Market Commentary
June 30, 2022

Quarterly Market Review

Global equity markets posted their sharpest decline since the 2020 COVID crisis. A tightening Fed, runaway inflation, China COVID lockdowns, the Russia/Ukraine war and recession alarms all weighed on risk assets for the quarter.

The S&P 500 posted back-to-back quarterly declines for the first time since the 2008-2009 financial crisis pushing major averages into a bear market (-20%) for 2022. Valuation concerns and earnings revisions continue to override the strong labor market dynamics and healthy consumer spending trends.

Foreign markets, while in the red for the year have held up relative to U.S. equities given the more attractive valuations and the prospects of a less hawkish central bank in Europe and Japan. However, the uncertainty surrounding the Russian/Ukraine war and supply pressures on oil and natural gas will provide a significant headwind the Eurozone economy.

Emerging markets continue to suffer under a strong dollar, rising interest rates and supply chain disruptions. EM has now posted four consecutive negative quarters. While commodity markets remain extremely volatile, recent declines in oil, copper, precious metals, lumber, and grains may be signaling that a decline in headline inflation is on the horizon.

Turning to the bond market, investors in fixed income have witnessed a once in a lifetime decline in bond prices with the U.S. Aggregate Bond Index falling -10% for the first half of 2022, the sharpest decline on record. Rising interest rates and runaway inflation have effectively deflated the decade long bond market bubble.

Looking deeper into the bond markets, investors continue to “price in” several more rate increases from the Federal Reserve. The two-year Treasury yield at 3.0% and Fed Funds at 1.75% would imply another 1.25% increase over this Fed tightening cycle. In addition, the five-year Treasury breakeven yield of only 2.5% (the difference between five-year inflation protected securities or TIPS and the 5-year Treasury bond) implies an eventual slowing of the inflation narrative over the next five years.

Global Economic Outlook *

United States: A second estimate confirmed that the economy contracted in Q1, driven by lower private inventory investment and defense spending, and a negative contribution from net exports. However, the economy’s underlying strength remained intact, with private consumption and fixed investment gaining steam. Turning to Q2, GDP is likely rebounding and is set to grow above 3.0% in quarter-on-quarter SAAR terms, as the contributions from net exports, government spending and inventories improve. Moreover, consumer spending has so far remained robust in the face of elevated price pressures—as shown by brisk retail sales growth in April—thanks to strong employment gains, the fading impact of the pandemic and households running down savings. That said, widespread labor shortages are constraining business activity, and PMI data suggests the manufacturing sector lost some steam at the outset of Q2.

Growth will slow in 2022 from 2021, on tighter financial conditions. That said, the buoyant labor market will support private consumption, investment should stay healthy as firms look to boost productive capacity, and the Ukraine war will support the energy sector. Possible new Covid-19 variants, an intensification of the war and tensions with China are risks. Analysts see GDP growing 2.8% in 2022 and 2.0% in 2023.

Eurozone: The economy likely expanded at a milder pace in Q2 compared to Q1. In April, industrial production increased timidly, restrained by surging energy prices and supply shortages. Meanwhile, retail sales took a hit amid soaring inflation and souring consumer sentiment. Consumer sentiment remained deeply entrenched in negative territory during May and June, with purchasing power squeezed by a further spike in inflation. Finally, sovereign bond rates have risen. On the other hand, the PMI readings have remained in expansionary terrain in Q2. In June, the EU approved a sixth round of sanctions against Russia, targeting oil and top bank Sberbank, and it signed a gas deal with Israel and Egypt to diversify energy provision away from Russia. Meanwhile, tensions are mounting between the UK and EU, with potential implications for trade, over the former’s attempts to rewrite trading rules for Northern Ireland.

Harmonized inflation jumped to a series high of 8.1% in May, from April's 7.4% reading. Loose fiscal and monetary policies, elevated commodity prices and supply chain disruptions will stoke inflation this year. The fallout from the war in Ukraine, second-round effects and further lockdowns in China pose upside risks.

China: The economy lost significant steam in early Q2 on widespread Covid-19 lockdowns: In April, retail sales and industrial production recorded their sharpest annual contractions since early 2020. The economy regained some momentum in May, as the impact of the pandemic ebbed, with retail sales, industrial production, fixed investment, and export figures all beating expectations. However, overall activity remained downbeat, with the housing market particularly depressed. Towards the end of Q2, the marked fall in total Covid-19 cases and the recent easing of lockdowns in many areas—including Shanghai—will aid household spending, exports, and industrial activity. On the other hand, the threat of further stop-start restrictions will continue to weigh on sentiment, with Beijing and Shanghai resuming mass testing in mid-June in response to the emergence of new Covid-19 clusters.

Growth will slow sharply this year due to the government's tough pandemic measures, the steep property downturn and cooling export growth. That said, stronger infrastructure stimulus should provide some support. Downside risks include persistent Covid-19 restrictions and a deepening of the property crisis, while the possibility of a rollback of U.S. tariffs is an upside risk. Analysts expect GDP to expand 4.4% in 2022 and 5.2% in 2023.

Investment Strategy & Outlook

"Bull markets don't die of old age, they are murdered". Indeed, investors are getting a front row seat of the "crime" and how a policy mistake can impact markets. Admittedly, we have been somewhat critical of the Central Bank over the last several years: Zero Interest Rate Policy (ZIRP), financial repression, negative bond yields, QE infinity, trillions in stimulus. It all seemed like an unsustainable policy that would ultimately end badly for investors.

This unprecedented global central bank experiment, which began decades ago and originated in Japan back in the late 1990s remains in play. The Federal Reserve and the European Central Bank now have the incredibly difficult task of bringing inflation under control without sending the global economy into recession. The track record for the Fed is not good with 1973-1974, 1982-1983 being the most painful on record. Their only success was 1994 when the Fed raised rates 300 basis points and avoided a recession.

Since 1950, the U.S. has experienced 11 recessions with the average length being 10 months and an average contraction in GDP of -3.9%. In each case the Fed was in a tightening cycle and the yield curve was inverted, i.e., short term yields were higher than long term yields. By comparison, the current yield curve has inverted, Q1 GDP print was -1.6% and the Fed is expected to raise rates another 175 basis points before year end. So, if history is any guide the recession probability is rising but not necessarily a foregone conclusion. The labor market remains very strong, consumer spending while slowing is above trend, corporate balance sheets are flush with cash, the inflation narrative is showing signs of easing and the first print of Q2 GDP is forecasted to be 2.2%, not a contraction.

In our view a recession in 2022 is unlikely but a slow down in economic growth and corporate earnings should be expected given the headwinds of inflation and higher interest rates. Markets are always forward looking and have priced much of this outlook in over the last several months. Several sectors of the U.S. equity market are down -20% to -35% year to date with energy the only sector positive thanks to the surge in oil prices.

While we continue to overweight equities, the selloff in bonds has created pockets of value in short term investment grade bonds. Finally, while rising interest rates will serve as a headwind for equities in the near term, dividend growth stocks and value-oriented strategies will likely continue to outperform non-dividend growth stocks over the medium term in our view.

Capital Markets Scorecard

Benchmark Description	Q2	YTD	1 Year
U.S. Treasury 3 Month T-Bill	0.1%	0.15%	0.17%
Barclays Aggregate Bond Index	-4.7%	-10.4%	-10.2%
Bloomberg US High Yield Bond	-9.8%	-14.2%	-12.9%
S&P 500 Index Total Return	-16.1%	-19.9%	-11.1%
NASDAQ Composite TR	-22.3%	-29.2%	-23.5%
NASDAQ Dividend Achievers TR	-11.4%	-15.7%	-6.1%
Russell 2000 Index TR	-17.2%	-23.4%	-25.8%
Alerian MLP Index TR	-7.4%	10.0%	3.0%
MSCI Emerging Markets Index	-11.9%	-17.2%	-25.1%
China SCI 300 Index LC	7.3%	-8.3%	-12.5%
U.K. FTSE 100 Index LC	-3.7%	-1.0%	4.4%
Japan Nikkei 225 Index LC	-4.9%	-7.3%	-6.2%

*Market Scorecard data as of 06/30/2022. Stokes Capital Advisors, LLC is a Registered Investment Adviser. * Global Economic Outlook provided by Focus Economics. This market commentary is solely for informational purposes. Advisory services are only offered to clients or prospective clients where Stokes Capital Advisors, LLC and its representatives are properly licensed or exempt from licensure. Past performance is no guarantee of future returns. Investing involves risk and possible loss of principal capital. No advice may be rendered by Stokes Capital Advisors, LLC unless a client service agreement is in place.*