Q2 2022: Is the Low In?

By Peak Trust Company's Chief Investment Officer, Lisa Russell, CFA. August | 2022

HIGHLIGHTS

- More rate hikes likely with inflation remaining stubbornly high
- Recession fears are lurking but key recession indicators are not present
- Value and growth equities, bond markets, international indices q2 results
- Risk mitigation strategies need to be used in uncertain markets

Market Uncertainty Remains; Rough Second Quarter for Bond and Equity Markets

Equity and fixed income markets in the second quarter of 2022 resembled the first quarter with both markets accelerating their declines. The Bloomberg Barclay Aggregate Bond Index (AGG) was down 4.69% on the quarter with a return through q2 of -10.35%. The S&P 500 was down 16.10% on the quarter with a return through q2 of -19.96%. A 60/40 portfolio consisting of passively investing in the S&P 500 and AGG would have returned -16.11% YTD, and adjusted for inflation, the portfolio would be down over 20%. This has been worst start of the year since the Great Depression.

There have been only three times in history in which we had two consecutive quarters in which stocks and bonds were negative: 1980, 1981, and 2008. Unfortunately, we can now add 2022 to that list. The 10-year treasury bond return was the worst since 1788. The same reasons that I wrote about in my last quarterly letter—Russia/Ukraine conflict, inflation concerns, and recession concerns—were all still present and largely unresolved. An uptick of COVID-19 cases also did not help improve consumer sentiment. Markets, in general, do not like uncertainty and they are reacting accordingly.

Rebound or Bear Market Rally?

Where do we go from here? This is the question that everyone wants to know but no one really does with any degree of certainty. Equities have officially entered a bear market with the S&P being down over 20% from peak to trough. Historically on average, bear markets last 9.5 months with an average loss of 36%. Economists at the largest banks are at odds as to what is next. Some are adamant that we have a little bit further to decline. Others say much further. Still others are more optimistic and think the low on June 16, 2022 is in and we will rebound from there. Rebounds have a very clever way of disguising themselves as bear market rallies, so the jury is still out on the latest move up. The current rally we have experienced from the most recent low is at approximately the same duration and percentage increase as the average of historical bear market rallies. If the rally continues to have staying power, then this could be an attractive entry point, but caution is still warranted.

It is helpful to look back at the other three times we had two consecutive negative quarters for stocks and bonds and see what happened, even though it is a limited sample size. In those three years, bonds outperformed stocks the following quarter with stocks continuing to decline. This scenario is entirely possible, especially if we enter a deeper-than-anticipated recession. Bonds tend to do well in this environment, while stocks suffer. So far, even though bonds are starting to recover, stocks are outperforming them considerably. Only hindsight will definitively tell the answer. There are claims that this has been the most volatile year for both stocks and bonds, so I would not be surprised if the current trend reversed course.

Are we in Recession? Definition Up for Debate

Are we in a recession now? The once generally accepted definition of a recession, two consecutive quarters with a decline in GDP, is now even up for debate. At the time of this writing, we do know that we have had two back-back quarters with a negative GDP print. GDP fell 0.9% in the second quarter after falling 1.9% in the first quarter. So we are in a recession, right? Most economists and the various governmental offices do not agree that we are. The main reasons are that we have never had a recession with this low of an unemployment rate or strong wage growth.

Larry Summers, the former Secretary of the Treasury and a Harvard Professor, recently said there is a 75% chance we will enter a recession. "There's a very high likelihood of recession when we've been in this kind of situation before," Summers said. He continued, "A recession has essentially always followed when inflation has been high and unemployment has been low." His estimates of a recession are much higher than most. While an argument can be made that we are not in one now because of the current low unemployment rate, which can change on a dime as well. In the last 100 years, the average expansion was 48 months, and the average length of a recession was 14 months with quite a bit of variance in both. Equities markets have lost an average of 30.8% in recessions.

Orchestrating a Soft Landing with More Rate Hikes Anticipated

What about inflation and the Federal Reserve (Fed)? Inflation is not transitory and is staying stubbornly high. The Fed has admitted so and will continue to raise the Federal Funds rate aggressively until inflation abates. Their first rate rise of 0.25% in March was followed by 0.50% in May, and 0.75% in both June and July. The looming question out there is whether the Fed can orchestrate a soft-landing. This phrase gets thrown around quite a bit, so it is worth explaining. Quite simply, a soft-landing is a euphemism for avoiding a recession.

There is a chance inflation will fall more than expected. Commodities prices have come down significantly this quarter, which is also confounding most experts as the supply/demand dynamic has not eased significantly.

Housing prices have also seemingly peaked with the rapid rise in mortgage rates. If inflation starts to slow significantly, the Fed may pivot with their aggressive raising of rates. We can enter a slower growth environment without a huge uptick in the unemployment rate. A recession, or at least a severe one, could be avoided. Stagflation would also be avoided as we would have the ideal soft-landing scenario. Stagflation is not a base-case scenario, but it is worth mentioning as a possibility if inflation cannot be contained. This is not an environment we want as most, if not all, asset classes perform poorly.

Overvalued Growth Continuing Sell-Off; International Indices Beat Domestic this Quarter

The S&P 500 was down 16.10% for the quarter and down 19.96% on the year through q2. The same drivers of these returns that occurred last quarter continued into this quarter. Value (S&P 500 Pure Value) succumbed to negative returns this quarter returning -11.63%, -5.99% through q2 versus Growth (S&P 500 Pure Growth) returning -19.35% for the quarter and -29.70% through q2. The large variance in returns continued as the overvalued growth stocks continued their sell-off.

All sectors were negative in q2 with energy now remaining the sole positive sector through q2. Energy is the smallest sector in the S&P by a large margin, and it is a difficult asset class to be overexposed due to the extreme volatility and high correlation to the price of oil.

The U.S. dollar has remained stubbornly high, which is continuing to hurt international and multi-national stocks. International stocks (MSCI EAFE) returned -13.18% qtd and -18.78% through q2, which is actually better than the S&P 500. We haven't seen this in quite some time. Emerging markets' stocks had similar numbers to their developed international counterpart. One explanation is the S&P 500 has been buoyed by growth stocks much of the last decade and growth stocks are a much lower percentage in the international indices. Increased commodity prices have also helped emerging markets. From a valuation perspective, both international and emerging market equites have been undervalued compared to the S&P 500 for quite some time, which also most likely contributed to the outperformance.

Bonds Reacting to Recession Fears More than Inflation

The bond market (AGG) did not fare much better in returning -5.93% for q2 and -10.35% through q2. Rates across the curve increased relentlessly thus causing bond prices to go down. Interestingly, this rapid rise in rates reversed course on June 13, 2022, which was a few days before the S&P 500 put in its most recent low.

The bond and stock markets are currently at odds with each other and telling different stories. The bond market recently is afraid of a recession more than inflation with longer-term rates declining while the equity markets have been rising. This is creating positive returns for both the equity and bond markets. While that certainly is a relief, bonds and stocks historically are negatively correlated and YTD they have been positively correlated both to the upside and downside.

Given the extreme sell-off in bonds, they are looking favorable from a valuation standpoint. We have kept the bond duration in portfolios relatively short to help minimize the impact of rising rates. We will gradually increase duration again as signs of inflation become less of the dominant concern and recession fears become more pronounced. Longer bonds have historically done well in recessions. This could be even more pronounced given the YTD sell-off. Something that merits watching is the 2-year and 10-year treasury curve that is currently inverted and has been so for a few months. This means that the 2-year is paying a higher interest rate than the 10-year. In normal conditions, a bond that is held for two years should pay a much lower interest rate than one that is held for 10 years. The 3-month and 10-year have a chance of inverting if the Fed hikes rates again in the September and November meetings. The inversion on this part of the curve has preceded every recession for the last 50 years.

Summary: Timing the Market Almost Always Bears Negative Results

While the recent declines in the stock markets and bond markets are painful, they probably feel more so than usual due to the extreme negative consumer sentiment and the impact of inflation. The good news is the stock market has historically always recovered from all bear markets and set new all-time highs. This bear market most likely won't be as severe as the 2007– 2008 Great Recession, which lasted 408 days nor is it resembling the 33-day COVID bear market we had in March 2020. While it may be tempting to try and time the market by going in and out of cash, this has almost always garnered negative results. Not only does one have to time the decision of getting out of the market, which is usually near the lows, but they also must know when to get back in as well. After the COVID decline in 2020, most people were not comfortable getting back in until the end of 2021. This turned out to be the peak in the stock market.

A better strategy, and one that we employ, is reducing the risk of the portfolios given the constraints of the investment objective. This can be done through a combination of increasing cash balances, increasing quality, dollar-cost averaging into positions, and making sure portfolios are properly diversified. While we always are a proponent of having diversified portfolios, adding other asset classes that do well in environments when stocks and bonds perform poorly are another way of mitigating risk. This should help us in achieving better downside protection than the S&P 500 and Barclays AGG.

There are not many (if any) investment professionals who can time the market consistently, so mitigating risk in times of uncertainty is a prudent strategy. We will not put our head in the sand and just "ride it out." Markets have been exceptionally difficult to figure out given the confluence of factors like interest rates, inflation, war, etc. that are almost impossible to predict. Your team at Peak Trust Company is paying attention and acting in a way that is best for the investments we manage.

Lisa Russell, CFA
Chief Investment Officer

About Lisa

Lisa Russell started with Peak Trust Company in 2003 and currently serves as Chief Investment Officer. Lisa brings over 25 years of investment experience to the Peak team. She specializes in designing unique investment programs for high-net-worth clients and trust accounts. She is highly attuned to the tax consequences of investment actions.

Lisa holds a Master of Business Administration in Finance from Emory University and a Bachelor of Science in Business Administration from the University of Southern California. Lisa holds the designation of Chartered Financial Analyst (CFA), and is a member of the CFA Institute and the CFA Society of Seattle.

LISA RUSSELL, CFA
Chief Investment Officer

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(888) 544-6775   expert@peaktrust.com