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Mid Year Review & Outlook: Dual Threats: Inflation & Recession

As we close the books on the second quarter, markets continue to focus on the dual threats of inflation and recession. The war in Ukraine continues, but no longer dominates the daily news. Oil prices remain stubbornly high and a key component of the inflation story.

Due to the Fed's inability to have a direct impact on high oil prices and lingering supply chain issues, they have taken strong action in raising the Fed Funds rate in an attempt to slow overall demand.

Capital Markets Review

June saw continued negative signs on virtually all asset classes, exacerbating declines on the year. U.S. large cap stocks finished the quarter down 16%, bringing the year-to-date numbers to a 20% decline. U.S. small cap fared a bit worse, down 17% on the quarter and -23.4% on the year. International stocks were down a bit less on the quarter, with emerging markets down 11.4% and developed markets down 14.5%.

As interest rates across all maturities continued to rise, bond markets suffered some of the worst declines in history. The U.S. Aggregate bond index has sustained a 10.3% decline for the first half of 2022, while high yield is down 14.2% and EM debt is down 20.3%. Alternative investments, as measured by the HFRX Global Hedge Fund Index, were down 5.1% for the first half of 2022. While we don't enjoy showing negative signs in client portfolios, our underweight position in fixed income and overweight to alternative strategies helped to limit losses.

Asset Class Returns

Asset Class	Index	June 2022	Q2 2022	YTD
U.S. Large Cap	S&P 500	-8.3	-16.1	-20.0
U.S. Small Cap	Russell 2000	-8.2	-17.2	-23.4
International Developed	MSCI EAFE	-9.3	-14.5	-19.6
Emerging Markets	MSCI EM	-6.6	-11.4	-17.6
U.S. Investment Grade	Barclays U.S. Aggregate Bond	-1.6	-4.7	-10.3
U.S. Inflation-Indexed	Barclays U.S. TIPS	-3.2	-6.1	-8.9
U.S. High Yield	BBgBarc U.S. Corp High Yield	-6.7	-9.8	-14.2
EM U.S. $ Debt	JPM EMBI Global	-6.2	-11.4	-20.3
Absolute Return	HFRX Global Hedge Fund	-1.8	-3.8	-5.1

Source: Morningstar

Sector Review

Energy remains the only sector with positive returns on the year in 2022, despite a -16.8% return in June. After peaking at $123.70 in March, West Texas Intermediate Crude Oil finished the quarter priced at $105.76, as U.S. oil rig counts remain stubbornly below levels seen earlier this decade (Source: FactSet). The supply/demand imbalance is obviously key to solving the inflation problem in a post-pandemic world.

Sector Returns: Q2 and 2022

Sector	Index	June 2022	Q2 2022	YTD
Energy	S&P 500 Sec/Energy TR USD	-16.8	-5.2	31.8
Utilities	S&P 500 Sec/Utilities TR USD	-5.0	-5.1	-0.6
Consumer Staples	S&P 500 Sec/Cons Staples TR USD	-2.5	-4.6	-5.6
Health Care	S&P 500 Sec/Health Care TR USD	-2.7	-5.9	-8.3
Industrials	S&P 500 Sec/Industrials TR USD	-7.4	-14.8	-16.8
Materials	S&P 500 Sec/Materials TR USD	-13.8	-15.9	-17.9
Financials	S&P 500 Sec/Financials TR USD	-10.9	-17.5	-18.7
Real Estate	S&P 500 Sec/Real Estate TR USD	-6.9	-14.7	-20.0
Information Technology	S&P 500 Sec/Information Technology TRUSD	-9.3	-20.2	-26.9
Communication Services	S&P 500 Sec/Commun Services TR USD	-7.7	-20.7	-30.2
Consumer Disc	S&P 500 Sec/Cons Disc TR USD	-10.8	-26.2	-32.8

Source: Morningstar

Investment Themes Review

THEME 1: COVID SLOWS, ECONOMIC REOPENING ACCELERATES

The U.S. consumer behaved as expected in the second quarter of 2022 as concerns over COVID-19 continued to fade. With case counts far below the pandemic's peak and fatalities at low levels, consumers continued to return to life outside the home. As of June 30, hotel occupancy, U.S. seated diners and TSA traveler traffic had returned to levels just below figures seen in 2019.

The labor market continues to look strong with the June unemployment rate coming in at 3.6%, just above the 50-year low seen in 2019. Demand for labor continues to be strong as well with the economy showing 5.45 million more job openings than unemployed workers in May (Source: JPMorgan).

The acceleration in consumer demand due to the economic reopening and lack of supply, has resulted in imbalances in the global economy, and has created an environment where inflation, has continued to persist. This has increased the probability of the economy slipping into a recession in the coming quarters.

Supply Chain disruptions are starting to improve. However, we need to keep an eye on areas such as wage inflation which tend to be "stickier." We would expect positioning for elevated inflation to remain an important part of our job as portfolio managers throughout 2022.

THEME 2: FED TAKES ACTION TO NORMALIZE RATE STRUCTURE

With a markedly improved labor market and persistently high levels of inflation the Federal Reserve has continued, as we had expected coming into 2022, the process of normalizing interest rates.

As of June 30, the Fed has increased the federal funds rate to a target level of 1.50-1.75%. Expectations are that the Fed will increase by another 0.75% at their July meeting, with a year-end target of 3.25-3.50%. In addition, after ending its bond purchase program ("Quantitative Easing") in March, the Fed has begun its bond sales program ("Quantitative Tightening") ramping up bond sales from $47.5 billion per month to $95 billion per month in September 2022. With the combination of increasing the fed funds rate and ending its "QE" program, the Fed hopes to engineer a "soft landing" to slow the economy enough to bring inflation back down to reasonable levels without causing a recession.

Better U.S. Treasury yields for income investors

The chart below shows the dramatic year-over-year increases in U.S. Treasury yields across the curve. The Fed's actions and guidance have resulted in significant repricing in the bond market, with asset values falling and market volatility increasing. Bond values will continue to be challenged until the Federal Reserve ends its rate normalization process and core levels of inflation return to their long-term target of 2%.

The silver lining should eventually turn out to be better yields for income-oriented investors and better returns for more "balanced" investors who prefer a combination of stocks and bonds in their portfolio.

Maturity	July 5, 2022 YIELD	One Year Ago YIELD	Change in YIELD
1M	1.23	0.04	1.19
3M	1.65	0.04	1.61
6M	2.44	0.05	2.39
1Y	2.63	0.07	2.56
2Y	2.82	0.25	2.57
3Y	2.82	0.47	2.35
5Y	2.82	0.90	1.92
7Y	2.87	1.24	1.63
10Y	2.83	1.47	1.36
30Y	3.07	2.09	0.98

Source: FactSet

THEME 3: EQUITIES EXPECTED TO RECOVER – AND LEAD

We expect equities to recover in the months ahead, as investors digest the "normalization" process in the global economy. Supply/demand imbalances resulting from the pandemic were to be expected, given the global shutdown, but the war in Ukraine was the curve ball that has complicated the recovery.

Providing us with hope is history which shows that following challenging periods in the market they have tended to see very strong returns over the subsequent 12 months. In fact, since 1980 the average market drawdown has been 22.10% and has had a duration of 186 days. The average return 12 months later has been 33.2%.

With that said, we do believe selectivity in equity exposure has become even more important. The Webster investment team is focused on finding companies with more sustainable earnings growth which has returned as the main driver of equity returns.

Returns 12 Months After 10%+ Stock Market Drawdowns Since 1980

Start	End	# of Days Peak-to-Trough	Losses	Returns 12 Months Later	State of Economy
02/13/1980	3/27/1980	43	-17.1%	37.1%	Recession
11/28/1980	8/12/1982	622	-27.1%	58.3%	Recession
10/10/1983	7/24/1984	288	-14.4%	29.6%	Expansion
8/25/1987	12/4/1987	101	-33.5%	21.4%	Expansion
1/2/1990	1/30/1990	28	-10.2%	5.6%	Expansion
7/16/1990	10/11/1990	87	-19.9%	29.1%	Recession
10/7/1997	10/27/1997	20	-10.8%	21.5%	Expansion
7/17/1998	8/31/1998	45	-19.3%	37.9%	Expansion
7/16/1999	10/15/1999	91	-12.1%	10.2%	Expansion
3/24/2000	10/9/2002	929	-49.1%	33.7%	Recession
11/27/2002	3/11/2003	104	-14.7%	38.2%	Expansion
10/9/2007	3/9/2009	517	-56.8%	68.6%	Recession
4/23/2010	7/2/2010	70	-16.0%	31.0%	Expansion
4/29/2011	10/3/2011	157	-19.4%	32.0%	Expansion
11/3/2015	2/11/2016	100	-13.3%	26.6%	Expansion
1/26/2018	2/8/2018	13	-10.2%	4.9%	Expansion
9/20/2018	12/24/2018	95	-19.8%	37.1%	Expansion
2/19/2020	3/23/2020	33	-33.9%	74.8%	Recession
January 2022	June 2022	72	-20.0%	?	Expansion
Average		186	-22.1	33.2	

Source: FactSet

Portfolio Positioning

Investors currently face the challenge of high inflation, rising interest rates, continued (but improving) supply chain disruptions and extreme geopolitical turmoil. As tragic as the Russian invasion of Ukraine is, the likely fallout from an economic perspective is somewhat limited, and it factored into our asset allocation positioning.

We remain bullish, with the understanding that volatility will spike as data points surprise on the downside. The influence of higher interest rates and stubborn inflation data will put a drag on the economy, but we don't see a recession on the immediate horizon.

Maintain Slight Equity Overweight:

As we entered 2022, we were cautiously optimistic on equities, particularly relative to fixed income. Obviously, equity markets all over the globe have had a brutal start to the year. While market activity has been disconcerting, we are focused on looking past the next few months when making our strategic positioning decisions. As a result, we maintain our cautiously optimistic stance on equities moving forward.

History of making a strong comeback

While we certainly don't know when equities will fully recover, we are confident that over time they will. One of the best cases to make for equities right now is simply our belief that stocks tend to come back very strongly from episodes like the one we are currently in – and you don't get an "all clear" warning before they begin to recover. Staying the course in equities is therefore prudent for long term investors.

Strong job market and low unemployment

Another reason we are optimistic on equities right now is the economy. That may seem like an odd statement given all the calls for recession in the financial media right now. While it is a possibility that the Fed over-tightens monetary policy and tips us into a recession (Jerome Powell told Congress as much in June), we would enter such a recession in a very different place than usual. The labor market is in a historically strong position, having added an average of 488K jobs per month so far in 2022 (source: Bureau of Labor Statistics), and unemployment is historically low, coming in at a rate of 3.6% as of the June jobs report.

Healthy consumer position and spending levels

Additionally, consumers are in a strong position in terms of cash on hand and low debt levels. This is a far cry from the period leading up to the 2008 Global Financial Crisis where consumers were over-leveraged, and 100-year-old financial institutions were on the brink of collapse. If a recession comes, it is likely to be relatively short and shallow by historical standards based mostly on the excellent health of both the consumer and labor markets.

Finally, the “Covid Reopening” factor can’t be ignored as a possible equity market tailwind (at least for another quarter or two). A review of “real time” spending data from JP Morgan Chase shows credit card spending up 30% from the same week in 2019 and restaurant reservations up 4% (Source: JPM Chase, data based on week ending 6/17/22). Anecdotally, anyone who has been at an airport lately would not think we have a “demand issue” in our economy!

While we remain optimistic on equities for the reasons provided above, we are cognizant that we need to constantly re-evaluate that overall call as well as the nuance of what geographies and sectors we are favoring. Currently, we are favoring quality “blue chip” companies with pricing power and strong balance sheets. It is our belief that those companies will be able to maintain earnings and profit margins in this more challenging environment. That leads to a continued favoritism for large company stocks over small and U.S. stocks over International.

Maintain Bearish Stance on Bonds:

In a contrast to equities, we entered 2022 negative on bonds and remain so. Bonds have arguably been more frustrating investments thus far in 2022, as the “portfolio insurance” quality they usually offer has been completely lost. Bonds have seen high correlation to equities and have certainly not offered any sort of buffer against volatility in stock markets. In fact, through May 31, this has been the worst year on record for the Bloomberg Barclays Aggregate Core Bond Index (Per Blackrock’s “Student of the Market,” May 2022).

Rising interest rates expected to depress bond prices

For now, we remain bearish on bonds as we expect interest rates to continue to rise. The Fed has dug its heels in and is likely to continue to raise rates aggressively at the next few meetings to stamp out inflation. This will continue to negatively impact bond prices (bond prices decline when interest rates rise). Because of this dynamic, we remain both underweight fixed income overall while favoring short duration for the bonds we have. Bonds with shorter durations decline less than long duration when interest rates rise, and that still seems like the prudent place to be. We also have exposure to floating rate bonds in portfolios (both bank loans and treasuries), which can offer some inherent protection against rising rates.

Longer duration issues can provide cushion against equity volatility

At some point longer duration bonds will again serve a valuable purpose in portfolios. The correlation dynamic between stock returns and bond returns will normalize, and bonds will offer “portfolio insurance” against equity volatility. This could happen sooner rather than later if we enter a growth slowdown (or recession) that is longer and stronger than anticipated. In a scenario like that, interest rates would go down, and bond prices would go up. We see that as a risk to our underweight allocation to bonds, but one that we are willing to take for the moment.

Alternatives: Still Have a Place

Alternatives have shown their worth as "portfolio diversifiers" in 2022 as bonds have not held up their end of that bargain. While still down on an absolute basis, all the alternative funds in our portfolios are down less than the S&P 500, some by a very significant margin. These alternatives provide return streams that have low correlations to traditional stocks. We would argue that alternatives show their mettle more in years like 2022 than in 2021 (where everything was up). As a result, we continue to maintain a favorable view toward liquid alternatives.

Risks To Our View

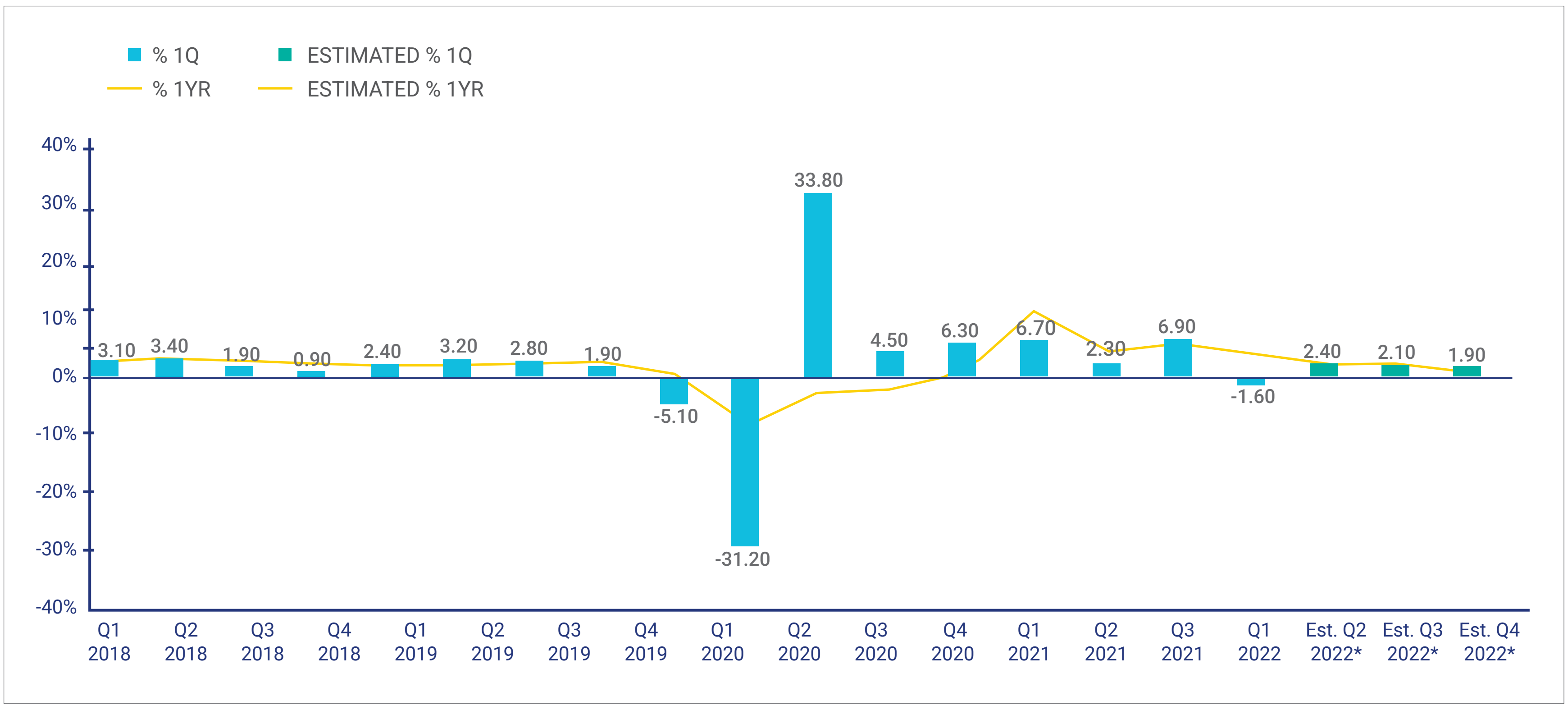
The threat of inflation could prolong pain

The dual threats of inflation and recession have taken center stage as we hit the midpoint of 2022. With a -1.6% real GDP print for the first quarter, recession fears have grown at the same time the Fed is aggressively raising rates to tame inflation. The Fed's continued "hawkish" approach will depend on inflation finally starting to roll over, and the Fed's margin for error in terms of a policy misstep has declined substantially. If we get additional "upside surprises" on inflation reports as we got in the May and June CPI reports, it will prolong the pain for markets.

The fear of recession could deteriorate growth

Recession fears are supported by a "self-fulfilling prophecy" that can't be ignored. If consumers continue to see $5 per gallon prices at the pump, and "Bear Market" plastered across every phone and TV screen they will change their behavior and growth could continue to deteriorate. The upcoming earnings season, which begins in mid-July, will provide critical data on how companies are performing in this challenging environment. We will be particularly keen to see how profit margins are holding up and what companies' future outlooks are for spending and employment. A negative tone to the upcoming earnings season could certainly be a risk to our relatively positive view.

Quarterly GDP Including 2022 Forward Estimates



Source: FactSet

Recession is not a foregone conclusion. The data is currently inconclusive and there is a lot of "guessing" going on in the media. In fact, the chart above shows actual (blue bars) and estimated real US GDP Growth (green bars), with Q2 at 2.4%, Q3 at 2.1% and Q4 at 1.9%.

Looking Ahead

While inflation is currently more of a concern to us than a long, painful recession, we recognize that a lot has to go right for the soft landing scenario to occur. Volatility is likely to remain elevated, and investors with a short time horizon might do well to reduce equity exposure on strength. However, long-term investors with the patience to withstand volatility may find bargains at current levels.

As always, please don't hesitate to reach out to your contacts at Webster Private Bank if you have any questions. It is a pleasure to serve you during these difficult times and we appreciate the trust you have placed in us.