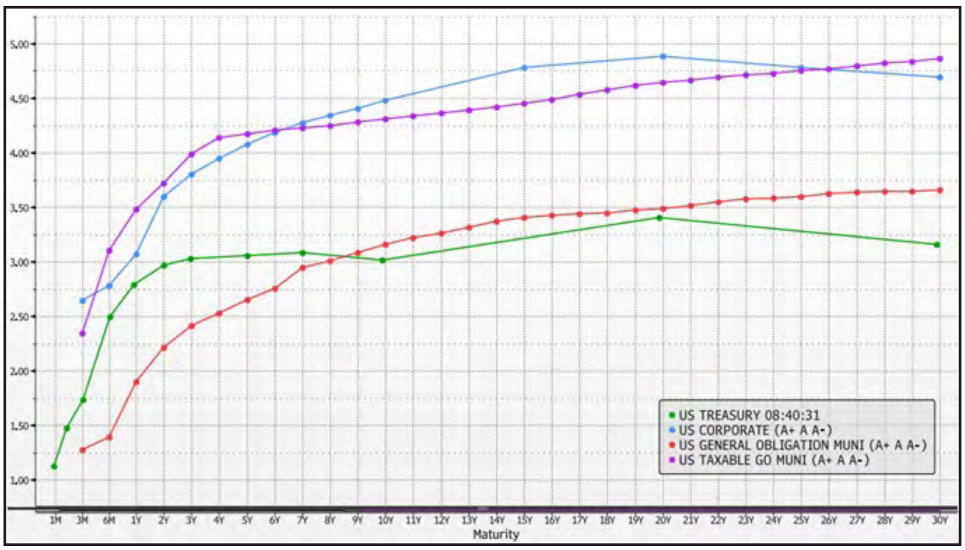
A View FROM THE TOWER

The second quarter of 2022 was once again filled with headwinds, not only on the broad, global equity front, but also in the fixed-income segment. Although equities rebounded slightly in May after a particularly difficult April, June returned to the downside as stocks posted back-to-back quarterly declines for only the fourth time since World War II. Additionally, bond prices and corresponding yields experienced material volatility throughout the quarter as rates once again increased significantly across the yield curve.

Yield Curve as of 06/30/2022

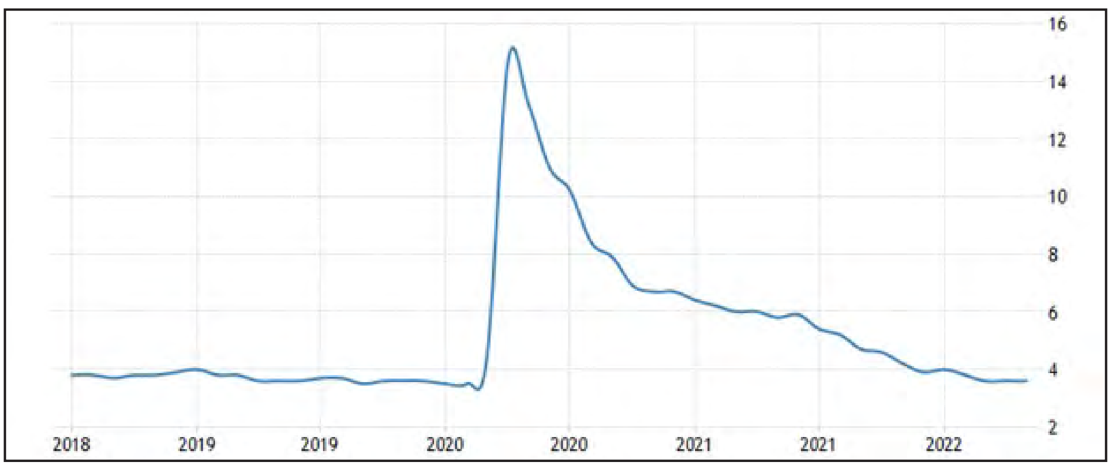


At the risk of being redundant, one dynamic we noted as we entered 2022 was mid-term election years tend to be the most volatile within the four-year presidential cycle. They often include many relatively sharp stock market selloffs, accompanied by strong rebounds. This has certainly been the experience so far this year. There have been numerous volatile days (and even weeks). However, activity has been more to the negative than the positive to date, resulting in the fourth worst start to a year since 1927, surpassed only by 1932, 1940 and 1970.

Some of the reasons for this environment were anticipated: the continuation of labor issues, supply chain disruptions, inflation concerns and higher interest rates. On the positive side of the ledger, significant liquidity, strong consumer financial positions/spending and stellar corporate profits were thought to have been positioned to provide ample support. As tends to happen, however, the unexpected can arise and tilt the scales. Certainly, this has been the case in regard to the Russian invasion of Ukraine. In addition to the ongoing, horrible devastation and human tragedies accompanying this unfortunate event, the economic uncertainties surrounding it have produced financial market skittishness, including a spike in oil prices, a key Russian commodity. Ukraine's significant agricultural exports have also been impacted. The concern is not only the fueling of additional inflation pressures (and consequently on interest rates as well), but also a global economic slowdown.

Speaking of interest rates, which rose considerably during the second quarter, the Federal Reserve has pivoted to a much more hawkish position than initially expected in an effort to crush inflation for the first time since 1982. Approaching 2022, we knew the Fed would be tapering bond purchases and we were under the assumption/guidance that up to three rate hikes would be in the offing this year. To date, the Fed has already made three moves totaling 1.50%, including .75% in June, with four more expected during the July, September, November and December meetings; possibly totaling an additional 1.75% prior to year-end.

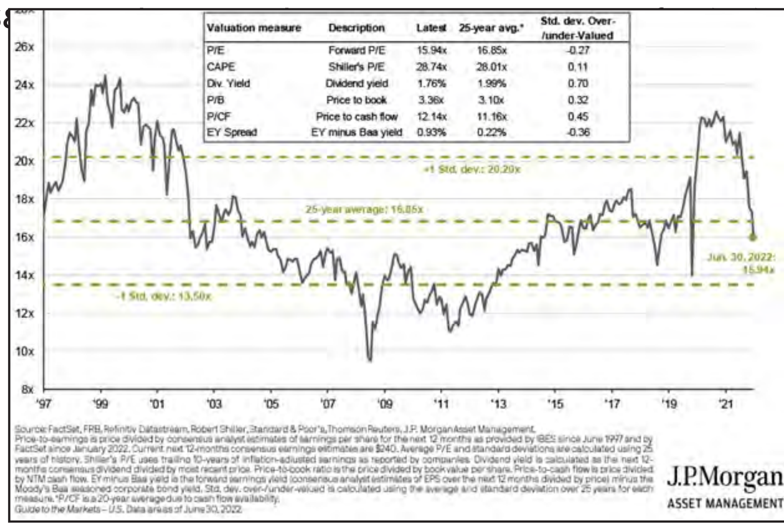
Additionally, as planned, the Fed will be shrinking its balance sheet by letting its bond positions "runoff" at a rate of $95 billion monthly. A worry is that this rate hike process will result in an overly corrective pendulum swing, with the Fed feeling it is "behind the curve," resulting in a "policy mistake" and consequently a potential recession. An outcome of this environment could be a slowdown of what has been a robust U.S. housing market, as rising mortgage rates (recently reaching the 6% level) impact affordability. Also, we will continue to keep tabs on any yield curve inversions (defined as a scenario where shorter-term U.S. Treasury securities yield more than their longer-term counterparts) because this circumstance is often a precursor to an economic slowdown. However, historically there has been a lag time with any recessions connected to inversions, ranging from 7 to 35 months, with an average of 20 months. Also, a U.S. recession tends to go hand-in-hand with labor market weakness, which as alluded to, is not the dynamic currently.



Source: TRADINGECONOMICS.COM | U.S. BUREAU OF LABOR STATISTICS

At the end of the day, will the Fed be able to corral inflation and succeed in having a "soft landing"? It will not be easy. The Fed is in the early stages of its tightening cycle. Historically, to get control of inflation, the Fed Funds Rate (currently targeted at 1.50% to 1.75%) needs to exceed the inflation rate. It has been debated whether or not the Fed's actions will indeed have the intended impact on reducing inflation given the Russia/Ukraine situation, which is outside of its control. An additional dynamic is that a significant portion of the current inflation scenario seems to be supply-side driven as supply chain issues around the globe continue. This would seem to be more difficult for the Fed to impact than the more traditional demand side scenarios. Also, we should consider the general make up of the U.S. Consumer Price Index, which is 20% food and energy, 20% core goods; and 60% services. Aside from Fed moves, one would think that a reduction in supply bottlenecks would help. Ongoing COVID-related shutdowns in China have been a major culprit in this regard. However, the recent news on this front has been more positive as Beijing and Shanghai have relaxed restrictions, including reducing the quarantine period for visitors from three weeks to 10 days.

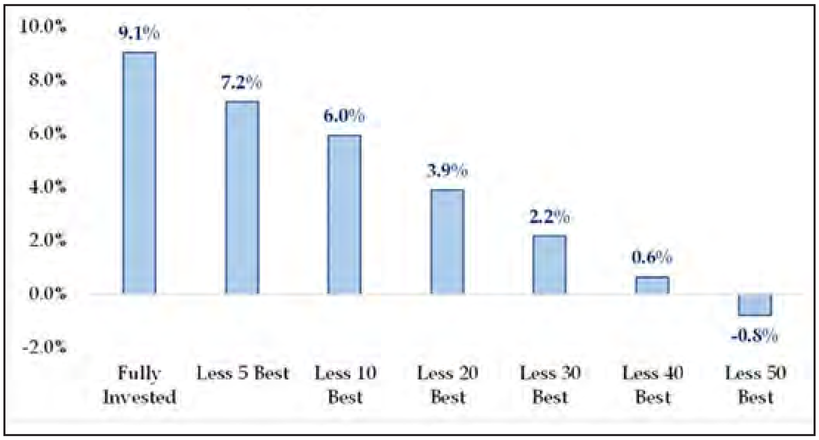
As one would imagine, this has been quite a lot for the financial markets to digest. Concerning stocks specifically, to date we believe the primary reason for the negativity has been the inverse relationship between inflation/interest rates and earnings multiples. As inflation and interest rates rise, price earnings ratios tend to compress, and this has been the scenario in 2022. So far, at least, there has not been a wave of downward earnings revisions. However, this is a concern on Wall Street and something we do have on our radar.



On the political front, Build Back Better (now known as Build Back Smaller) legislation, which has been considered dead multiple times, now has some new life in what would likely be a very trimmed down version, as key senators Joe Manchin and Chuck Schumer have been in productive revival talks. Additionally, due to the significant increase in gasoline prices, President Biden has called on Congress to pass a three-month suspension of federal taxes on gasoline and diesel, which amounts to 18 and 24 cents respectively. However, "within the beltway" prognosticators generally feel this has little chance of passage.

Despite the difficult market environment so far this year, we remind you once again we believe the race is usually won by the investor focused on the long-term versus those chasing the illusion of "timing." Missing just a handful of market "best days" could result in a materially lower long-term, realized return. Despite discomfort during times of uncertainty, discipline and patience have historically been rewarded in the long run. We continue to note the S&P 500 has not declined in the 12 months following a mid-term election since 1946.

S&P 500 Compound Annual Growth Rate
(January 1, 1995 - December 31, 2021)



Source: STRATEGAS

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Thank you!

Take care!

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