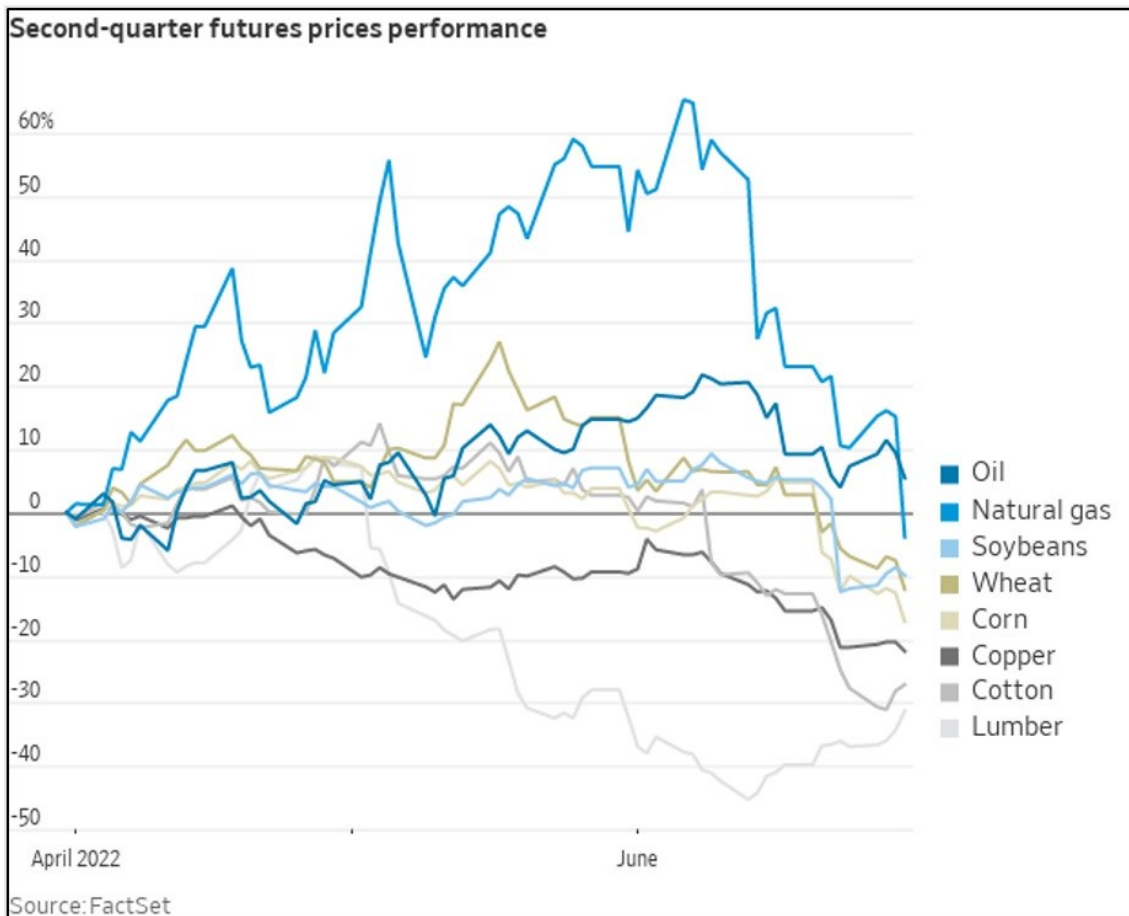


# Market Review: Second Quarter 2022

Global markets ended the first half of the year in downturn, reacting badly to the macroeconomic background of rising rates, creeping inflation, and recessionary fears. Markets gave in to selling pressure that intensified in June despite three attempts to rally in the second quarter. As a result, the S&P 500 entered a bear market, which is defined as a drop of at least 20% from a recent peak. Investors have undoubtedly endured a difficult six months as both stocks and bonds saw consecutive quarterly falls. In more than a century, this has only happened three other times, resulting in grave mid-year portfolio returns.

Losses in June were not limited to just stocks and bonds; total commodity prices also fell. Fears about the state of the world economy and the consequent decline in demand drove down prices, resulting in a more than 10% decline in the Bloomberg Commodity Total Return Index in just June. The index dropped 5.66% for the quarter. Energy, metals, and agriculture were among the many industries that experienced index level losses in June. Natural gas fell 33.52% in June from record highs earlier in the quarter, finishing with a loss of 6.02%. U.S. crude oil finished at \$106 per barrel on June 30, well below its prior highs of \$120 per barrel. All three commodities cycled lower and ended the quarter at a lower price than they had been at the end of March.



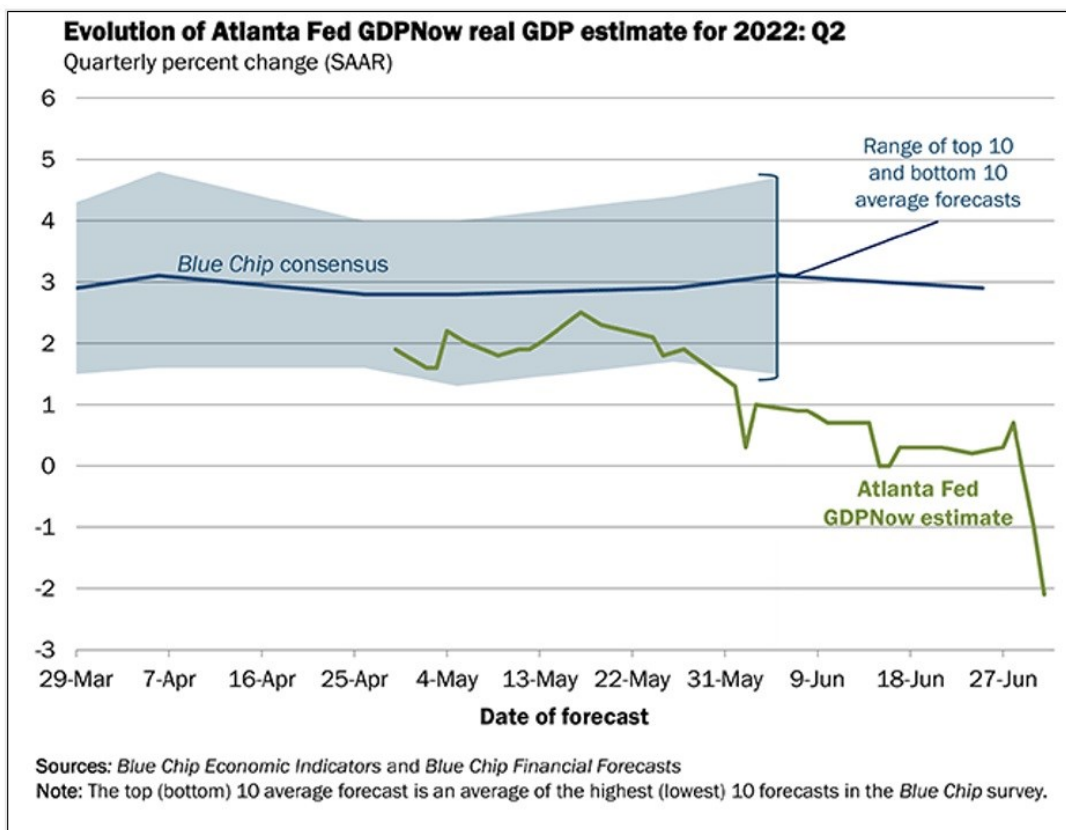
The second quarter's ongoing bitcoin sell-off was driven by aversion to risk. The frequently volatile asset class managed to lose \$2 trillion in value this year, with Ethereum plummeting by 80% and Bitcoin declining by 70% from its peak.

Much of the quarter was dominated by inflation concerns, although there was rising confidence that inflation had already peaked and would eventually "roll over" as predicted by subsequent inflation readings. Unfortunately, May's headline Consumer Price Index (CPI) figure of 8.6% year over year and a staggering 1% month over month, which was hotter than anticipated, established a new cycle high. This significant bit of information marked a turning moment for the central bank. The Dallas Trimmed Mean inflation gauge, which eliminates the biggest data outliers before averaging the remaining data, and subsequent inflation data confirmed the underlying durability and further broadening of inflation pressures. The Fed agreed, admitting that controlling inflation was essential, even if doing so meant sacrificing economic growth. As a result, the Fed undertook a series of rate hikes that were aggressively front-loaded in order to reduce surplus demand and control prices.

Market participants quickly accepted the Fed's resolve and priced in a noticeably higher terminal rate for the Fed funds rate. The economic effects of escalating stricter banking restrictions were contested at the same time. Investors sold economically sensitive stocks and switched to longer-dated bonds at the end of the quarter as a result of slowing economic growth and the risk of a short-term recession. As a result, the 10-year Treasury fell from a peak of 3.48% on June 14 to 3.01% on June 30.

## ECONOMY

Recession odds are increasing as we end the first half of the year. The GDP Now model of the Atlanta Fed has aggressively lowered the second quarter's economic activity as of June 30, predicting an annualized GDP loss of 2.1% and stoking recessionary fears. This estimate builds on the dismal first quarter GDP, which showed a -1.6% annualized fall in economic activity. A recession would be considered to have occurred if the real GDP reading for the second straight quarter was negative. A more thorough examination of the length and worsening of economic conditions is required before any conclusive recession classification can be made, according to the National Bureau of Economic Research, the official arbiters of recessions.



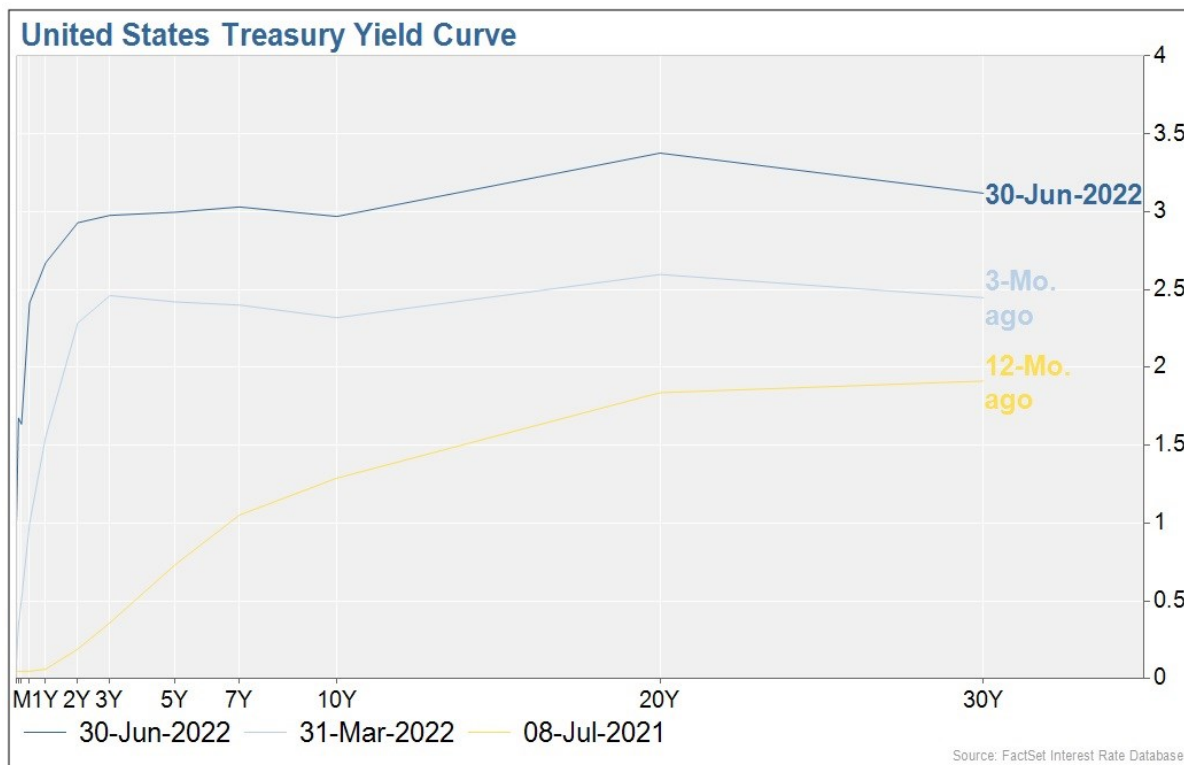
While waiting for signs of deterioration, we turn to a number of important economic indicators. The LEI (Leading Economic Indicators) of the Conference Board fell 0.4% year-over-year in April and May, resulting in a six-month moving average of -0.4%, showing signs of a slowdown that should be monitored. The Citi Economic Surprise Index determines whether economic data surprises upside (a positive surprise) or downside (a negative surprise). It strengthened the case for a fall in economic activity by ending the quarter at or near the worst level for the year—deeply negative territory.

Given that spending accounts for more than two thirds of GDP, consumer attitudes and behavior frequently indicate the economy's resilience. Whether measured by the Confidence Expectations Index of the Conference Board or the University of Michigan Consumer Sentiment Index, the consumer sentiment leading indicators are at decade lows. Additionally, real personal expenditure in May fell for the first time this year, suggesting a slowdown in spending may be on the horizon, despite anecdotal evidence to the contrary.

Although the economy is slowing and all of these leading signs are flashing yellow, it is NOT coming to a complete stop. After experiencing unusually rapid growth in 2021, the economy is now declining in response to tighter financial circumstances. It continues to be supported by a robust labor market, a healthy consumer base, and companies with excellent fundamentals, all of which are evidence that any near-term recession should be brief and modest.

## FIXED INCOME

The bond market has experienced another difficult quarter. The Fed's projected rate rises' rapidity, particularly after their meeting in June, had a negative influence on total returns across the fixed income market. The 10-year Treasury finished at 2.98% but increased to as high as 3.5% earlier in June. The 2-year Treasury increased this quarter to 2.93%. The yield curve flattened this quarter but avoided inverting since the 2-year Treasury rate is still lower than the 10-year Treasury yield. Investors will be on the lookout for any extended periods where rates exhibit this dislocation since an inversion, where short-term rates are higher than long-term rates, may herald a recession.



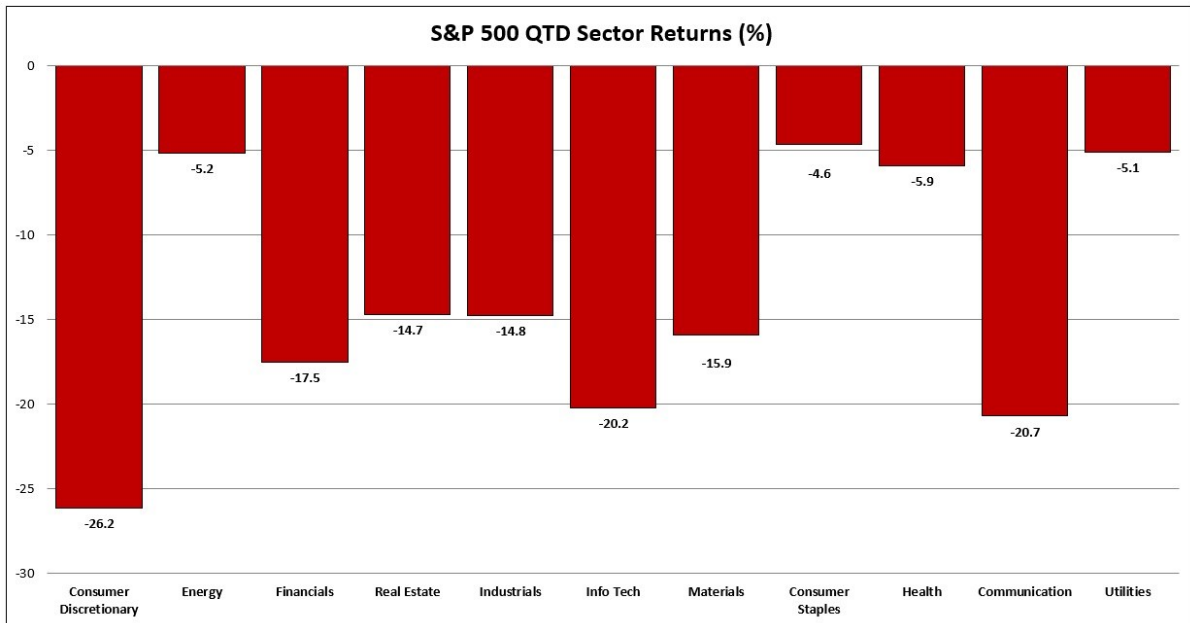
Prices continued to decline this quarter amid rising rates. The Bloomberg U.S. Aggregate Index fell 4.69% for the quarter and 10.35% year to date. This broad-based benchmark comprises investment grade corporate bonds, treasuries, and mortgage-backed securities. Credit-vulnerable sectors including U.S. high yield decreased by 9.97% in the second quarter and 14.04% overall this year. At the end of the quarter, spreads widened as recession fears increased and worries about future corporate profit growth emerged ahead of the Q2 reporting season. The difficulties in fixed income were shared by international bonds. The J.P. Morgan EM Bond Index, which tracks debt in emerging markets, showed a decline of 11.43% for the quarter and 20.31% for the year, both of which were attributed to the strengthening of the US dollar, tighter financial conditions, and inflation. The ICE BofA Inflation-Linked Treasury Index, which measures inflation-linked bonds, had a fall of 6.73% for the quarter and 9.24% YTD as a result of the index's longer duration being negatively impacted by the increase in rates.

The bond market has already priced in a large amount of agony, which is the silver lining. Even if rates move a little higher, new higher yields may provide a margin of safety. A positive total return could be achieved by using the increased amount of income to partially offset the fall in market value. Additionally, the increase in yields not only offers a greater level of current income on assets with rates that are marked to the market, such as money market rates, but also higher coupon rates offer more enticing reinvestment prospects.

### Asset Class Returns as of June 30, 2022

<u>Index</u>	<u>Asset Class</u>	<u>Q2 2022</u>	<u>1 Year</u>	<u>3 Years</u>
S&P 500	Large-Cap US Stocks	-16.10	-10.62	10.60
S&P 400	Mid-Cap US Stocks	-15.42	-14.64	6.87
S&P 600	Small-Cap US Stocks	-14.11	-16.81	7.30
MSCI EAFE	Developed International Stocks	-14.51	-17.77	1.07
MSCI Emerging	Emerging Market International Stocks	-11.45	-25.28	0.57
BarCap Intermediate Gov't/Credit	Intermediate Bonds	-2.37	-7.28	-0.16
Ice BofA US High Yield	US Corporate High Yield	-9.97	-12.66	-0.04
BBgBarc US Treasury US TIPS	TIPS	-6.08	-5.14	3.04
JPM EMBI Global Diversified	Emerging Market Bonds	-11.43	-21.22	-5.22
S&P GSCI Gold	Gold	-7.62	1.31	6.95
Ice BofA 0-90 Day Treasury	Cash	0.13	0.18	0.57

Data from Morningstar Direct



## EQUITY

Equity markets accelerated drops that had already begun earlier in the year, and by the end of Q2, all three major averages—the DJIA, S&P500, and the NASDAQ—had corrected and two had entered a bear market.

On June 16, the S&P 500 joined the NASDAQ and entered its fifteenth bear market, losing 23.55% from its high on January 3. The S&P 500 saw a loss of 8.25% in June, extending its second quarter losses to 16.20% overall, and the year-to-date losses to -19.96%. Currently, the market multiple reflects the reduction, with the forward P/E ratio falling to 15.9X earnings, which is below the S&P's 25-year average of 16.8X. The market now has a more fair and appealing valuation than it did at the start of 2022 as a result of this shift. This revaluation indicates how the market has processed rate hikes, inflation worries, and the start of an economic slowdown pricing. With additional volatility anticipated surrounding corporate earnings this quarter, we might be in the seventh inning of a baseball game, to use a baseball analogy. We would have anticipated a considerable downgrade to corporate profits from the research community given the hazy macro environment. However, according to FactSet, as of June 30, the Q2 bottoms-up earnings projection only dropped by 1.1%. This indicates that the analyst community is now much more upbeat than in the past. According to FactSet, the average decline during the previous five years was 2.4%, and the average decline over the previous ten years was 4.7%. Once the earnings season begins, it will be closely watched to see how earnings estimates stack up against actual quarterly data. Will profits continue to expand at the anticipated rate for the entire year? Weaker earnings and multiple compression are typically factors in the majority of market selloffs. As reports are released, company commentary will be of particular interest.

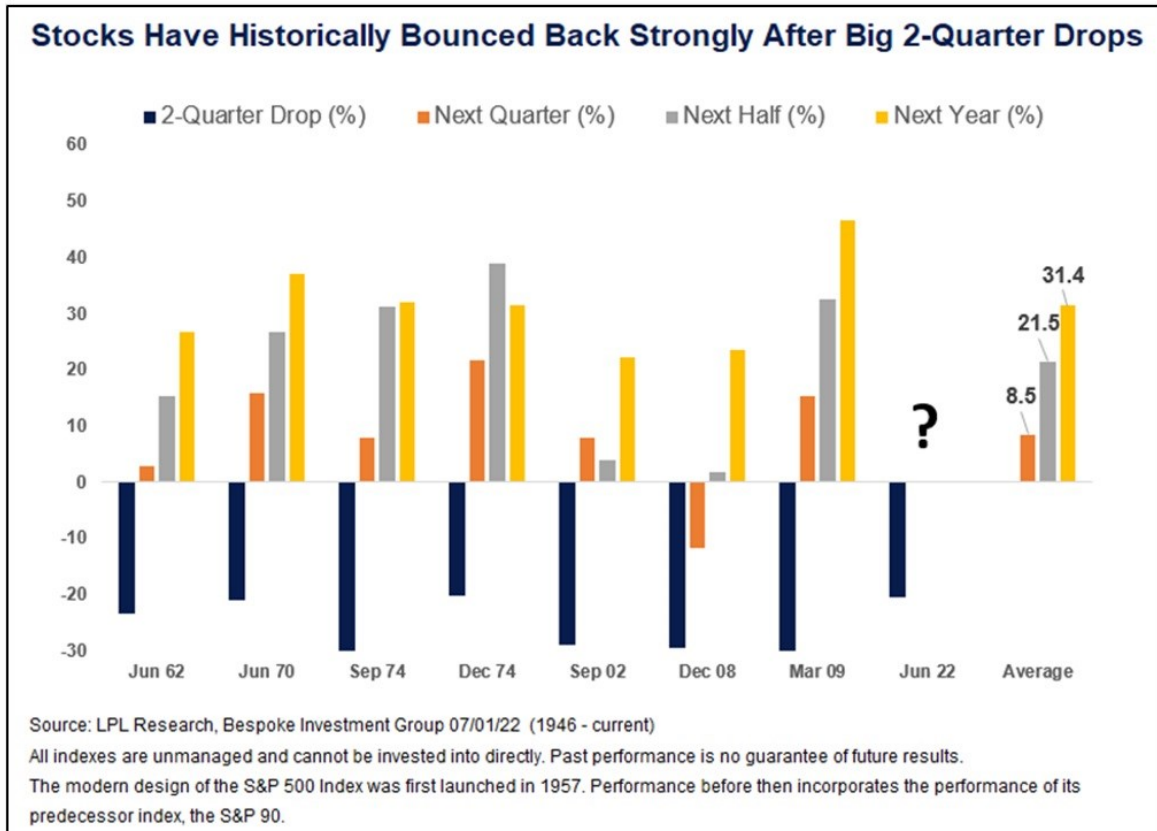
Sector-level areas with strong ties to consumer demand, growth, and major exposure to foreign sales lurched downward. Consumer discretionary (-26.2%), technology (-20.2%), and communication services (-20.7%) were the three industries that had a loss of more than 20%. Healthcare (-8.3%), consumer staples (-4.6%), and utilities (-5.1%) were among the other more defensive industries that experienced a dip. Even the energy sector saw a quarterly decline of 5.2% but a strong year-to-date return of 31.8%.

The mid-cap and small-cap universe had quarterly double-digit drops as well as global declines of more than 10% in developed and emerging markets during the second quarter.

## CONCLUSION

We understand that maintaining an investment is considerably simpler when the market is rising than when it is falling. Following a cumulative decrease of at least 20% over the previous two quarters, LPL Research offers us a historical perspective that focuses on market performance. According to the report, there was an average gain of 21.5% the following two quarters and 31.4% the following year. While there is no

assurance that a recovery will occur in the second half of this year, this does provide a historical precedent that can be used as a basis for cautious optimism.



Over the past 30 months, the world has shown nothing but resiliency. Even if the present can feel uncomfortable, a longer glance over the horizon will reveal more truth. We at AFG continue to be on guard, so perhaps your summer can be calm and relaxing. Please pause now and take it all in! And as usual, get in touch with us whenever you have questions or to discuss your particular situation.