RonaldBlueTrust®
Wisdom for Wealth. *For Life.*®

# Economic Review & Outlook

THIRD QUARTER | 2022

## Ripping Off the Band-Aid®

We've all had to deal with scrapes and cuts at one point or another. While the injury itself is often bothersome, one of the worst parts in the process of returning to normal is removing the bandage. Sometimes, it hurts. Although our instincts tell us to react to the initial discomfort of that process by pulling it off slowly or even procrastinating, we learn at an early age that it's usually smarter to just rip it off and deal with the pain quickly.

What does that have to do with the economy? In a sense, the U.S. Federal Reserve (Fed) and policymakers are trying to transition us back to a more typical interest rate environment, knowing there will be some pain along the way—especially given the expensive stock and bond market valuations we've seen in recent years. While the Fed would prefer a slow, orderly transition, what we've seen in markets this year has looked much more like a painful shock to the system. This jolt left many investors wondering whether there is more pain to come or if the most difficult period is over. Perhaps this shift is just what the doctor ordered: Ripping off the bandage is almost always better in the long run.

# Economic Overview

## WAR RAGES ON IN UKRAINE

The war in Ukraine passed the 100-day mark with no end in sight, escalating the humanitarian crisis for the country's citizens, further straining Russia's resources, and adding more pressure to global supply chains. Russia and Ukraine are major suppliers of fertilizer, sunflower oil, wheat, barley, and corn. The war has prevented exports of these crops, driving up food prices, intensifying shortages, and threatening a food crisis—especially in developing countries. NATO Secretary General Jens Stoltenberg warned that the war could drag on for years, and European Union (E.U.) leaders agreed to impose a partial embargo on Russian oil imports, which is due to take effect by the end of this year. Russia's energy corporation, Gazprom, said it would halt gas supplies to Shell in Germany after the oil firm refused to use the Kremlin's ruble payment mechanism. Ukraine's efforts to join the E.U. got a boost when the union voted unanimously to grant Ukraine candidate status in late June, though membership will likely take years.

## INFLATION CONTINUES TO RUN HOT

In May, the U.S. Consumer Price Index (CPI) showed inflation accelerated to an 8.6% annual rate, the highest number since 1981. Price increases were broad-based and ran the gamut from energy to groceries. The current inflation increases initially started with basic supply-and-demand imbalances, as consumers bought more goods during the pandemic. When economies reopened, however, energy prices started a steep climb upward. Global supply chain disruptions, another consequence of the pandemic, have persisted. The war in Ukraine and COVID-19 lockdowns in China exacerbated all of those issues and added upward pressure to prices, and the costs of everything from production to sales rose. As inflation grabbed the headlines in recent months, there was often a category or two to blame. However, May's figures strained that narrative. While the Fed and other central banks remain hopeful they can engineer a soft landing, the latest personal consumption expenditure (PCE) projections (5.2% for the end of 2022 vs. March's estimate of 4.3%) indicate it could be bumpier and may take longer than expected.

## INTEREST RATES ON THE RISE

The Fed raised its key interest rate by 75 basis points (bps) in mid-June, the biggest move since 1994. It was a bit of a surprise, given many expected a 50-bps hike, but the high May inflation figure and signs that rising prices are more embedded than previously thought seemed to drive more aggressive action. The Fed also signaled the possibility of further big moves. The "dot plot," which measures the sentiment of Central Bank officials, continued to shift, with policymakers predicting the rate to rise to 3.4% by the end of 2022 (much higher than March's 1.9% figure) and 3.8% by the end of 2023. The Fed also lowered its 2022 and 2023 growth forecasts to below 2%, with expectations for higher unemployment.

While the Fed did not predict a recession, Fed Chair Jerome Powell told the media that factors beyond its control—including the war in Ukraine and the heightened risk of still-higher commodities prices—could make things worse than current forecasts predict. Finally, the Central Bank started the process of reducing its balance sheet, which had more than doubled to $9 trillion in two-plus years as a result of actions taken to support markets during the height of the pandemic. The Fed started to allow bonds to mature without pumping the proceeds back into the debt market, which created some uncertainty in the bond market as to how it will play out over time.

# Asset Class Performance

Equities broadly declined in the second quarter. In June, the S&P 500 Index entered a bear market—defined as a 20% or larger decline from a recent high, which occurred in January—for just the seventh time in the last 50 years. Consumer discretionary and information technology sectors, which led markets higher over the last decade-plus and through the bull market that began in early 2020, were the weakest performers. The CBOE Market Volatility Index, or VIX, ran nearly 50% higher in the second quarter than the year prior. June's preliminary reading of the University of Michigan U.S. Consumer Sentiment Index fell sharply from May, missing economists' consensus forecast and reaching the lowest figure on record. Despite record-low sentiment, however, consumer spending remained strong.

The Bloomberg Aggregate Bond Index returned -4.7% in the second quarter and closed the first half of 2022 down 10.4%, pressured by

| JANUARY | FEBRURARY | MARCH | APRIL | MAY | JUNE | Q2 | YTD |
|---|---|---|---|---|---|---|---|
| Commodities 8.8% | Commodities 6.2% | Commodities 8.7% | Commodities 4.1% | Commodities 1.5% | Diversified Bonds -1.6% | Diversified Bonds -4.7% | Commodities 18.4% |
| Gold -1.9% | Gold 5.8% | U.S. Stocks 3.7% | Gold -2.1% | Int'l Developed Stocks 0.9% | Gold -2.1% | Commodities -5.7% | Gold -1.5% |
| Emerging Market Stocks -1.9% | Diversified Bonds -1.1% | Gold 2.7% | Diversified Bonds -3.8% | Diversified Bonds 0.6% | Emerging Market Stocks -6.6% | Gold -7.6% | Diversified Bonds -10.4% |
| Diversified Bonds -2.2% | Int'l Developed Stocks -1.8% | Int'l Developed Stocks 0.8% | Emerging Market Stocks -5.6% | Emerging Market Stocks 0.5% | U.S. Stocks -8.3% | Emerging Market Stocks -11.3% | Emerging Market Stocks -17.5% |
| Int'l Developed Stocks -4.8% | Emerging Market Stocks -3.0% | Emerging Market Stocks -2.2% | Int'l Developed Stocks -6.4% | U.S. Stocks 0.2% | Int'l Developed Stocks -9.3% | Int'l Developed Stocks -14.3% | Int'l Developed Stocks -19.3% |
| U.S. Stocks -5.2% | U.S. Stocks -3.0% | Diversified Bonds -2.8% | U.S. Stocks -8.7% | Gold -3.6% | Commodities -10.8% | U.S. Stocks -16.1% | U.S. Stocks -20.0% |

Indices used: Commodities—Credit Suisse Commodity Index, Diversified Bonds—Barclays Aggregate U.S. Bond Index, Gold—S&P GSCI Gold Index, U.S. Stocks—S&P 500 Index, Int'l Developed—MSCI EAFE Index, Emerging Markets—MSCI Emerging Markets Index. Indices do not reflect the deduction of advisory fees, transaction charges, and other expenses. You cannot invest directly in an index. Past performance does not indicate future returns.

hawkish policy moves by the Fed and other major central banks, which pivoted to normalize rates faster than many investors—and even policymakers themselves—expected. After the Fed's interest rate hike, Treasuries—already suffering their worst losses since the 1970s—resumed their decline amid concerns about further inflationary surges. Policymakers' median forecast for the Fed's benchmark rate at the end of 2023 rose to nearly 4% during the quarter, before somewhat abating. Oil prices rose 6.5% during the quarter and 40.6% in the first half of 2022, though June saw some pullback. Broader commodities indexes fell as slowing demand from China weighed on iron ore, copper, and other metals toward the end of the quarter. Inflationary pressures were not enough to bolster gold, which declined 7.6% in the second quarter and is down year to date—though still well ahead of equity markets.

# Our Perspective

## CHECKING THE WOUND

There's no doubt that the economy and markets have had a difficult year so far. We've seen inflation persist much longer and run much hotter than central bankers expected, forcing them to drastically revise their rate projections. Markets reeled and produced some of the worst short-term bond returns in history. Still, supply chain issues, booming real estate values, and one of the tightest job markets of all time continue to put upward pressure on the CPI and other inflation measures. In this section, we will examine how these events impacted markets and the economy recently, and if they can weather the impact of future rate increases.

## ARE WE HEADED FOR A RECESSION?

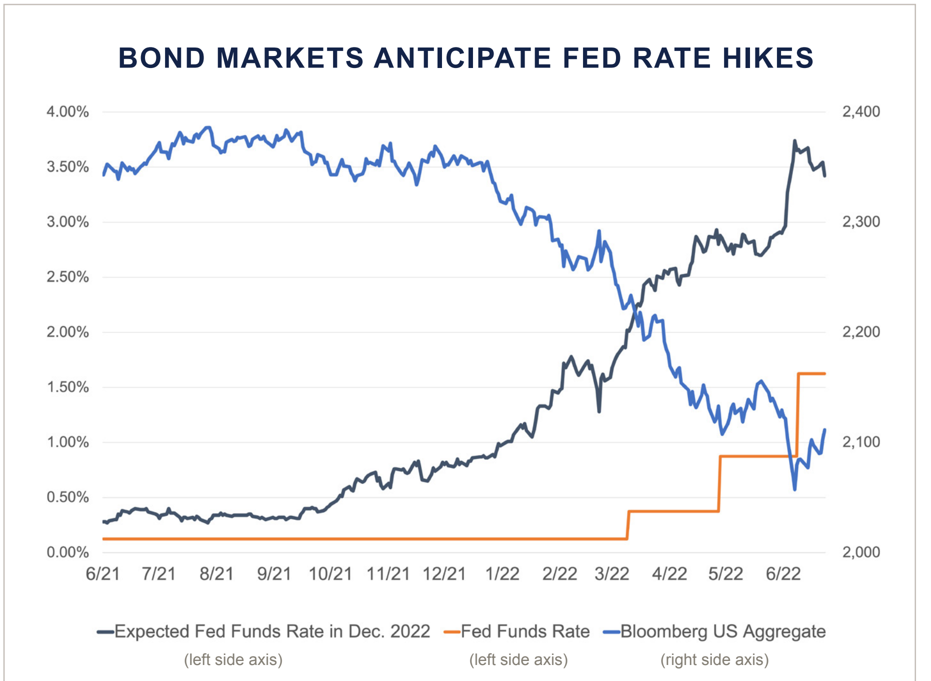
Pulling off our metaphorical bandage too hard or too soon could lead to reopening the wound or making things worse. Right now, some investors fear that with inflation spiking, stock and bond markets struggling, and geopolitical uncertainty continuing, the Fed's aggressive rate hikes could do just that and tip the U.S. economy into a recession. That's certainly possible, and some of the warning signs are flashing, including the Treasury yield curve, which plots the difference between interest rates on short-term and long-term government bonds and usually slopes upward, meaning the yield increases with duration. This year, the closely watched curve between two-year and 10-year Treasuries briefly inverted, meaning the two-year yield was higher. That occurrence is considered a fairly reliable signal of a forthcoming recession and almost certainly shows that investors are worried.

Economists are worried too. A June survey by the Initiative on Global Markets at the University of Chicago's Booth School of Business revealed that nearly 70% of economists expect the National Bureau of Economic Research (NBER) to declare a recession in 2023.[1] That said, it's far from a foregone conclusion. Most U.S. consumers have excess cash, helped by pandemic savings and stimulus payments; and so far, they're still spending. The job market is very strong, with the economy averaging about 400,000 new jobs per month in 2022, and wages are on the rise. The Fed's projections suggest a recession is unlikely, with Powell saying in June that there's "no sign" of a broad slowdown. Even if a recession does happen, it's important to remember that it's an inevitable part of long-term investing, as are drawdowns. After all, by the time NBER declared a recession in 2020, the markets had already started to sharply recover.

## BOND MARKET CHECKUP

Bonds have had a difficult year, with the Bloomberg U.S. Aggregate Bond Index down approximately 10% in the first half of 2022—the worst drawdown in four-plus decades—as the ongoing themes of inflation and interest rate hikes pressured bond prices. This decline was not easy to live through, especially when stock prices also fell, leaving portfolios without the cushion bonds usually provide.

However, we believe it's not time to panic. First, there is some good news: Yields, especially for short-term bonds, are more attractive than they've been in years. We still believe bonds dampen the overall volatility of a portfolio over the long term by providing cash flow and returns that historically help investors through recessions. Remember, the Bloomberg index's 2022 losses had less of an impact than the gains recorded in 2019 and 2020, helped by the Fed's dovish policy. It is also important to remember that the bond market is forward-looking. While the Fed has only begun to raise rates, bond yields have moved much higher, reflecting a series of steady rate hikes. In that vein, this year's bond sell-off has been very orderly and valuation-driven. In other words, the increase in interest rates can explain the simultaneous negative returns in stocks and bonds.




Source: CME FedWatch, FactSet

[1] www.ft.com/content/53fcbbf1-39e3-483c-a6f2-b0de432ed5a3t

There are no signs of liquidity stress, credit deterioration, or panic selling driving the markets, which is a good sign. We believe that if rate expectations stay the same, bonds will benefit from their higher yields. If the Fed is forced to back off and change course (which has happened several times since 2008), bond prices could rally. Even if market rates continue to rise from here, the current yields (which seemed to grow quickly near the end of the quarter, especially for corporate bonds) will serve as a greater buffer for returns this time around.

### STOCK MARKET CHECKUP

As much as inflation and interest rate talk have put the focus on bonds, equity markets underperformed bond markets in 2022, with many key indexes reaching bear market territory. The potential for future volatility remains high, particularly if economic concerns continue to grow. The pain hasn't been evenly distributed. Value stocks performed relatively well, while small caps and technology-related shares were hit particularly hard.

However, there is a silver lining to the volatility: Stock valuations have come down, particularly in the U.S. market. In May, the forward 12-month price-to-earnings ratio for the S&P 500 dropped below 18 for the first time since April 2020, then dipped to 15.8 in mid-June, well below the 19.4 recorded at the end of the first quarter, as well as five- and 10-year averages. Five- and 10-year averages reflect the historically low interest rates and the largely bull market conditions over those periods. Therefore in our view, valuations have gone from very expensive to slightly expensive. As with bonds, more reasonable prices bode well for future returns, though valuations may normalize further.

As you can see below, while both bonds and stocks have the potential to lose money in the short run, the longer you hold them, the greater the probability of a positive return.

## Our Investment Strategy

The chance of a recession in any given year is about 15%, and the near- to medium-term odds are higher now given all the issues we've catalogued here. Recessions happen, but investors should not necessarily fear them. While the odds of a recession have increased, a recession over the next couple of years is not a foregone conclusion—or even a base-case assumption—for many economists. Perhaps more important, the odds of a deep recession are even lower. Even if a recession were to occur, that could positively impact bonds.

Improving valuations is a reason for long-term optimism in equity markets. Bear markets are scary, but history has shown them to have good buying opportunities. While this bond drawdown has been historically bad, prior large declines have led to strong rebounds, signaling the importance of remaining invested. The longer you plan to hold bonds, the better returns you should receive as rates climb higher.

**BOND RETURNS FOLLOWING THEIR WORST 10 HISTORICAL DRAWDOWNS**

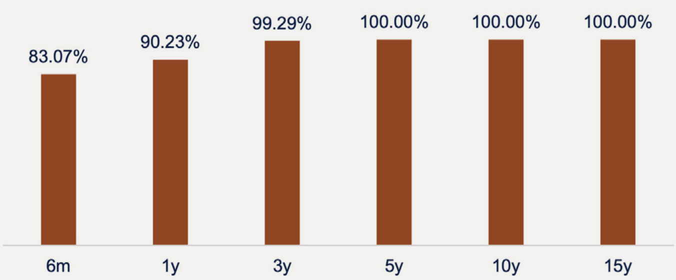
(1926 - 2022)

| Date | Drawdown Percentage | Drawdown Length (months) | 1-yr return | 3-yr return |
|---|---|---|---|---|
| Feb 1980 | -12.7% | 8 | 10.51% | 63.48% |
| Apr 2022 | -11.1% | 22 | ? | ? |
| Sep 1981 | -9.0% | 16 | 35.21% | 69.96% |
| Aug 1959 | -5.7% | 16 | 10.87% | 18.87% |
| Jan 1932 | -5.3% | 8 | 8.99% | 22.54% |
| Jun 1971 | -5.0% | 4 | 10.33% | 15.57% |
| Sep 1987 | -4.9% | 8 | 13.30% | 35.60% |
| May 1984 | -4.9% | 5 | 30.23% | 64.40% |
| Jun 1994 | -4.2% | 9 | 12.55% | 27.83% |
| Sep 1939 | -4.1% | 3 | 6.86% | 10.41% |

Source: Ibbotson® SBBI® US Intermediate-term Government Bond data and Bloomberg US Aggregate Bond Inde

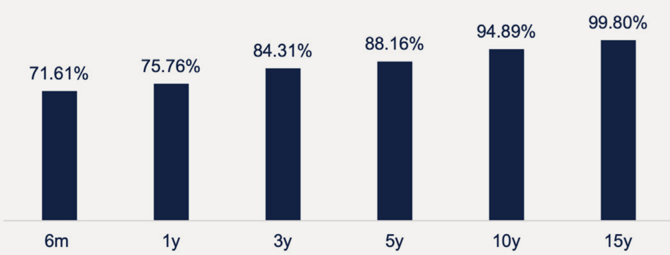
**PERCENTAGE OF POSITIVE U.S. BOND ROLLING PERIODS**

(1/1/26 - 5/31/22)




**PERCENTAGE OF POSITIVE U.S. LARGE-CAP STOCK ROLLING PERIODS**

(1/1/26 - 5/31/22)




Source: Ibbotson® SBBI® US Intermediate-term Government Bond. Bloomberg US Aggregate Bond Index.Ibbotson® SBBI® US Large-Cap Stock. S&P 500 data

Remember, the market is not just the S&P 500. Some areas of the equity market—value stocks, developed international, and emerging markets equities—are more reasonably priced than others and look attractive, especially over the long term. We also see opportunities in the bond market, where investors can find opportunities to increase yield without taking on too much interest-rate or default risk.

In the end, we believe that diversification is the best defense for uncertainty. Markets and asset classes cycle in and out of favor, and things can change very quickly, as we've seen this year. Innovative U.S. technology companies had many years of excellent performance but have struggled mightily in 2022. Commodities languished for nearly a decade before stealing the show in this inflationary environment. Trying to guess tomorrow's winner is a risky venture, but making sure you have a balanced, resilient portfolio puts the odds in your favor, especially over the long haul.

## Conclusion

The path to more reasonable or normalized interest rates—and valuations—is never easy, especially in the wake of years of strong market performance. Investors may face more turbulence in the days ahead, and yes, we may experience a recession. Nonetheless, it's worthwhile to step away from the emotional toll of seeing our portfolios decrease in the first half of 2022, take a deep breath, and note that much of the pain is likely behind us. Hopefully, we've ripped off the bandage, and we're ready to heal.