Market Commentary

The Quarter in Review – 2Q 2022

M·C·M

Performance

Both stocks and bonds were negative in the second quarter as markets moved to price in further interest rate hikes and an increased risk of recession. Equity declines have been widespread and not one of the eleven major stock market sectors posted a positive return for the quarter. The Energy sector remains the only real winner on the heels of higher oil prices, with an outlying +31.84% return thus far in 2022. The DJIA "led" the major U.S. indexes with a decline of -10.78% for the quarter, while the S&P 500 and the tech-heavy NASDAQ declined -16.10% and -22.28%, respectively. Non-U.S. equities suffered similar results amidst the turmoil as the MSCI EAFE Index lost -14.29% and the MSCI Emerging Markets Index fell -11.34%.

When equity markets struggle, fixed income securities usually provide some ballast. This has not been the case thus far in 2022. Bonds have provided no relief for investors as Fed rate hikes and traders' assessment of risk to the economy have caused yields to grind higher throughout the year. The 10-Year U.S. Treasury bond finished the quarter with a yield of 2.97%, nearly 70 basis points (+0.70%) higher than where it started, after rising as high as 3.49% in mid-June. As the ascent in yields continued, so did the move lower in bond prices. The Barclays Intermediate Government/Credit Bond Index and the Barclays 5-Year Municipal Bond Index declined -2.37% and -0.42%, respectively. Of the 186 quarters since 1976, a negative quarterly return for both stocks and bonds has occurred just twenty times, including 2Q 2022. Furthermore, over the same 46-year period, there are just five instances where both stocks and bonds were negative for two consecutive quarters as they have been in 2022.

15%+ Quarterly Drops for the S&P 500: Post WW2

Quarter	Quarterly Drop (%)	Next Quarter (%)	Next Half (%)	Next Year (%)
Sep-46	-18.83	2.27	1.40	1.00
Jun-62	-21.28	2.78	15.25	26.70
Jun-70	-18.87	15.80	26.72	37.10
Sep-74	-26.12	7.90	31.19	32.00
Dec-87	-23.23	4.78	10.69	12.40
Sep-02	-17.63	7.92	4.04	22.16
Dec-08	-22.56	-11.67	1.78	23.45
Mar-20	-20.00	19.95	30.12	53.71
Jun-22	-17.02	?	?	?
	Average	6.22	15.15	26.07
	Median	6.34	12.97	25.08

Source: Bespoke.

For the first half of the year, the bellwether S&P 500 Index declined -20.6%, its largest first half decline in fifty years and the third worst on record. Inflation, at forty-year highs, is the main source of financial markets' distress. Of course, there is also ongoing stresses related to COVID and Russia's invasion of Ukraine, the first major act of aggression and the largest humanitarian disaster in Europe since WWII. A lot of damage has been done in this bear market, with the average stock in the S&P 500 down –28.5%, and –35.7% for the average NASDAQ stock. Volatility, too, has been far above trend thus far in 2022. Of note, the S&P 500 experienced a daily range of greater than 1% in 90% of trading days in the first half of 2022. This is the highest reading since 2009, and ties for the third highest since 1982. Despite the current anxiety about future market direction, similar periods of instability and market declines in modern history have often corresponded with the type of capitulatory conditions from which positive returns follow.

Peak Inflation?

Monetary policy is tightening to address the inflation situation, and investors have re-priced risk and the increasing probability that we enter a recession along the way. June data will not be released until mid-July, but the May numbers released by the Commerce Department and the Bureau of Labor Statistics (BLS) revealed that two widely-followed inflation indicators, the Consumer Price Index (CPI) and the Personal Consumption Expenditure (PCE) Index, grew +8.6% and +6.3%, respectively, from year-ago levels. These figures remain elevated and are well-above the Fed's 2% target. Fed Chair Jerome Powell was asked last week at a panel discussion presented by the European Union what he would tell the American people about how long it will take for monetary policy to tackle the surging cost of living. He responded by saying his message would be, "we fully understand and appreciate the pain people are going through dealing with higher inflation, that we have the tools to address that and the resolve to use them, and that we are committed to, and will succeed in, getting inflation down to 2%. The process is highly likely to involve some pain, but the worse pain would be from failing to address this high inflation and allowing it to become more persistent." Rising rates have already negatively impacted consumer activity, with home purchase applications and refinancing activity down –17% and –78%, respectively, from year-ago levels. And there are some recent signs of price abatement in the commodity complex. Oil prices have declined from their mid-June peak of $120 a barrel to near $100. Other benchmark commodity prices, such as copper and lumber, have also declined significantly from recent highs.

The Fed was behind the curve and will need some skilled mastery to "thread the needle" by raising rates just enough to slow the economy and ease inflationary pressures without causing a recession. The Fed began their current hiking campaign in March when they raised rates from zero to 0.25%, the first such increase since 2018. In May, they raised the Fed Funds Rate again (+0.50%), followed by another hike in June (+0.75%), the largest since 1994. Current activity in Fed funds futures markets suggest another ~+1.50% worth of Fed hikes by February 2023, to a high of 3.4%, before dropping to 2.9% by December 2023.

ABOUT THE FIRM

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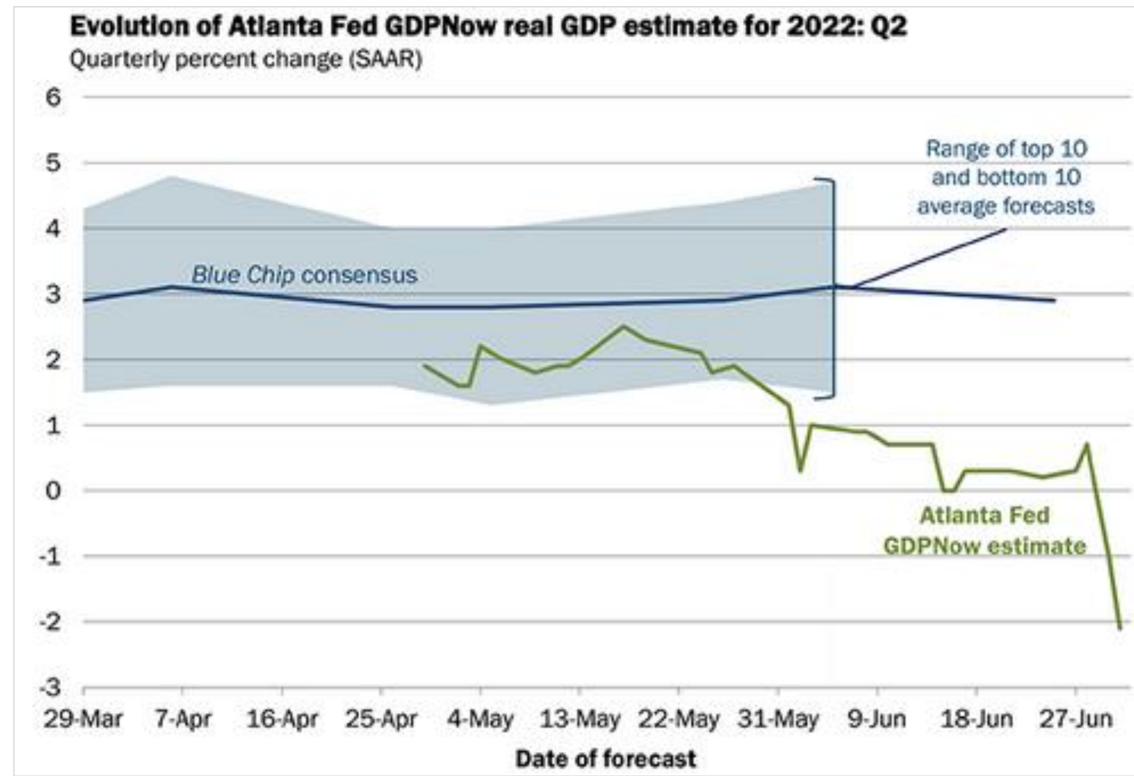
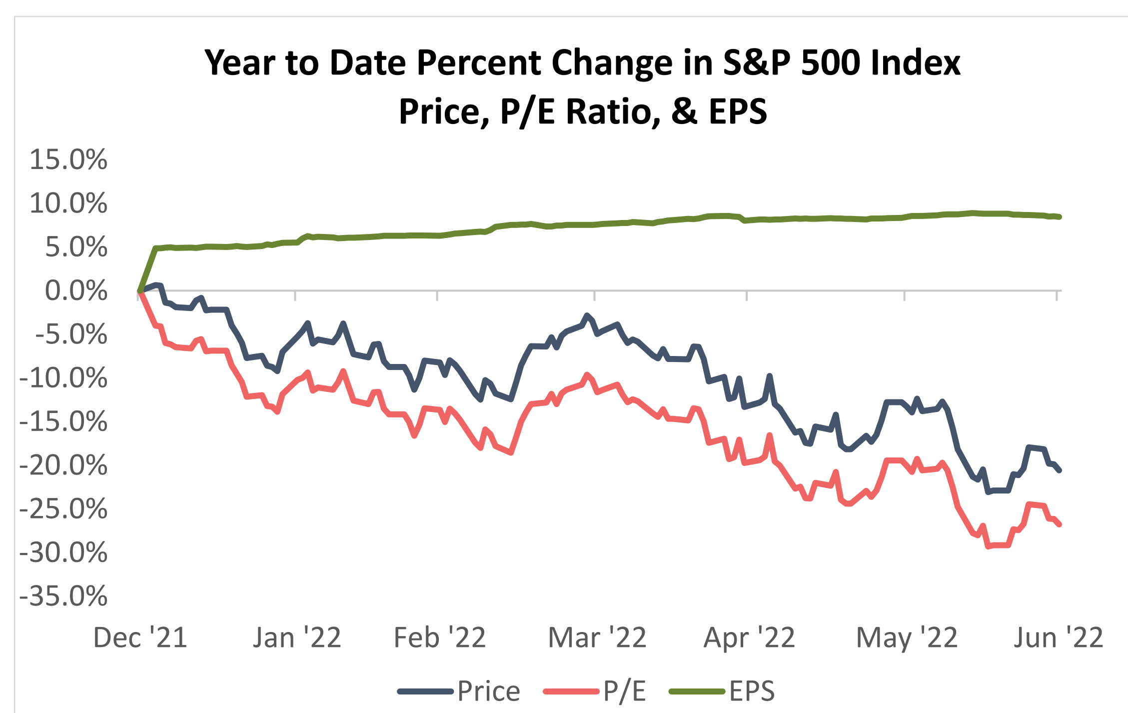
All Eyes On The Economy and Earnings



Source: Atlanta Fed GDPNow, Jones Trading.



Source: Strategas Research Partners.

As of the end of the quarter, an argument can be made that the economy is already starting to slow. Manufacturing activity, as measured by the Institute of Supply Management (ISM), was weaker than expected in June. ISM's Index of National Factory Activity dropped to 53.0 for the month, the lowest reading since June 2020. The New Orders Index also fell to 49.2 from 55.1 – showing contraction for the first time since May 2020. The Bureau of Economic Analysis's (BEA) official release of the initial 2Q GDP estimate will not be released until July 28, but the Atlanta Fed's GDPNow gauge suggests 2Q 2022 GDP is running at a negative -2.1% clip. This, coupled with 1Q 2022's decline of -1.6%, would technically indicate the U.S. is currently in a recession. Traditionally, two negative quarters signals a recession. But this is not necessarily the exact definition from the National Bureau of Economic Research (NBER), the official arbiter of such classifications. Their definition emphasizes that a recession is a significant decline in economic activity that is spread across the economy and that lasts more than a few months. Clearly, this leaves room for debate, and the determination is always retrospective, sometimes after multiple quarters and revisions. There is no precedent or playbook for the global shocks that have compounded on each other - pandemic, supply chain distortions, massive fiscal stimulus, and war. We would argue that we may already be experiencing what everyone is predicting we are heading for.

In the Labor Department's recent release of the May Job Openings and Labor Turnover Survey (JOLTS) report, job openings totaled 11.25 million for May. While this is a considerable drop from 11.68 million in April, there are still 5.95 million unemployed persons in the U.S.. That equates to a historically high ratio of 1.9 openings per every available worker. Fewer job openings have been on the Fed's wish list. Wage increases have been a main contributor to the inflation problem as companies have been forced to pay up for new hires. This is another complication for the Fed in the whole "soft landing" scenario. That is, can we slow down the economy enough to kill job openings without losing existing jobs?

Based on quarter-end data from FactSet, the current forward 12-month PE multiple for the S&P 500 is a reasonable 15.8x, below both the 5-year average (18.6x), and the 10-year average (16.9x), and a far cry from the record high set in 4Q 1999 (24.1x) prior to the tech bubble burst. Dating back to 1950, the average S&P 500 PE multiple when inflation was between 0 and 2%, was 18.1x. But when inflation is in the range of 2-4%, that average declined to 17.4x, and the 4-6% inflation range commanded a 15.1x PE multiple. The market bears are suggesting that earnings estimates still must come down. All the negative price action year-to-date has been from PE multiple compression, not a decrease in earnings expectations. The interesting thing is that negative earnings preannouncements were below normal over the past few months, and companies certainly had the opportunity in this market environment to "guide down" their numbers with relative impunity. During 2Q, analysts reduced estimates for the quarter by only -1.1%. During the past fifteen years, the average quarterly decline in bottom-up EPS estimates has been -4.7%. Earnings expectations for the full year 2022 remain at +10.2%, with revenue growth of +10.7%. If earnings expectations hold, stocks are inexpensive at these levels as more bad news appears to already be "priced in." 2Q 2022 earnings season is about to begin in earnest and we will be paying very close attention to company's comments on the business environment and how they manage investor expectations regarding future profitability.

Outlook

Strategas Research's Jason Trennert summed it up pretty well when he recently opined that, "Given a pandemic that shuttered the world's economy, and the overwhelming fiscal and monetary responses employed to combat the concomitant recession that followed, perhaps it's not all-that-surprising that the bill for the global economy would come due sooner or later. The real question now is whether that debt has been paid, at least metaphorically, or whether a balance remains." Interest rates are moving higher, although still at historically low levels. Consumers are experiencing elevated prices at the pump and elsewhere. We may or may not currently be in a recession. If not, the odds of recession in the coming quarters has certainly increased. The stock market is in bear market territory. The question for markets now, for which no one knows the answer, is – how much bad news is currently priced in to the markets? Many stocks are now trading back at pre-pandemic levels. Over $14 trillion in market value has been lost in the U.S. equity market alone (not to mention bonds, crypto currencies, etc.), dwarfing the $8 trillion that evaporated in the 2009 bear market. As we enter the dog days of summer and what is historically a seasonally weak period for markets, we remain focused on upgrading portfolios by finding high-quality, "shorter-duration" companies with strong cash flows and lower valuations. Higher interest rates means that bond yields are finally more attractive for balanced portfolios, especially in the shorter end of the yield curve. We anticipate continued choppiness over the coming months that could test investors' nerves. Markets will react to headline earnings results and guidance, consumer spending trends, and employment and inflation data. We remain committed to being a prudent advisor, adding value for our clients, and steadfast in our pursuit of delivering competitive risk-adjusted returns across MCM's various investment strategies. Thank you for the continued confidence you have placed in us. As always, do not hesitate to contact us should you have any questions or concerns.

Market Commentary

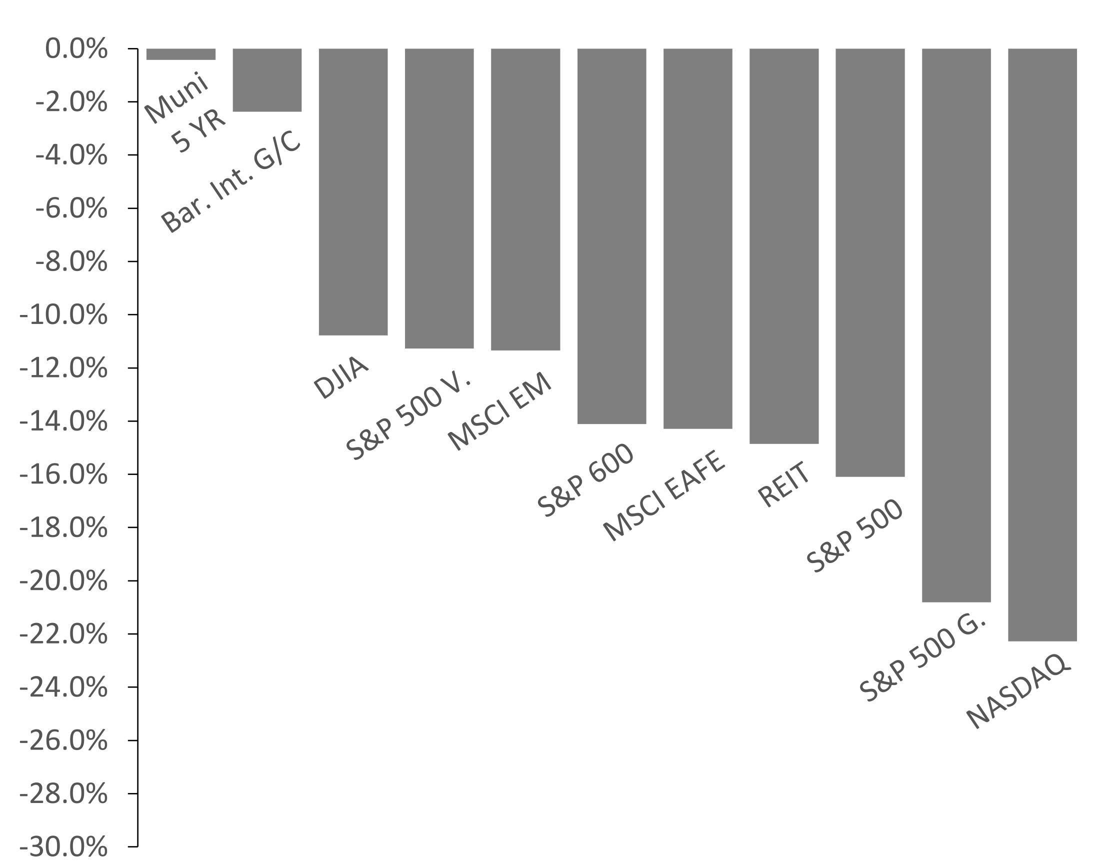
The Quarter in Review

Ranked by 2Q 2022 Performance

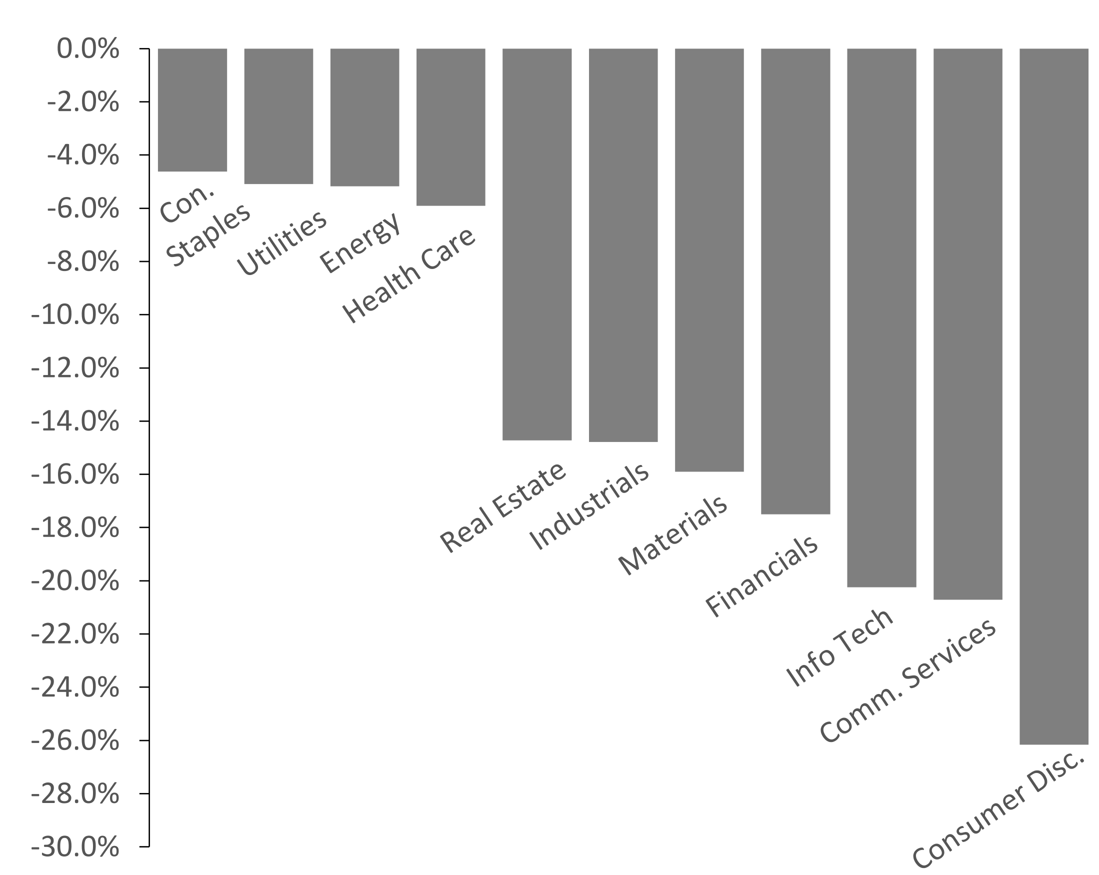
Major Market Indices	*Apr*	*May*	*Jun*	*Qtr*	*YTD*
Barclays Cap Muni Bond – 5 YR	-1.65%	1.56%	-0.31%	-0.42%	-5.50%
Barclays Int G/C (Bond Ind)	-2.00%	0.74%	-1.11%	-2.37%	-6.77%
DJIA	-4.82%	0.33%	-6.56%	-10.78%	-14.44%
S&P 500 Value	-4.86%	1.64%	-8.23%	-11.27%	-11.41%
MSCI Emerging Markets (EM)	-5.55%	0.47%	-6.56%	-11.34%	-17.47%
S&P 600 (Small Cap)	-7.81%	1.86%	-8.55%	-14.11%	-18.94%
MSCI EAFE (International)	-6.38%	0.89%	-9.26%	-14.29%	-19.25%
NAREIT All REIT	-4.03%	-4.32%	-7.27%	-14.85%	-19.31%
S&P 500	-8.72%	0.18%	-8.25%	-16.10%	-19.96%
S&P 500 Growth	-12.48%	-1.36%	-8.28%	-20.81%	-27.62%
NASDAQ Composite	-13.24%	-1.93%	-8.65%	-22.28%	-29.23%

U.S. Industry Groups	*Apr*	*May*	*Jun*	*Qtr*	*YTD*
Consumer Staples	2.56%	-4.61%	-2.50%	-4.62%	-5.58%
Utilities	-4.25%	4.32%	-4.98%	-5.09%	-0.55%
Energy	-1.54%	15.77%	-16.80%	-5.17%	31.84%
Health Care	-4.71%	1.44%	-2.66%	-5.91%	-8.33%
Real Estate	-3.56%	-5.02%	-6.90%	-14.72%	-20.02%
Industrials	-7.53%	-0.48%	-7.40%	-14.78%	-16.79%
Materials	-3.49%	1.14%	-13.84%	-15.90%	-17.89%
Financials	-9.87%	2.73%	-10.90%	-17.50%	-18.73%
Information Technology	-11.28%	-0.85%	-9.32%	-20.24%	-26.91%
Communication Services	-15.62	1.79%	-7.69%	-20.71%	-30.16%
Consumer Discretionary	-13.00%	-4.85%	-10.80%	-26.16%	-32.82%

2Q 2022 Index Returns



2Q 2022 Industry Group Returns



Source: FactSet