Beacon Trust
INNOVATING WEALTH STRATEGY

Market Outlook 2Q 2022 Review **July 7, 2022**

Second Quarter Summary

The S&P 500 experienced its worst six months to start a calendar year since 1970, falling 20%. To make matters worse, most bond indexes have also dropped sharply, with the benchmark Bloomberg Barclays U.S. Aggregate Bond Index down 10.2% for the calendar year. In terms of quarterly damage, the losses for Q2 were 16.4% and 4.6%, respectively. A traditional 60% stock / 40% bond portfolio lost roughly 16% so far, the worst combined performance since at least 1976. Quite simply, traditional diversification approaches have largely failed. The main culprit, of course, was rising inflation, with the latest inflation rate reading of the Consumer Price Index (CPI) at an uncomfortable 8.6%, the highest since December 1981.

The Federal Reserve acknowledged that they are behind the curve in tackling inflation and have aggressively commenced financial tightening measures. Specifically, they increased the Federal Funds Rate by 0.75% in June and are expected to take a similar course of action at their July meeting. Futures markets are estimating that short-term interest rates will be 3.5% by the end of the calendar year, a far cry from the roughly 0% rates that have existed since the beginning of The Great Recession. The Fed has also started to shrink its balance sheet, which has resulted in an increase in long-term interest rates that are especially relevant for mortgage loans and corporate borrowings.

Market Outlook

A combination of high inflation, an aggressive Fed, continued supply chain complications, the war in Ukraine, and lingering COVID related problems have put the U.S. and many international economies on the brink of a recession. In fact, our base case is that we are in the early stages of a recession or likely to enter one within a matter of months. As we have communicated in our prior writings, the most comparable era to the present is the 1980-1982 time period. During that time the Fed was also aggressively raising rates and helped tilt the economy into a recession. Although history never repeats itself exactly, the bear market during the early 1980s resulted in a peak to trough loss for stocks of roughly 30%. If there is some light at the end of the tunnel it is that financial markets typically begin to rise 3 to 6 months in *advance* of the end of the recession.

Patience is not only a virtue, but a necessity for successful long-term investing. In fact, historically the stock market has had strong returns precisely because of its volatility. If an asset went straight up with little risk, the returns should be comparable to U.S. Treasury Bills. During frustrating periods for the financial markets, it often helps to have a long-term perspective. Below, we reproduced a table distributed internally by a Beacon colleague.

Year	S&P 500 Return
2022	-20.00
2021	28.71
2020	18.40
2019	31.49
2018	-4.38
2017	21.83
2016	11.96
2015	1.38
2014	13.69
2013	32.39
2012	16.00
2011	2.11
2010	15.06
2009	26.46
2008	-37.00

The data in the table show that despite the severe pain experienced by most investors on a year-to-date basis, recent stock market returns have been exceptional. Historically, U.S. stocks return about 10% per year and 2022 comes on the heels of performance for U.S. stocks that have roughly doubled or tripled this figure. In fact, prior to this year, it was largely smooth sailing for U.S. stocks since the end of the Great Recession in early 2009. The slight market drop in 2018 was a mere pause in a relentless bull market that lasted about a decade.

As we enter earnings season, given the problems cited previously, it is hard to envision most companies painting a rosy picture regarding near-term earnings. Indeed, consumer spending bellwethers Walmart and Target pre-announced disappointing earnings citing consumer belt tightening in the midst of inflationary pressures. Furthermore, Microsoft reported that the strong U.S. Dollar will negatively impact earnings, a story that is likely to be repeated among stocks with heavy international exposure. We expect continued volatility until signs emerge that inflation is under control, the Fed is close to ending its rate hiking cycle, and supply chain functioning further approaches something resembling normality.

In our view, the bulk of the damage in the fixed income markets has already been done. In fact, the yield on the benchmark 10 Year Treasury Note has fallen from roughly 3.5% to 3.0% in a just the past few weeks. We expect the 10 Year Treasury to be largely restricted to the 2.5% - 3.5% area, with the odds skewed to the higher end of the range. Accordingly, on a forward looking basis, bonds may revert to their typical functions of providing income and some protection to offset stock market volatility.

Risks are ever present in the financial markets. In addition to the inflationary and recession risks discussed in this writing, we must also acknowledge the elephant in the room. Although we hope for a quick and sustainable peace process, there is a small, but non-negligible, risk that we face the prospect of World War III if the Russia-Ukraine War spills over into a NATO country. Indeed, the risk is significant enough that Finland and Sweden will soon become members of NATO. Although the Russia-Ukraine War appropriately garners the bulk of the international headlines, the long-term direction of China-U.S. relations poses a bigger threat to the global economy given the enormous size of the world's two biggest economies.

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