%	-0.47%	0.20%
JPM GBI EM Global Diversified	2.13%	0.29%	-14.28%	-18.70%	-6.00%	-2.65%	-1.68%
U.S. Equity Indices							
DJ Industrial Average	6.82%	6.82%	-8.60%	-4.14%	9.22%	10.86%	12.31%
S&P 500	9.22%	9.22%	-12.58%	-4.64%	13.36%	12.83%	13.80%
NASDAQ Composite (Price)	12.35%	12.35%	-20.80%	-15.55%	14.87%	14.31%	15.47%
Russell 1000	9.31%	9.31%	-13.58%	-6.87%	12.91%	12.55%	13.69%
Russell 1000 Growth	12.00%	12.00%	-19.44%	-11.93%	16.05%	16.30%	15.95%
Russell 1000 Value	6.63%	6.63%	-7.08%	-1.43%	8.88%	8.26%	11.10%
Russell Mid Cap	9.87%	9.87%	-13.83%	-9.83%	9.47%	9.69%	12.32%
Russell 2500	10.35%	10.35%	-13.72%	-11.27%	9.07%	8.95%	11.66%
Russell 2000	10.44%	10.44%	-15.43%	-14.29%	7.51%	7.12%	10.60%
Russell 2000 Growth	11.20%	11.20%	-21.55%	-23.18%	4.71%	6.87%	10.66%
Russell 2000 Value	9.68%	9.68%	-9.30%	-4.77%	9.44%	6.71%	10.18%
Non-U.S. Equity Indices							
MSCI World	7.97%	7.97%	-13.94%	-8.74%	10.11%	9.37%	10.80%
MSCI ACWI	7.02%	7.02%	-14.35%	-10.07%	9.03%	8.40%	9.91%
MSCI ACWI Ex-U.S.	3.46%	3.46%	-15.32%	-14.83%	3.38%	2.93%	5.52%
MSCI EAFE	4.99%	4.99%	-15.22%	-13.86%	3.64%	3.11%	6.28%
MSCI EAFE Growth	7.93%	7.93%	-20.80%	-18.86%	4.38%	4.93%	7.30%
MSCI EAFE Value	2.10%	2.10%	-9.82%	-9.22%	2.25%	0.88%	5.00%
MSCI Europe	4.96%	4.96%	-16.42%	-14.52%	4.14%	3.17%	6.45%
MSCI Japan	5.70%	5.70%	-15.55%	-13.97%	3.22%	2.85%	6.77%
MSCI AC Asia	1.21%	1.21%	-16.54%	-17.65%	2.82%	2.38%	6.03%
MSCI EAFE Small Cap	6.62%	6.62%	-19.45%	-19.95%	3.94%	2.69%	8.22%
MSCI ACWI Ex-U.S. Small Cap	5.83%	5.83%	-18.19%	-18.21%	5.55%	3.41%	7.16%
MSCI Emerging Markets	-0.16%	-0.16%	-17.61%	-19.77%	1.25%	1.32%	3.21%
MSCI EM Asia	-1.18%	-1.18%	-18.03%	-20.04%	3.57%	2.32%	5.54%
MSCI China	-9.44%	-9.44%	-19.58%	-28.23%	-3.52%	-1.42%	4.50%
MSCI EM Eastern Europe	0.34%	0.34%	-83.37%	-83.32%	-42.05%	-23.44%	-12.64%
MSCI EM Latin America	4.27%	4.27%	3.91%	-8.35%	-4.73%	-0.97%	-1.58%
MSCI EM Small Cap	2.90%	2.90%	-17.53%	-16.93%	7.76%	3.74%	4.98%
MSCI Frontier Markets	1.32%	1.32%	-19.39%	-15.75%	0.42%	1.75%	5.44%
Hedge Fund Indices							
IQ Hedge Long/Short	4.03%	4.03%	-11.26%	-10.91%	3.97%	3.31%	--
IQ Hedge Multi-Strategy	2.19%	2.19%	-7.24%	-8.05%	0.76%	1.48%	2.42%
Real Assets Indices							
FTSE NAREIT Composite	8.78%	8.78%	-12.10%	-2.43%	7.16%	7.85%	8.67%
Alerian MLP	12.49%	12.49%	23.78%	25.26%	4.14%	1.83%	1.43%
Bloomberg Commodity	4.26%	4.26%	23.49%	27.23%	16.21%	8.82%	-1.03%
S&P Global Infrastructure	4.01%	4.01%	3.48%	8.77%	5.56%	4.97%	7.47%
Other							
Oil Price Brent Crude	-4.18%	-4.18%	41.44%	44.12%	19.07%	15.88%	0.47%
CBOE Market Volitility (VIX)	-25.71%	-25.71%	23.87%	16.94%	9.78%	15.76%	1.20%

Source: Morningstar

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