

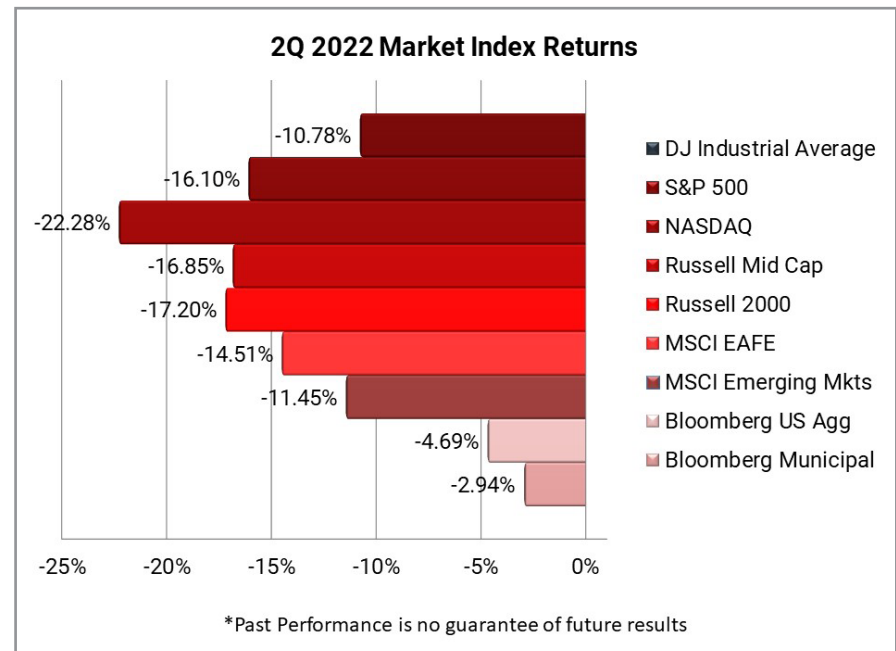
## QUARTERLY MARKET COMMENTARY: *Second Quarter 2022*

### *the* ECONOMY

Stock market volatility is nothing new for investors, but the experience so far in 2022 does have a different feel compared to other relatively recent drawdowns. The last three major corrections in the stock market – 2016 coinciding with a dramatic decline in oil prices, late 2018’s near bear market, and the COVID-induced sell off in 2020 – were comparable, if not worse, in magnitude relative to this year. However, each of those was rather brief, with peak to trough declines lasting between 1 -3 months, and in each instance was followed by a quick recovery. 2022 on the other hand, has seen the market malaise last much longer. This is perhaps unsurprising though, given the lingering uncertainty surrounding the geopolitical environment, enduring inflationary pressures, and the state of the global economy.

Regarding the U.S., whatever momentum the economy had heading into the year has faded. First quarter GDP contracted at a 1.6% annual rate and the consensus is calling for another decline in the second. By one common definition of a recession – two consecutive quarters of negative growth – it is possible that the U.S. is in one already. There is a collection of data points that support this view. Financial asset prices

are down across most asset classes, consumer confidence has fallen significantly, industrial metals like copper are well off recent highs, and there has been a definitive slowdown in the housing market. That said, several other indicators tell a different story. First and foremost, would be the labor market. Over the first half of the year, over 2 million new



jobs were added, and the unemployment rate remains near all-time lows at 3.6%. You'd be hard-pressed to find any other recessions where employers were hiring at this rate. Typically, it's the opposite. Also, current job openings are holding steady above 11 million compared to just 6 million total unemployed persons, a near 2 to 1 ratio. Clearly demand for labor is still strong. In addition, we'd note both industrial production and retail sales have continued to increase, loan delinquency rates remain low, generally positive revenue growth for corporations, and record high federal and state tax revenues as other factors largely inconsistent with a recessionary environment.

To be sure, persistently high inflation likely makes this data harder to interpret than usual. And at last check, the Consumer Price Index (CPI) measure had increased at a historically high 9.1% rate over the past year. The primary driver continues to be food and energy prices, with the core measure (which excludes those two items) up 5.9% over that same period. Lower, though still well above long term averages. But going forward, we do see reasons to believe that inflation should moderate. Some of the key commodities we track are all down meaningfully in recent weeks. For example, from yearly highs – gasoline futures are down 24%, copper is down 29%, corn is off 23%, soybeans have declined 15%, and wheat has fallen 36%. This hasn't yet been fully incorporated into the Consumer Price Index, which is a lagging indicator, but should in future reports. We do think that rent increases are likely to remain above average for the foreseeable future, reflective of the surge in home prices.

The European Union (E.U.) did manage to post positive GDP growth in the first quarter, but we don't believe the region's

economy is in particularly better shape than the U.S. It is experiencing many of the same issues, especially regarding consumer confidence and energy inflation. And the proximity to the ongoing Russia/Ukraine conflict is certainly no help. Yet like the U.S., the labor market does appear to be a source of relative strength. The current E.U. unemployment rate is 6.1%, which is the lowest in the bloc's history. We are keeping a close eye on government bond yields in peripheral Europe, especially Italy. Too rapid a rise could make servicing Italian debt a challenge going forward. European monetary authorities are aware of this issue though and have pledged a form of mutual backing for heavily indebted sovereigns.

Japan likely experienced a mild economic contraction as well, though in our opinion more due to certain Covid restrictions rather than an inflationary shock. The good news on that front is that the country continues to open up and is now allowing overseas visitors. Also, corporate Japan is awash in cash, and anecdotally, most major companies are maintaining positive yearly outlooks. Interestingly, Japan is the one large country where interest rates haven't risen, thanks to the Bank of Japan's (BoJ) stated yield cap. It remains to be seen though if the BoJ will remain committed to this policy going forward.

In emerging markets, inflation is a bit of a double-edged sword. On one hand, many countries are major raw materials exporters, so rising prices can be a boon to both their economies and stock markets. On the other though, food makes up a larger portion of spending, especially in lower income countries. So rising food prices disproportionately hurt consumption. That in mind, emerging market stocks in aggregate have managed to outperform their developed

peers modestly this year. As the largest emerging economy, a budding rebound in China is a primary driver of that. Despite what official statistics might say, we think China was entering into a recession in late 2021 and is only now beginning to emerge from it. The recent positive performance of the country's equity market aligns with that view.

## CENTRAL BANKS

Consistent with its stated plan, the Federal Reserve (Fed) continued to raise its key interest rate in the second quarter. The current target range for the federal funds rate is between 1.5% - 1.75%, up from 0% at the beginning of this year. In addition to raising interest rates, the Fed is also engaging in "quantitative tightening." To simplify, this means that the Fed is no longer going out into the market to purchase bonds and is in some cases selling them from its own inventory. With government deficits shrinking rapidly though, there is less need for the Fed to step in, as there are fewer outstanding bonds to buy. Compared to this time last year, the Fed is clearly more concerned with one part of its dual mandate – inflation – rather than the other – full employment. So, though we do believe some inflationary pressures are already easing, we would expect the Fed to again raise interest rates in forthcoming meetings.

The European Central Bank (ECB) has been far less aggressive in tightening monetary policy. This makes sense to us, as Europe's inflation problem is driven even more by high energy prices, which central banks have little if any control over. That said, the ECB does plan to begin modestly raising rates this July.

## BONDS

Rising interest rates globally took a toll on bonds for the second straight quarter. Typically, staid investments, volatility in bond markets has been very elevated this year compared to historical norms. That isn't to say that bonds haven't provided some cushion to falling stock prices – they have – just not necessarily as much as expected. For the quarter, the Bloomberg US Aggregate Bond index, composed of highly rated government and corporate securities, fell 4.69%. Corporate bonds on their own did fare worse than government ones, down 6.90%.

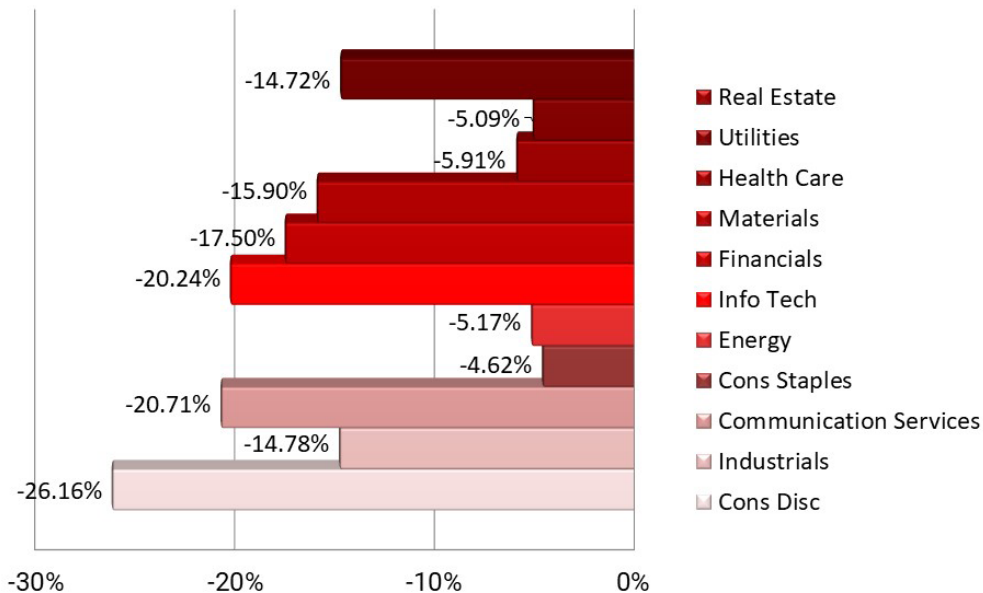
We do want to reiterate though that corporate balance sheets look to be in good shape overall, so the losses are mostly a reflection of the aforementioned higher interest rates. For example, the benchmark 10-year U.S. Treasury yield rose from 2.33% to 3.09% from the beginning of April through the end of June. We'd also note that this had an impact on mortgage rates, which ended the quarter in the mid-5% range.

On the municipal bond side, the story is largely the same. There were price declines across the board, but as discussed earlier, state and local tax revenues are, in aggregate, at all-time highs. So, we have few concerns about the overall credit quality with the municipal market.

## STOCKS

The combination of rising interest rates, sticky inflation, and geopolitical turmoil have led to a slowing global economy and a rerating of stocks by investors. After falling 16.10% in the

### 2Q 2022 S&P 500 Sector Returns



\*Past Performance is no guarantee of future results

second quarter, the S&P 500 is now officially in a bear market, defined as down 20% from its high. Interestingly, earnings have grown by about 7% this year, meaning the entirety of the decline is due to valuation compression. Or in simpler terms, investors are paying a lower price for the same dollar of earnings. This could of course be a rational response to an uncertain environment, but it certainly is different from other bear markets which had usually already seen material profit declines. Digging into the details, the more defensive sectors including staples and utilities, as well as energy, held up well over the quarter. More economically sensitive ones like certain technology, communication, and consumer discretionary firms tended to be laggards.

International stocks were not immune from the volatility, but they did hold up marginally better than their U.S. peers. Developed international stocks fell 14.51% in the second quarter, while emerging markets declined 11.45%. A few reasons we think international stocks may have outperformed over the second quarter include less expensive starting valuations as well as a higher concentration in both commodity sensitive industries as well as more typical defensive sectors. The U.S. on the other hand tends to have more higher growth, higher valuation technology and internet-adjacent consumer firms. Also, we did mention China earlier, whose stocks eked out a 3.41% gain over the past three months.

It's important to note that continued market drawdowns combined with steady cash generation, has improved valuations significantly. The free cash flow yields on U.S. and international stocks are now 4.79% and 10.15%, respectively. We'd also point out that even with the volatility in markets, both dividend payments and stock buybacks are on pace to hit new record highs in the second quarter.

## OUTLOOK

With the first half of the year in the books, forecasts for 2022 economic growth and asset returns have been ratcheted downward in response to an increasingly uncertain environment. The ongoing Russia/Ukraine situation has exacerbated existing trends in inflation along with further delaying the normalization of global supply chains. We can't make any firm predictions regarding its eventual resolution, but with no obvious end in sight, the conflict may,

unfortunately, become something we have to live with for the time being. Consumers and businesses have already begun to adjust as the risks have become “known,” but energy and food supplies from the region will remain in a precarious state.

In the U.S., though we are well aware that the economy is in the midst of a slowdown, we still believe there are some positive dynamics in play. One being consumer spending, which represents the largest share of GDP. The employment market remains strong, which is the primary driver of that spending. It is true that inflation has, in a sense, neutralized recent gains in wages. But if we combine the increase in wages with the growth in employment and hours worked, the aggregate income generated in the U.S. has closely tracked overall price increases. Also, there is a large savings cushion that has been built up over the past two years. We estimate it to be worth about 10% of GDP, compared to the longer-term average of 5-6%. That cushion represents pent-up demand that could support the economy until inflation moderates. And it's not just a hope that people will use this excess savings, we do see evidence for it today, especially in service industries. Despite the lows in consumer confidence, there is clearly an appetite for leisure spending. Whether it is airline passengers, hotel occupancy, restaurant reservations, or theatre box office receipts - all of which are at post-COVID recession highs - people appear ready and willing to get out of the house for entertainment purposes, and we see this trend continuing.

Europe's situation is arguably less stable, due to many of its countries' dependence on Russia for energy supplies. The region's transition to utilizing fewer fossil fuels over

the past decade has been clunky at best. But we do see a renewed appetite for diversifying its energy sources away from certain hostile producers, and generally taking energy security far more seriously going forward. Also, longer-term we see many European countries warming up to the idea of a large fiscal stimulus package. Not only to address energy, but also containing funds for infrastructure, transportation, trade, and job training. If and when these funds are deployed, they ought to provide a tailwind for the European economy that it hasn't seen in years.

China is also worth noting, as its size has made it a crucial swing factor in global growth rates. Recent business surveys point to a strong rebound in activity in June, and should this continue, would certainly provide support for developed world economies. However lingering property market issues, a capricious regulatory regime, and zero-COVID policy are a risk to this burgeoning recovery.

There are four main risks we're watching going forward. First, further disruptions in energy production. Fortunately, energy prices have declined meaningfully in recent weeks, and the world is learning to adjust to lower Russian output. Second, and related, would be more persistent inflation driven by energy prices. This would require central banks to tighten monetary policy more quickly, likely slowing economies further. Next would be supply chain disruptions, either due to the geopolitical environment or COVID policies in China. And finally, is financial contagion emanating from Russia. But on this score, foreign holdings of Russian securities look minimal, so we think this is a much lower probability risk.

In conclusion, the outlook today is certainly more cautious compared to the beginning of the year. And though the economy has more or less muddled through the first half, we could see a modest growth rebound in the second half. Also, with the declines in most asset classes so far, a lot of bad news is already accounted for in market prices. Valuations have improved significantly across both stocks and bonds. We aren't market timers but purchasing securities with stronger cash flow yields and higher interest payments implies a better return profile going forward.

We find it important, particularly during these more volatile periods, to remind ourselves that market drawdowns are inevitable, and that successful long-term investing requires a disciplined approach and adherence to a well thought out plan. As always, we will continue to monitor the market environment and attempt to position portfolios appropriately in response.

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