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MARKET VIEW QUARTERLY

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The stock market closed out its worst six-month stretch to start a year since 1970 as inflation-driven upheaval spread across nearly every part of the economy. Stocks and bonds around the world have together fallen by the most on record, according to Bloomberg data going back to 1990, with $8 trillion wiped off the S&P 500 alone.[1] Investor sentiment has been rattled this year, dominated by concerns around persistently high inflation, slowing economic momentum, and a hawkish Federal Reserve (Fed). The Fed has taken aggressive action to try and bring down rampant inflation, which has surged to a 40-year high, in the form of interest rate hikes worth 1.5 percentage points, with more to come.[2] Uncertainties about whether the Fed can tiptoe the narrow path of hiking interest rates enough to get inflation under control but not so much that they cause a recession has been the main driver of the market volatility in the first half of 2022. However, the fundamentals of the economy, such as the labor market and corporate earnings remain strong, and despite the inflationary challenges to the consumer, households have accumulated significant savings that can be used to supplement income and support consumption going forward.

DOMESTIC EQUITIES

As we outlined in the introduction, the first half of 2022 has been a historically rough start as stocks sold off through the end of the second quarter. The S&P 500 was down -16.10% for the second quarter and is down -19.96% year to date through the end of June.[3] Meanwhile, the Dow Jones Industrial Average Index was down more than -10.78%[3] during the second quarter and -14.44%[3] year to date, and the tech-heavy NASDAQ Composite Index was down -22.28%[3] and -29.23%[3] for the second quarter and year to date, respectively. From an investment style perspective, mature, dividend-paying companies are favored by investors currently. These stocks tend to hold up better in a rising rate and high inflation environment. As a result, the Russell 1000 Value index returned -12.21%[3] for the second quarter versus -20.92%[3] for the Russell 1000 Growth index. Investors continue to fear that small cap companies lack the ability to pass along rising prices to the consumer, which could ultimately hurt their bottom lines. As a result, small cap stocks have underperformed their larger cap peers. Small caps returned -17.20% for the second quarter versus -16.85% for mid-caps and -16.67% for large cap equities.[3] We acknowledge that if inflation surprises persist, or a sizable shift in Fed policy occurs, equity markets could see a further pullback. However, we want to continue to stress that the fundamentals of the economy remain on solid footing. The labor market still looks strong, as job growth continued through May. Even with more workers rejoining the labor force this year, the job market remains tight, with nearly twice as many openings as unemployed people. And despite investor worries about an imminent recession, the unemployment rate has fallen this year, hovering near record lows of 3.6%.[2] Additionally, in the Q1 GDP reading, personal consumption and business investment grew at a +3.1% and +9.2% annual pace[2], respectively. As the largest driver of the U.S. economy, an acceleration in consumer spending provides reason for optimism that the underlying momentum in the economy remains positive. Similarly, ramped up business investment shows companies are confident in continued consumer demand, which should lead to economic growth. Lastly, the first-quarter earnings results and forward guidance provided some reassurance that corporate earnings can still grow at a solid pace this year, partly offsetting the headwind of declining valuations. Despite some high-profile earning misses in the tech space, consensus expectations still see aggregate S&P 500 earnings growing 10.5% this year and 9.2% in 2023.[4] However, economic growth and stock market growth can diverge at times, and that may be what we are seeing currently.

INTERNATIONAL EQUITIES

International developed and emerging market (EM) equities returned -11.45%[3] and -14.51%[3] for the second quarter, respectively, both outperforming the S&P 500. Although international and emerging markets encountered similar pressures to those faced by their domestic counterparts, foreign equities navigated a brutal quarter fairly well, firmly outpacing broad U.S. indices. However, it should be noted that domestic markets experienced more significant inflation and subsequently more aggressive central bank policy. Most foreign economies are cyclical in nature, defined by prominent, traditional manufacturing sectors and few high-tech, growth companies. Amidst the valuation reset that pulled down share prices across the globe, high-flying technology, and growth stocks (many commanding hefty weights within the primary U.S. benchmarks) saw the most severe declines. This then spurred investors to favor value-biased sectors and regions, directing flows to international developed markets. Emerging markets, however, have proven a more complicated investment landscape. The diversity of the asset class, at both the country and company levels as well as across the quality and risk spectrums, makes achieving substantial returns in this space particularly challenging. Additionally, China has been and will continue to be the main driver of emerging market performance. Despite multiple variants forcing shutdowns and stifling supply chains under the Party's draconian Zero-COVID policy, rampant insolvency throughout the real estate sector, and geopolitical risks, the quarter finished on a positive note for Chinese stocks as lockdowns lifted, COVID policy tempered, and shares responded with a much-needed bounce. However, given the strength of the dollar, the divergence of winners and losers along commodity importer/exporter lines, and continuing geopolitical strife stemming from the Russia-Ukraine war, we expect to see fairly significant volatility ahead for emerging markets.

FIXED INCOME

After starting 2022 with the worst quarter in more than 40 years, bonds declined even further in a volatile second quarter that saw the yield on the 10-year Treasury climb to its highest level since 2011. After ultimately reaching 3.482%, Treasury yields fell on growth concerns in the final days of June. With this, the U.S. Aggregate Index settled at -10.35% through the first half of the year. In one of the fastest increases in history, bond yields have reflected the significant degree of uncertainty pervading markets currently. Persistent high levels of inflation have turned the Federal Reserve increasingly hawkish, and policy tightening at the June Fed meeting clearly demonstrated the monetary authority's intent to remain data dependent and desire to return the federal funds target rate to neutral "expeditiously." A weekend Wall Street Journal article published just days before the Federal Reserve’s conclave shifted market expectations for the upcoming interest rate hike from 0.50% to 0.75% by sharing the central bankers' response to a surprisingly hot CPI report and shockingly negative consumer sentiment reading late in the week prior. Rising interest rates, which have been necessary to combat elevated inflation, coupled with slowing growth and ongoing fallout from Russia's war on Ukraine, have all added to the ambiguity fueling market volatility, which investors should expect to continue in the months ahead. While recession probabilities have creeped up in consideration of an aggressive Fed potentially slamming the breaks too firmly on an already slowing economy, not all is bleak. More moderate inflation sits on the horizon with many forecasters projecting year-end headline figures in the 4-5% range, eventually approaching target over the next 18 months or so. Perhaps most attractive, despite the beating that taxable fixed income endured through the first half and the dramatic rise in interest rates sending yields higher, much of the bad news has now been priced in. With some sense of stability in the asset class, these now-higher yields (at least at the short end of the curve) should deliver consistent income and better risk-adjusted returns over the life of a bond. Tax-exempt municipal securities also look especially attractive at current levels after outflows compounded early losses. Looking forward, remaining underweight duration continues to make sense, although as yields move higher, increasing maturity will be beneficial in time.

ALTERNATIVES

Alternative assets continued to climb in 2022 as investors weighed the effects of higher inflation expectations. Commodities strategies and other inflation-hedging investment approaches led the diverse asset class higher through the first half. WTI Crude prices had another volatile quarter as continued pressure and sanctions on Russian oil reared its head in broader energy markets. WTI crude oil prices started the quarter at $99.27 a barrel, reaching as high as $122 before retreating to $105.76 by quarter end.[2] Additionally, other major commodities tied to the Russia-Ukraine conflict experienced similar volatility. For example, natural gas, historically one of the most volatile commodities, rose to $9.34 from $5.32 at the start of the quarter, before pairing some of those gains and ending the quarter at $5.42.[2] Hedge fund-like alternatives moved lower on the quarter, down -4.19%, as measured by the Morningstar Diversified Alternative index.[3]

REAL ESTATE

As the 10-year yield surged, mortgage rates eclipsed the 6% mark for the first time since 2008, placing pressure on home buyers, especially first-time owners.[2] It appears as though the Fed has been trying to fight inflation through the housing market, given home prices reached record levels in 2021. Existing home sales fell for the fourth month in row in May, and now grow at the slowest pace since the initial pandemic slowdown in 2020. Moving to the supply side of housing, starts declined tremendously in May, dropping 14.4%[2] to the lowest levels in months. Home builders are facing a slew of difficult challenges: higher mortgage rates, labor shortages, and persistent supply-chain disruptions. It is no surprise that the housing market is feeling the brunt of new Fed policy. Owner's equivalent rent makes up nearly 30% of CPI[2], so the housing sector seems a logical point of focus for the central bank attempting to quell 40-year highs in inflation.

CONCLUSION

Overall, Ladenburg believes that although the economy is moderating and growth is slowing, we do not think tightening financial conditions will lead to a recession in the near-term. To gauge whether the market gets back on track, we will look for evidence of moderating inflation and signs that the Fed does not need to take a more aggressive tightening approach than what investors already expect. If that happens, we believe markets could begin to find some footing, but expect any sort of recovery to take a "U-shape" rather than the "V" we saw following the COVID-induced bear market of 2020. Investor sentiment already reflects a high degree of pessimism, which we think improves the prospects for better returns ahead as widespread pessimism is a traditional component of a market bottom. Stock-market valuations (price-to-earnings) have already dropped by an amount that is consistent with a recession. Therefore, a good portion of the pain may already be priced in. We suspect some downward revisions to corporate earnings are coming as historic profit margins are dented by rising input costs, but earnings growth should remain positive thanks to record cash balances and reasonably healthy revenue growth. Ultimately, we anticipate inflation will cool off in second half of this year. This will have a two-fold impact, first, a positive boost to consumer sentiment, which should then decrease the volatility seen across markets through the first half of 2022.

Economic Definitions

GDP: Gross domestic product (GDP) measures the final market value of all goods and services produced within a country. It is the most frequently used indicator of economic activity. The GDP by expenditure approach measures total final expenditures (at purchasers' prices), including exports less imports. This concept is adjusted for inflation.

Unemployment Rate: The unemployment rate tracks the number of unemployed persons as a percentage of the labor force (the total number of employed plus unemployed). These figures generally come from a household labor force survey.

CPI (headline and core): Consumer prices (CPI) are a measure of prices paid by consumers for a market basket of consumer goods and services. The yearly (or monthly) growth rates represent the inflation rate.

Housing Starts: Housing (or building) starts track the number of new housing units (or buildings) that have been started during the reference period.

Building Permits: This concept tracks the number of permits that have been issued for new construction, additions to pre-existing structures or major renovations. These statistics are based on the number of construction permits approved

Conference Board Consumer Confidence Index: The Consumer Confidence Survey® reflects prevailing business conditions and likely developments for the months ahead. This monthly report details consumer attitude, buying intentions, vacation plans and consumer expectation for inflation, stock prices and interest rates. Data are data available by age, income, region and top 8 states.

West Texas Intermediate (WTI): West Texas Intermediate (WTI) crude oil is a specific grade of crude oil and one of the main three benchmarks in oil pricing, along with Brent and Dubai Crude. WTI is known as a light sweet oil because it contains around 0.34% sulfur, making it "sweet," and has a low density (specific gravity), making it "light."

The Federal Reserve System: The central bank of the United States. It performs several general functions to promote the effective operation of the U.S. economy and, more generally, the public interest.

Index Definitions

S&P 500: The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

NASDAQ: The NASDAQ Composite Index is a broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market. The index was developed with a base level of 100 as of February 5, 1971.

Dow Jones Industrial Average: The Dow Jones Industrial Average is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

Russell 1000 Value: Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The index was developed with a base value of 200 as of August 31, 1992.

Russell 1000 Growth: Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The index was developed with a base value of 200 as of August 31, 1992.

Russell Mid-Cap: Russell Midcap Index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index.

Russell 2000: The Russell 2000 Index is comprised of the smallest 2000 companies in the Russell 3000 Index, representing approximately 8% of the Russell 3000 total market capitalization. The real-time value is calculated with a base value of 135.00 as of December 31, 1986. The end-of-day value is calculated with a base value of 100.00 as of December 29, 1978.

MSCI EAFE: The MSCI EAFE Index is a free-float weighted equity index. The index was developed with a base value of 100 as of December 31, 1969. The MSCI EAFE region covers DM countries in Europe, Australasia, Israel, and the Far East.

MSCI EM: The MSCI EM (Emerging Markets) Index is a free-float weighted equity index that captures large and mid-cap representation across Emerging Markets (EM) countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

Bloomberg Barclays US Agg Bond: The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

Bloomberg Barclays High Yield Corp: The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

Morningstar® Diversified Alternative Index: The Morningstar® Diversified Alternatives Index is designed to provide diversified exposure to alternative asset classes in order to attempt to enhance risk-adjusted portfolio returns when combined with a range of traditional investments. The index consists of a diversified set of ProShares alternative exchange traded funds that employ alternative and nontraditional strategies such as long/short, market neutral, managed futures, hedge fund replication, private equity, infrastructure, or inflation-related investments.

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[2] Data obtained from Bloomberg as of 6/30/2022
[3] Data obtained from Morningstar as of 6/30/2022
[4] https://www.edwardjones.com/us-en/market-news-insights/stock-market-news/previous-weeks-weekly-market-update